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1-1-2009

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Heather M. Field

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### Recommended Citation

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## CHECKING IN ON “CHECK-THE-BOX”

*Heather M. Field\**

*Twelve years ago, new regulations dramatically changed the manner in which the federal income tax system determines how business entities are taxed. The new explicitly elective “check-the-box” regulations for entity classification drew wide praise when they replaced the old multi-factored corporate resemblance test. Now, with the benefit of hindsight and with previously unpublished data regarding entity classification elections made since 1997, this Article revisits the check-the-box regulations. As the first comprehensive study of these regulations in action, this Article critically examines the successes and failures of arguably the most significant change to the business tax system in the last twenty years. The Article argues that the experience with the check-the-box regulations suggests that they fall short of their promise even though they are an improvement over the prior entity classification rules. The Article also examines the scope of the check-the-box election itself and argues that the election lacks a coherent set of limitations, which undermines the goals behind the provision of the election. Ultimately, this Article concludes that the policy weaknesses revealed by an examination of the check-the-box regulations stem fundamentally from the existence of a multi-regime system for taxing businesses. Hence, the regulations expose a problem with the business tax regimes among which taxpayers can choose, thus adding an additional reason to reform the federal income tax treatment of businesses.*

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\* Associate Professor of Law, University of California, Hastings College of the Law. The author wishes to thank the University of California, Hastings College of the Law, and the 1066 Foundation for their generous support. The author appreciated the opportunity to present this Article at the 2008 Tax Law Colloquium hosted by the Business and Transactional Law Center at Washburn University School of Law, the opportunity to present this Article at the National Tax Association Annual Meeting, and the opportunity to have this Article included in the Fourth Annual Conglomerate Junior Scholars Workshop. She thanks Brad Borden, Leandra Lederman, Gregg Polsky, Steven Dean, David Gamage, Victor Fleischer, Darien Shanske, and John Swain for their thoughtful and thorough feedback on prior drafts of this Article. In addition, she wishes to thank Tom Henning, Darryll Jones, Walter Schwidetzky, Tony Luppino, Dan Lathrope, Bill Hutton, and Richard Winchester for their helpful comments. Further, the author thanks the individuals at the Statistics of Income Division of the Internal Revenue Service for assistance with the data regarding entity classification elections.

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## I. INTRODUCTION

Imagine that you are starting a business with a few colleagues. You learn that, in order to obtain favorable tax treatment for the business, you are going to have to alter parts of your agreed-upon business arrangement. Although you may be a little frustrated, you think that favorable tax treatment for the business is important, so you all agree to allow the tax rules to dictate some of your business terms on issues such as how you and your colleagues will handle management responsibilities, under what circumstances you or your colleagues can sell interests in the business, what happens to the business when one of you dies, and whether any of you will be personally responsible for debts of the business. Given this situation, how would you react if the tax rules were changed so that you could keep all of the terms of your desired business arrangement without interference from the tax rules *and still* obtain favorable tax treatment for the business? If you are anything like the taxpayers who were affected when the tax rules were actually changed in the mid-1990s, you probably welcome the new "check-the-box" rules enthusiastically, thinking that the change is practically a cure-all for the business problems (and the headaches) that the old tax rules created. However, this Article argues that the purported panacea produced significant side effects, which call into question the wisdom of both the new tax rules and the federal income tax's overall approach to taxing businesses.

This dramatic change to the tax rules occurred a little more than a decade ago, when the U.S. Treasury Department finalized new regulations addressing how the federal income tax system determines whether business entities are taxed as partnerships under Subchapter K<sup>1</sup> of the Internal Revenue Code<sup>2</sup> or as corporations under Subchapter C<sup>3</sup> of the Code. The new regulations,<sup>4</sup> effective as of January 1, 1997,<sup>5</sup> created an entity classification regime that is, in large part, explicitly elective. Generally, domestic business entities

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1. I.R.C. §§ 701-777 (2007).

2. Unless otherwise stated, all references to the "Code" and subchapters or sections thereof refer to the Internal Revenue Code of 1986, as amended.

3. I.R.C. §§ 301-385 (2007). Except where specific reference is made to Subchapter S, this Article treats all corporations as C corporations, taxed under Subchapter C of the Code.

4. Treas. Reg. §§ 301.7701-2,-3 (as amended by T.D. 8697, 1997-1 C.B. 215).

5. Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584 (Dec. 18, 1996) (to be codified at 26 C.F.R. pts. 1, 301, 602).

incorporated under state or federal law and specifically enumerated types of foreign business entities are taxed as corporations,<sup>6</sup> but almost any other business entity can elect its status for federal income tax purposes. An unincorporated entity can choose to be classified either as (1) an association taxable as a corporation, or (2) a partnership (if the entity has two or more owners) or a disregarded entity (if the entity has only one owner).<sup>7</sup> An unincorporated business entity can make this entity classification election quite easily by checking a box on a two-page form that is filed with the Internal Revenue Service (“IRS” or “Service”).<sup>8</sup> Hence, these entity classification regulations are commonly referred to as the “check-the-box” regulations (“CTB regulations”). This explicitly elective approach to entity classification differs markedly from the pre-check-the-box classification regime, which depended on a multi-factored analysis of the extent to which a business entity had corporate-like characteristics.<sup>9</sup>

As business and tax lawyers generally know, the tax consequences to business entities and their owners can vary considerably depending on the entity’s classification as a partnership or corporation. Entities classified as partnerships are afforded conduit or pass-through treatment and are subject to only one level of taxation.<sup>10</sup> In contrast, entities classified as corporations are generally subject to double taxation—taxation at the corporate level *and* taxation at the shareholder level.<sup>11</sup> Although the impact of double taxation was reduced when the tax rates on individuals’ capital gains and qualified dividends were lowered in 2003,<sup>12</sup> and can

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6. Treas. Reg. §§ 301.7701-2(b)(1), (8) (as amended in 2008).

7. *Id.* § 301.7701-3(a) (as amended in 2006). There are some limited exceptions to the elective nature of entity classification. *See, e.g.*, I.R.C. § 7704 (2008) (mandatorily taxing all publicly traded partnerships as corporations, unless an exception applies); Treas. Reg. § 301.7701-2(b) (as amended in 2008) (mandatorily classifying certain types of business as corporations). *See also* discussion *infra* Part IV.B.

8. Entity Classification Election, I.R.S. Form 8832 (rev. Mar. 2007).

9. 26 C.F.R. §§ 301.7701-1 to -3 (1993).

10. I.R.C. §§ 701-702 (2007) (providing that partners shall be taxed on their distributive share of partnership income, but that partnerships themselves shall not be subject to income tax).

11. *Id.* §§ 11, 301 (imposing federal income tax on corporations, and taxing corporate shareholders on distributions, respectively). This is the general treatment of corporations that are subject to tax under Subchapter C of the Code. However, certain types of corporations, including corporations that elect to be treated as Subchapter S corporations, may be subject to only one level of taxation rather than two. *See id.* §§ 1361–1379.

12. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat.

also be mitigated through tax planning,<sup>13</sup> tax classification still matters. Many tax and non-tax considerations factor into the choice of entity, and much has been written (and countless hours have been billed) analyzing whether businesses should use entities taxable as corporations or entities taxable as partnerships.<sup>14</sup>

Given the potential tax cost (and hence, monetary importance) of the threshold question of whether a business entity is taxed as a corporation or a partnership, we should look carefully at how the tax law makes that initial determination. This is a productive time for that inquiry because the validity of the CTB regulations was upheld recently.<sup>15</sup> In addition, we can now reflect on over a decade's worth of experience with the CTB regulations, spanning ups and downs in the economy and important changes to the tax law,<sup>16</sup> among other major developments. Accordingly, this Article, which is the first comprehensive study of the CTB regulations in action, critically examines the successes and failures of one of the most significant changes to the business tax system, in an effort to determine what lessons can be learned from more than ten years worth of experience with the CTB regulations.

To provide background for this examination, Part II of this Article traces the history of the entity classification rules, starting with the multi-factored corporate resemblance test reflected in *Morrissey v. Commissioner*<sup>17</sup> and then in the pre-CTB "Kintner"

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752, 758–64 (2003). The Tax Increase Prevention and Reconciliation Act of 2005 extended the sunset date for these lowered rates until December 31, 2010. Pub. L. No. 109-222, 120 Stat. 345, 346 (2006).

13. For example, a corporation may be capitalized with a significant amount of debt, interest payments on which are deductible. See I.R.C. § 163(a) (2009). See also John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do"*, 78 TEX. L. REV. 885 (2000) (suggesting that the conventional wisdom that the "double tax" makes corporations a bad choice for small businesses is erroneous).

14. See, e.g., Darryll K. Jones & David Kirk, *Choice of Entity Planning After JGTRRA: Brainstorming the Triple Split*, BUS. ENTITIES, Mar./Apr. 2004, at 1, 3–4; Leslie H. Loffman & Sanford C. Presant, *Choice of Entity—Business and Tax Considerations*, in TENTH ANNUAL REAL ESTATE TAX FORUM 307 (Tax Law and Estate Planning Course Handbook Series, No. 14248, 2008); Carol J. Miller et al., *Limited Liability Companies Before and After the January 1997 IRS "Check-the-Box" Regulations: Choice of Entity and Taxation Considerations*, 25 N. KY. L. REV. 585 (1998).

15. *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007), cert. denied, 128 S.Ct. 1290 (2008).

16. E.g., Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345, 346 (2006); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752, 758–64 (2003).

17. 296 U.S. 344, 357–59 (1935).

entity classification regulations.<sup>18</sup> Part II also explains the Treasury's approach to classification of limited liability companies and provides background regarding the adoption of the CTB regulations. As part of this overview of the evolution of the entity classification rules, Part II discusses both the policy rationale behind the mid-1990s change to the entity classification regulations and the generally positive public response to the adoption of the CTB regulations.

Part III of this Article evaluates the extent to which the CTB regulations, *as applied* over the last decade, accomplish the policy goals behind their adoption. Accordingly, Part III examines issues of simplicity, administrability, certainty, transaction costs, efficiency, and equity, among others. In addition, Part III analyzes how the CTB regulations allow for greater flexibility in structuring and operating businesses, focusing on the role of the CTB regulations in the increasing popularity of limited liability companies. Further, Part III discusses the impact of the CTB regulations on the implementation of business transactions, both in domestic and cross-border contexts. That discussion notes that the CTB regulations allow for the increased flexibility in structuring business transactions such as corporate reorganizations, but that discussion also acknowledges that a number of scholars have identified difficulties (and potential abuses) when the CTB regulations apply in the international context.<sup>19</sup> Part III also inquires into the fiscal and systemic impacts of the CTB regulations' explicitly elective entity classification system. This analysis is informed by unpublished data regarding CTB elections made since 1997.<sup>20</sup> All of this analysis will be undertaken assuming that the federal income tax system retains multiple different regimes for taxing businesses, where C corporations continue to be subject to two levels of taxation and partnerships continue to be subject to only one.

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18. 26 C.F.R. § 301.7701-2(a) (1960). The Kintner regulations, which were promulgated in response to the decision in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), made it somewhat more difficult for business to qualify as an association taxable as a corporation. See *infra* Part II.A.

19. See, e.g., Peter H. Blessing et al., *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 736-46 (2006); Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, 7 FLA. TAX REV. 185, 194-202 (2005). See also discussion *infra* Part III.D.

20. This data was provided by the I.R.S. Statistics on Income Division. See *infra* note 110 (describing the data) and Appendix A (providing graphical representations of the data).

Part IV of this Article approaches the CTB regulations from a different perspective, asking what the CTB election *itself* reveals about the propriety of using an explicitly elective entity classification system. Part IV asks why taxpayers should be allowed to choose their tax treatment and argues that, for the tax law's provision of an explicit choice to be appropriate, the scope of that choice and the limitations on a taxpayer's ability to make that choice must be defensible, at the very least. Then, Part IV evaluates the limitations on the availability of the CTB election and concludes that while some limitations are justifiable, it is much more difficult to explain why entities that are incorporated under state or federal statutes and entities that are publicly traded partnerships should not be able to choose their entity classification. Part IV argues that the lack of a coherent set of limitations on the CTB election undermines the provision of the explicit entity classification election, suggesting the need for modification.

Part V reflects on the implications of the foregoing analysis on the manner in which the federal income tax system taxes businesses. Part V concludes that the policy weaknesses revealed by a close examination of the CTB regulations stem primarily from the existence of a multi-regime system for taxing businesses. Although this multi-regime system for taxing businesses ironically may have been entrenched by the promulgation of the regulations, this Article ultimately concludes that the CTB regulations, which provide many entities with a choice of applicable business tax regime, expose a problem with the choices themselves, thus adding an additional reason to reform the federal income tax's treatment of businesses.

## II. EVOLUTION OF THE ENTITY CLASSIFICATION REGULATIONS

Businesses that are corporations by virtue of the fact that they are formed under, and operate pursuant to, state incorporation law are (and have historically been) classified as corporations for federal income tax purposes.<sup>21</sup> However, for tax purposes, the term

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21. Treas. Reg. § 301.7701-2(b)(1) (as amended in 2008); Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 625 (1965) ("No case has been found holding that a business organized under a state corporation law, calling itself a corporation, and actually operating under that form, should be characterized other than as a corporation for federal income tax purposes."). One major exception to this was the treatment of professional service corporations, which the Service tried to exclude from being taxed as corporations. See Treas. Reg. § 301.7701-1(c) (as amended by T.D. 6797, 1965-1 C.B. 553). After the courts invalidated the regulations' treatment of professional corporations, the



“corporation” includes more than just these incorporated businesses; since at least the early 1920s, the term “corporation” also included “associations, joint-stock companies, and insurance companies.”<sup>22</sup> Accordingly, there has been a need to determine which unincorporated entities are “associations” and hence are taxable as corporations. The manner for making this determination has varied over time.

### A. *The Corporate Resemblance Test*

Prior to the CTB regulations, the classification of a business entity as a corporation, on one hand, or a partnership or trust, on the other hand, depended on the extent to which the entity resembled a corporation.<sup>23</sup> *Morrissey v. Commissioner*,<sup>24</sup> which was decided in 1935 and was generally regarded as the “leading Supreme Court case on the issue of what is an association,”<sup>25</sup> explained that the key issue was “resemblance”: “The resemblance points to features distinguishing associations from partnerships as well as from ordinary trusts.”<sup>26</sup> In explaining the resemblance test, the Court articulated which features make an entity that has associates,<sup>27</sup> “when created and maintained as a medium for the carrying on of a business enterprise and sharing its gains[,] . . . analogous to a corporate organization . . . .”<sup>28</sup> Specifically, the Court in *Morrissey* focused on the following corporate-like features: “title to the property embarked in the corporate undertaking,”<sup>29</sup> centralized management,<sup>30</sup> continuity of life,<sup>31</sup> transferability of interests,<sup>32</sup> and limited liability.<sup>33</sup>

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Service issued Revenue Ruling 70-101, 1970-1 C.B. 278, conceding that professional corporations would be treated as associations taxable as corporations. See generally Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 487-91 (1995) (providing a more detailed discussion of the classification issues for professional corporations). But see *infra* Part IV.B.4 (questioning why incorporated entities are denied a choice of tax classification).

22. I.R.C. § 7701(a)(3) (2008); *Morrissey v. Comm’r*, 296 U.S. 344, 349 (1935) (citing the statutory language from the Revenue Acts of 1924 and 1926 defining the term “corporation”).

23. See generally Hobbs, *supra* note 21; Scallen, *supra* note 21 (both providing a detailed history of entity classification rules).

24. 296 U.S. 344.

25. Scallen, *supra* note 21, at 628; see also Hobbs, *supra* note 21, at 478 n.232.

26. *Morrissey*, 296 U.S. at 357.

27. *Id.* at 356 (“‘Association’ implies associates.”).

28. *Id.* at 359.

29. *Id.*

30. *Id.* (“Corporate organization furnishes the opportunity for a centralized management

It was clear from *Morrissey* and subsequent court decisions applying the *Morrissey* corporate resemblance test that an entity need not have all of these corporate-like features for the entity to be classified as an association. Rather, an entity created and maintained to carry on a business enterprise and to share its gains would be treated as an association if it, on balance, closely resembled a corporation, taking into account the features listed in *Morrissey*.<sup>34</sup>

The IRS encountered some difficulty with the *Morrissey* corporate resemblance test almost two decades later, in *Kintner v. United States*,<sup>35</sup> when the Court applied the *Morrissey* factors to a medical association formed by a group of doctors. The doctors, hoping to be able to establish a tax-favored pension plan (available to entities taxed as corporations but not to entities taxed as partnerships), argued that the features of their medical organization enabled the organization to be classified as an association taxable as a corporation under *Morrissey*.<sup>36</sup> Although the government, contrary to its typical position in association cases,<sup>37</sup> argued that the medical organization in *Kintner* should not be treated as an "association,"<sup>38</sup> the federal district court concluded that the medical organization satisfied the corporate resemblance test and should be treated as an association taxable as a corporation.<sup>39</sup>

Dissatisfied with the court's decision in *Kintner*, the Service issued Revenue Ruling 56-23,<sup>40</sup> disavowing any precedential effect of the *Kintner* decision. Although the revenue ruling was rescinded the next year,<sup>41</sup> the Service issued a new set of entity classification

through representatives of the members of the corporation.").

31. *Id.* (Corporate organizations are "secure from termination or interruption by the death of owners of beneficial interests . . .").

32. *Id.* (Corporate organization allows for "the transfer of beneficial interests without affecting the continuity of the enterprise . . .").

33. *Id.* (Corporate organization "permits the limitation of the personal liability of participants to the property embarked in the undertaking.").

34. *See, e.g.,* Bert v. Helvering, 92 F.2d 491, 493-96 (D.C. Cir. 1937); *Kintner v. U.S.*, 107 F. Supp. 976, 979 (D. Mont. 1952) [hereinafter *Kintner I*], *aff'd*, 216 F.2d 418 (9th Cir. 1954).

35. *Kintner I*, 107 F. Supp. at 979.

36. *See id.* at 977-78.

37. *See, e.g.,* Pelton v. Comm'r, 82 F.2d 473 (7th Cir. 1936).

38. *See Kintner I*, 107 F. Supp at 978.

39. *See id.* at 979-80.

40. 1956-1 C.B. 598.

41. Rev. Rul. 57-546, 1957-2 C.B. 886.

regulations in 1960 to try to make it harder to achieve association status under the corporate resemblance test.<sup>42</sup> Commonly referred to as the “Kintner regulations,” the new entity classification regulations identified six major characteristics of corporations: “(i) associates, (ii) an objective to carry on a business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests.”<sup>43</sup> Under the Kintner regulations, an entity that had more corporate characteristics than noncorporate characteristics would be treated as an association taxable as a corporation.<sup>44</sup> In making this determination, characteristics common to corporate and noncorporate entities were disregarded, meaning that for business entities, the resemblance test was based on just the last four characteristics.<sup>45</sup> This revised formulation of the corporate resemblance test made it more difficult for entities like general partnerships to be treated as associations because the regulations deemed them unable to possess a majority of the corporate characteristics.<sup>46</sup> Although the Kintner regulations reflected a somewhat narrower formulation of the corporate resemblance test than was articulated in *Morrissey*, the determination of whether an unincorporated entity was classified as an “association” continued to depend on the extent to which the entity had corporate-like features.

The revised corporate resemblance test, embodied in the Kintner regulations, faced a new challenge beginning in the late 1970s with the development of limited liability companies (“LLCs”). In 1977, in an effort to develop a vehicle that provided owners corporate-like protection from liability for the entity’s debts while attempting to achieve pass-through tax treatment under the Kintner regulations,<sup>47</sup> the Wyoming legislature enacted the country’s first legislation authorizing LLCs.<sup>48</sup> LLCs combined very desirable characteristics—

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42. 26 C.F.R. § 301.7701-2(a)(1) (1960).

43. *Id.*

44. *Id.* §§ 301.7701-2(a)(2) to (3).

45. *Id.*

46. *Id.* §§ 301.7701-2(b)(2) (general partnership cannot have continuity of life), -2(c)(4) (general partnership cannot have centralized management), -2(d)(1) (1960) (general partnership cannot have limited liability).

47. See Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in BUSINESS TAX STORIES 295, 295–98 (Steven A. Bank & Kirk J. Stark eds., 2005) [hereinafter Hamill, *Story of LLCs*].

48. Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 577.

“limited liability for all members, partnership features such as dissolution at will and lack of free transferability, and members’ ability to participate in control without risking loss of their limited liability.”<sup>49</sup> The creation of this new type of entity required the IRS to analyze how it would be classified for federal income tax purposes. The IRS addressed this question in Private Letter Ruling 81-06-082 (Nov. 18, 1980), concluding that under the Kintner regulations, a particular Wyoming LLC would be classified as a partnership, and not as an association taxable as a corporation, because the LLC lacked the corporate characteristics of continuity of life and free transferability of interests.<sup>50</sup> Although the Service admitted that the Wyoming LLC would be treated as a partnership under the existing regulations, the Service was dissatisfied with that result and, contemporaneously with the Private Letter Ruling, issued proposed regulations that “provide[d] that an organization in which no member has personal liability for the debts of the organization be classified as an association taxable as a corporation.”<sup>51</sup> These proposed regulations would have changed the tax classification of Wyoming LLCs, causing them to be treated as associations taxable as corporations.<sup>52</sup> In 1983, the IRS withdrew these proposed regulations in the face of public criticism but explained that it would “undertake a study of the rules of classification of entities for federal tax purposes with special focus on the significance of the characteristic of limited liability.”<sup>53</sup> In the absence of certainty regarding the federal income tax treatment of LLCs,<sup>54</sup> very few LLCs were formed,<sup>55</sup> and only one other state enacted an LLC statute.<sup>56</sup>

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49. See generally Larry E. Ribstein, *LLCs: Is the Future Here?*, BUS. L. TODAY, Nov./Dec. 2003, at 11 (discussing the history, benefit, and future of LLCs).

50. I.R.S. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980).

51. *Id.*; Classification of Limited Liability Companies; Notice of Proposed Rulemaking, 45 Fed. Reg. 75,709 (proposed Nov. 17, 1980) (to be codified at 26 C.F.R. pt. 301) (proposing such regulations).

52. In addition, the IRS ruled privately in 1982 that an LLC would be classified as an association taxable as a corporation. I.R.S. Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982).

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

54. See Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 402-03 & n.46 (1996) [hereinafter Hamill, *The LLC*].

55. See Tom Petska et al., *An Analysis of Business Organizational Structure and Activity from Tax Data*, at 9, 13, 28, available at <http://www.irs.gov/pub/irs-soi/05petska.pdf> (showing that, while complete data regarding the number of LLCs in existence is unavailable for years prior to 1993, there were only approximately 17,000 LLCs taxed as partnerships in existence by 1993,

In 1988, the IRS finally resolved the issue of the tax classification of an LLC formed under Wyoming's LLC statute.<sup>57</sup> In a published revenue ruling, the Service concluded that any LLC formed under Wyoming's LLC statute to carry on a business and divide the gains therefrom would necessarily (by virtue of the terms of the LLC statute itself) lack the corporate characteristics of continuity of life and free transferability of interests, and therefore would be classified as a partnership for federal tax purposes.<sup>58</sup> The Service reached this conclusion despite the fact that "neither the managers nor the members of [the LLC] are personally liable for [the LLC's] debts and obligations."<sup>59</sup>

After this IRS pronouncement clarifying the federal tax classification of LLCs, demand for LLCs grew rapidly, and states quickly began enacting their own LLC statutes.<sup>60</sup> Some of these state statutes, like Wyoming's LLC statute, were "bullet-proof," causing any LLC formed thereunder to necessarily lack at least two corporate characteristics, thereby automatically resulting in partnership classification.<sup>61</sup> Other state statutes were sufficiently flexible so as to allow the LLC to qualify as either a partnership or a corporation for federal tax purposes, depending on the terms of the specific LLC agreement.<sup>62</sup>

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which was a tiny number in comparison to the over 21 million businesses in existence in 1993).

56. See Florida Limited Liability Company Act, 1982 Fla. Laws 82-177 (enacted Apr. 21, 1982).

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

58. *Id.*

59. *Id.*

60. LLC statutes were enacted in two states in 1990, four states in 1991, ten more states in 1992, eighteen more states in 1993, and by 1996, all fifty states had limited liability statutes. See Hamill, *The LLC*, *supra* note 54, at 403-04. For the "inside story" on the rise of LLCs, see Hamill, *Story of LLCs*, *supra* note 47.

61. See, e.g., COLO. REV. STAT. ANN. §§ 7-80-101 to -1101 (West Supp. 1994); MICH. COMP. LAWS ANN. §§ 450.4101-.5200 (West 1994); NEV. REV. STAT. ANN. §§ 86.011-.571 (West 1994); S.D. CODIFIED LAWS §§ 47-34-1 to -59 (1994); VA. CODE ANN. §§ 13.1-1000 to -1073 (West 1993); W. VA. CODE §§ 31-1A-1 to -69 (Cum. Supp. 1994).

62. See, e.g., DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1992); MO. STAT. ANN. §§ 359.70-.908 (West 1994) (both allowing flexibility regarding transferability of interests and centralized management). See generally Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 378, 425-30 (1992) (discussing the application of the *Kintner* factors to LLC statutes from various states); Miller et al., *supra* note 14, at 586-600 (discussing "bullet proof" versus flexible LLC statutes).

This flexibility afforded under some state LLC statutes "highlight[ed] the failure of the resemblance test."<sup>63</sup> One commentator explained that, "[p]ractically speaking, there is no difference between a closely-held entity that is organized as an LLC and one that is organized as a corporation. . . . Left unchanged, two very different tax regimes will govern entities with almost identical management and perhaps even similar financial structures."<sup>64</sup> The failure of the corporate resemblance test was also illustrated by professional corporations and limited partnerships, which are also business organizations that could be classified for tax purposes as partnerships under the corporate resemblance test while retaining significant corporate features like limited liability.<sup>65</sup> Moreover, given the bright line rules set forth in the Kintner regulations and the flexibility afforded under the applicable state business statutes, practitioners were often able to create LLCs and other business entities with a carefully tailored set of rights and responsibilities so as to achieve tax classification as either a corporation or a partnership, as desired by the client, while retaining significant features of the other classification.<sup>66</sup>

### *B. Adopting an Explicitly Elective Entity Classification Regime*

In 1995, the Service acknowledged that the flexibility afforded by applicable state laws undermined the theory of the corporate resemblance test and explained:

[M]any 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

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63. Hobbs, *supra* note 21, at 517.

64. *Id.* at 517–18.

65. *See id.* at 481–510.

66. Litriello v. U.S., 484 F.3d 372, 376 (6th Cir. 2007), *cert. denied*, 128 S. Ct. 1290 (2008) ("These unincorporated business entities had the characteristics of both corporations and partnerships, combining ease of management with limited liability, and were increasingly structured with the Kintner regulations in mind, in order to take advantage of whatever classification was thought to be the most advantageous."); *see also* Victor E. Fleischer, "If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification, 96 COLUM. L. REV. 518, 527 (1996); William S. McKee, *Issues Relating to Choice of Entry, Entity, Characterization and the Consequences of Entering a Partnership*, in TAX PLAN FOR CORP. JOINT VENTURES, PARTNERSHIPS & OTHER STRATEGIC ALLIANCES 9, 24–53 (PLI Tax Law and Estate Planning, Course Handbook Series, No. J4-3673, 1994).

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.

. . . .

The Service and Treasury recognize that there is considerable flexibility under the current rules to effectively change the classification of an organization at will . . . .<sup>67</sup>

Accordingly, the preamble to the proposed CTB regulations explained that the "Treasury and the IRS believe[d] that it [was] appropriate to replace the increasingly formalistic rules under the [Kintner] regulations with a much simpler approach that generally is elective."<sup>68</sup>

Moreover, the Service acknowledged that, under the Kintner regulations, "taxpayers and the IRS must expend considerable resources on classification issues."<sup>69</sup> Since the issuance of Revenue Ruling 88-76, the Service issued seventeen revenue rulings, several revenue procedures, and numerous letter rulings on entity classification issues.<sup>70</sup> Presumably, taxpayers also incurred significant legal fees in obtaining advice on these classification issues. Further, the Service noted that small businesses could be particularly hard hit by the considerable costs of obtaining advice regarding how to structure business entities to obtain the most favorable combination of state law and tax treatment.<sup>71</sup> These additional cost, resource allocation, and distributive considerations contributed to the Service's decision to move to a simplified elective entity classification regime, where taxpayers could "elect to treat

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

68. Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,990 (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301).

69. *Id.*

70. *Id.*

71. *Id.*; see also Rod Garcia, *Treasury Officials Address Check-the-Box Entities*, 67 TAX NOTES 1009 (1995) (A Treasury official explained: "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.") (internal quotations omitted).

certain domestic unincorporated business organizations as partnerships or as associations for federal tax purposes,<sup>72</sup> while still availing themselves of the local laws' flexibility for structuring unincorporated businesses.<sup>73</sup>

As a result, regulations adopting an elective classification regime were proposed in May of 1996,<sup>74</sup> were finalized in December of 1996,<sup>75</sup> and became effective as of January 1, 1997.<sup>76</sup> These CTB regulations generally provide that a separate<sup>77</sup> business<sup>78</sup> entity (not subject to a special tax regime, like real estate mortgage investment conduits) will be mandatorily classified as a corporation if it is a domestic entity "organized under a Federal or State statute . . . if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic,"<sup>79</sup> if it is a foreign entity of a type enumerated in the regulations,<sup>80</sup> or if it falls into certain other specific categories.<sup>81</sup> Any other separate business entity (an "eligible entity") may choose its classification under the CTB regulations; an eligible entity with two or more owners can elect whether to be classified as a partnership or an association taxable as a corporation, and an eligible entity with one owner can elect whether to be classified as a disregarded entity or as an association taxable as a corporation.<sup>82</sup> The CTB regulations contain default rules for these eligible entities, so an election is only needed when the

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

73. Simplification of Entity Classification Rules, 61 Fed. Reg. at 21,990. This goal of increased flexibility in organizational choice actually dates back to the adoption of Subchapter S, enacted to enable "certain corporations to opt out of the double tax system so as to maximize organizational choice for small business owners." Steven A. Bank, *The Story of Double Taxation: A Clash over the Control of Corporate Earnings*, in BUS. TAX STORIES 153, 178 (Stephen A. Bank & Kirk J. Stark, eds., 2005) (citing S. REP. NO. 85-1983, at 87 (1958)).

74. Simplification of Entity Classification Rules, 61 Fed. Reg. at 21,989.

75. T.D. 8697, 1997-1 C.B. 215.

76. *Id.* Although there have been some changes to the CTB regulations since 1997, they remain largely as originally enacted. See *infra* note 125 and accompanying text.

77. The CTB classification regulations only apply if there is a separate entity for federal tax purposes. Treas. Reg. § 301.7701-1(a)(1) (as amended in 2009). See *infra* Part IV.B.1. and note 259.

78. In addition, the CTB regulations only apply if the separate entity is a *business entity* as opposed to a trust or other entity subject to special treatment under the Code. Treas. Reg. § 301.7701-2(a) (as amended in 2008). See *infra* Part IV.B.2.

79. Treas. Reg. § 301.7701-2(b)(1) (as amended in 2008).

80. See *id.* § 301.7701-2(b)(8) (as amended in 2008).

81. *Id.* §§ 301.7701-2(b)(1), -2(b)(3) to -2(b)(7) (as amended in 2008).

82. *Id.* § 301.7701-3(a) (as amended in 2006).



eligible entity wishes to be classified in a manner different than the default classification.<sup>83</sup>

The default rules differ slightly for domestic and foreign eligible entities. The default for a domestic eligible entity is treatment as a partnership if it has two or more members and as a disregarded entity if it has one member.<sup>84</sup> The default for a foreign eligible entity is treatment as an association if all members have limited liability; otherwise, it will be treated as a partnership or disregarded entity (depending on the number of members).<sup>85</sup> Notwithstanding the largely elective nature of the CTB regulations, partnerships remain subject to the publicly traded partnership rules of Code section 7704, which generally tax as a corporation any partnership whose interests are publicly traded.<sup>86</sup>

The replacement of the Kintner regulations' corporate resemblance test with the CTB regulations led to a flurry of activity among commentators, most of whom supported the new explicitly elective approach.<sup>87</sup> Commentators generally agreed with the Service that a largely elective approach would simplify the entity classification of businesses,<sup>88</sup> afford greater certainty to taxpayers

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83. *Id.*

84. *Id.* § 301.7701-3(b)(1) (as amended in 2006).

85. *Id.* § 301.7701-3(b)(2) (as amended in 2006).

86. I.R.C. § 7704 (2008).

87. *See, e.g.*, The Association of the Bar of the City of New York Committee on Taxation of Partnerships and Other Pass-Through Entities, *Report on the Proposed "Check-the-Box" Regulations on Entity Classification*, 51 THE RECORD 663 (1996) ("enthusiastically" supporting the proposed CTB regulations); Sheri E. Nott & Richard J. Razook, *Classification of Entities for Tax Purposes Just "Check the Box"*, FLA. B. J., May 1997, at 70, 73 ("The check-the-box regulations have been warmly greeted by the business community . . ."). *See also* George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 125 n.2 (collecting articles praising the CTB regulations).

88. *See, e.g.*, Craig W. Friedrich, *One Step Forward—Final Check-the-Box Entity Classification Regulations Issued*, 24 J. CORP. TAX'N 107 (1997); New York State Bar Association Tax Section, *NYSBA Tax Section Strongly Endorses Check-the-Box Entity Classification Proposal*, 95 TAX NOTES TODAY 173-64 (Sept. 5, 1995) (asserting that an explicitly elective classification regime would "considerably simplify the tax law"); Roger F. Pillow, John G. Schmalz & Samuel P. Starr, *Check-the-Box Proposed Regs. Simplify the Entity Classification Process*, 85 J. TAX'N 72 (1996) (concluding that the proposed CTB regulations "dramatically simplify the classification process"). *Cf.* JOINT COMM. ON TAXATION, 105TH CONG., REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES, No. JCS-6-97, at 17 (Comm. Print 1997) (noting that "the principal impact is that taxpayers may now choose with greater simplicity and lower compliance costs whether they will pay two levels of tax on business income under the corporate tax rules, or whether they will pay only one level of tax under the partnership tax rules[;]" but also noting that the CTB regulations will also raise several new issues). *But see* Aaron W. Brooks, *Chuck the Box: Proposed Entity Classification*

that they would receive their desired and expected treatment,<sup>89</sup> and reduce the transaction costs and economic burden that the pre-CTB entity classification regime imposed on taxpayers and the Service.<sup>90</sup> Moreover, commentators generally concurred with the Service's assessment that the traditional distinctions between corporations and partnerships had been sufficiently blurred so that the Kintner regulations were increasingly formalistic,<sup>91</sup> meaning that an explicitly elective regime would allow for much more flexibility in the business entities' operating agreements<sup>92</sup> without introducing additional legal inconsistencies.<sup>93</sup> To a significant extent, the CTB

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*Regulations Bring Bad Policy*, 70 TAX NOTES 1669, 1673–74 (1996) (arguing that the perceived need for simplification was temporary); Yin, *supra* note 87, at 125, 146–58 (suggesting that the CTB regulations may not “prove to be a simplifying change in the law”).

89. See Fleischer, *supra* note 66, at 532 (noting that the CTB regulations “assure[] investors that they will receive flow-through treatment”).

90. See 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, 600 (1995) [hereinafter Hamill, *Taxation*] (CTB regulations “save both taxpayers and the Service an enormous, if largely unmeasurable, amount of transaction costs. Without having to seek expensive advice or use the Service’s resources, persons deciding among the major domestic entities—the corporation, the partnership, and the LLC—can be absolutely certain of the tax treatment of their entity.”); Fleischer, *supra* note 66, at 531–32 (commenting that the CTB regulations “reduce[] the transaction costs of closely examining local law when organizing a business venture”); *ABA Tax Lawyers Embrace ‘Check-the-Box’ Proposal and Say Extend It to Foreign Organizations*, 95 TAX NOTES TODAY 145-25 (July 26, 1995) [hereinafter *ABA Tax Lawyers*] (noting the significant professional fees incurred by taxpayers and the costs imposed on the Service and the Treasury). Cf. JOINT COMM. ON TAXATION, *supra* note 88, at 17, (suggesting that the CTB regulations lower taxpayers compliance costs).

91. See Hamill, *Taxation*, *supra* note 90, at 600 (CTB regulations “add[] no new legal inconsistencies or formalistic distinctions to those that already exist under the current classification regulations. The choice of entities in the business world has evolved to a point where the traditional business characteristics once attributable only to corporations can be found in limited partnerships, while the traditional partnership characteristics can be found in many statutory corporations.”); New York State Bar Association Tax Section, *supra* note 88 (“Many of the legal distinctions in the classification area are largely formalistic and/or do not seem particularly relevant to the question of whether an entity should be treated as a corporation.”). *But see* Brooks, *supra* note 88, at 1671 (arguing that the distinction between corporations and partnerships was not really narrowing.)

92. See Jerold A. Friedland, *Tax Considerations in Selecting a Business Entity: The New Entity Classification Rules*, 9 DEPAUL BUS. L.J. 109, 124–25 (1996) (concluding that under the CTB regulations, business entities would no longer be required to have particular provisions in their operating agreements regarding continuity of life, treatment at dissolution, and free transferability of interests). Cf. Association of the Bar of the City of New York, *supra* note 87, at 664 (explaining that before the CTB regulations, “[p]artnership agreements [were] permeated with provisions designed to address [entity classification] issues which have no relationship to the parties’ business arrangement,” and noting that such provisions would be unnecessary under an elective classification regime).

93. Hamill, *Taxation*, *supra* note 90, at 600; New York State Bar Association Tax Section, *supra* note 88, at 93 (explicit election will not “materially chang[e] the substantive outcome of the vast majority of cases”).

regulations merely turned an implicit election regarding entity classification (whereby taxpayers could effectively elect entity classification through action, by including specific terms in a business entity's operating agreement)<sup>94</sup> into an explicit election (whereby taxpayers choose their tax treatment by filing a form with the IRS), while reducing the "toll charge" for making the election<sup>95</sup> and leveling the playing field between sophisticated and unsophisticated business owners.<sup>96</sup> As a result, commentators suggested that an explicitly elective entity classification regime could increase efficiency by removing the tax barrier hindering business entities from having the optimal combination of business terms<sup>97</sup> and by promoting proper resource allocation.<sup>98</sup> In addition, while some commentators expressed concerns that the CTB regulations might lead to a rise of "disincorporation" and hence to an erosion of the

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94. See New York State Bar Association Tax Section, *supra* note 88 ("[E]ntity classification under [the pre-CTB regime] is effectively elective in the domestic context, at least for well-advised taxpayers. . . . [P]arties always find a way to take [steps to organize the entity so that it will achieve the desired entity classification status] because of the paramount importance of achieving the desired entity classification."). Cf. JOINT COMM. ON TAXATION, *supra* note 88, at 17 (noting that while "entity classification regulations in effect prior to the check-the-box regulations were . . . effectively elective for well-advised taxpayers, [the CTB regulations] make this choice much more broadly available to all businesses").

95. See *ABA Tax Lawyers*, *supra* note 90 (explaining that, while the entity classification under the pre-CTB regime was effectively elective, the pre-CTB regime imposed a "significant toll charge" on taxpayers in making that election in the form of professional fees incurred to "navigate the tricky and somewhat difficult straits of the [pre-CTB] classification regulations").

96. See *id.* ("While knowledgeable taxpayers can effectively elect whether their business enterprises will be classified as corporations or partnerships, less sophisticated taxpayers may not be aware of the available options. The result is that similar types of taxpayers are treated differently based solely on the relative amount of knowledge and sophistication they possess. Even those taxpayers who are knowledgeable must incur significant costs for professional advice."). Cf. JOINT COMM. ON TAXATION, *supra* note 88, at 17 (recognizing that the CTB regulations "make [the choice of tax classification] much more broadly available to all businesses").

97. See Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX. POL'Y 13, 35 (1995) (explaining that Kintner regulations forced LLCs to have non-corporate characteristics, which may "represent a net detriment that may undermine the efficiency of LLCs"); William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. COLO. L. REV. 1001, 1002 (1995) ("The [pre-CTB] tax system . . . generates an incentive to adopt suboptimal organizational forms."); New York State Bar Association Tax Section, *supra* note 88 ("The [pre-CTB] system also creates economic inefficiencies in that it requires taxpayers to make certain business decisions (such as management structure, transferability of interests in the entity and exposure to liabilities) based on tax considerations.").

98. See New York State Bar Association Tax Section, *supra* note 88; Daniel Shefter, *Check the Box Partnership Classification: A Legitimate Exercise in Tax Simplification*, 67 TAX NOTES 279, 281 (1995).

corporate tax base,<sup>99</sup> others concluded that the adoption of the CTB regulations was unlikely to result in a significant drain on the fisc. This was, in part because, for closely-held businesses, "the well advised have always been able to avoid the corporate tax by forming as a partnership or LLC that complies with the classification regulations or a corporation that pays out its earnings in deductible items or elects Subchapter S."<sup>100</sup>

Notwithstanding the foregoing, other commentators expressed words of caution about the new CTB regime. Specifically, some questioned the real need for simplification<sup>101</sup> and the ability of the CTB regulations to accomplish simplification;<sup>102</sup> others discussed difficulties that could arise from applying the CTB regulations to foreign entities;<sup>103</sup> some questioned whether states would follow the federal tax treatment of entities classified under the CTB regulations;<sup>104</sup> and still others questioned whether the parameters and scope of the CTB election made good policy sense.<sup>105</sup> Commentators

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99. See *ABA Tax Lawyers*, *supra* note 90 (acknowledging such concern, but not giving it much weight); William C. Sheffield, *New Jersey and the Limited Liability Company—Perfect Together?*, 25 RUTGERS L.J. 151, 170 n.138 (1993); Shefter, *supra* note 98, at 281–82.

100. Hamill, *Taxation*, *supra* note 90, at 600 (also commenting that the fisc is protected because the "publicly traded partnership provisions still prevent LLCs and limited partnerships from displacing the domain of the C corporation").

101. See, e.g., Brooks, *supra* note 88, at 1673 (arguing that the perceived need for simplification might be temporary).

102. See Yin, *supra* note 87, at 125, 146–58.

103. See, e.g., JOINT COMM. ON TAXATION, *supra* note 88, at 19–21; Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,992 (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301) (raising the application of the CTB regulations to foreign entities as a possible concern); Marc M. Levey & Richard D. Teigen, *International Implications of "Check-the-Box"*, 85 J. TAX'N 261, 261 (1996) (discussing potential issues with regard to "accelerating U.S. taxation of Subpart F income, the status of foreign entities that may have been acquired or divested by U.S. taxpayers . . . and an entity's ability to change its classification[,] . . . transfer pricing, treaty withholding, functional currency, and hybridizing existing entities"); New York State Bar Association Tax Section, *supra* note 88 (discussing "a number of potential areas of abuse" that may arise from applying an elective entity classification regime to foreign entities, but "conclud[ing] that the potential for abuse would not be exacerbated to any significant extent by applying an elective classification system to foreign entities. . . [and arguing that] the appropriate means to deal with potential abuses in the foreign area is to adopt specific reforms targeted to the particular abuses involved"); Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, 96 TAX NOTES TODAY 118–79 (June 17, 1996); Joni L. Walsler & Robert E. Culbertson, *Encore Une Fois: Check-the-Box on the International Stage*, 76 TAX NOTES 403 (1997).

104. See, e.g., Scott D. Smith, *What Are States Doing on the Check-the-Box Regs?*, 76 TAX NOTES 973 (1997).

105. See Yin, *supra* note 87, at 129–36 (asking whether "the income taxation of business firms [should] be determined by explicit taxpayer election[,]") whether "public firms [should] be ineligible to make the explicit classification election[,]") whether "state law corporations [should]

critiqued a number of other aspects of the CTB regulations, including the transition rules and the treatment of changes in entity classification.<sup>106</sup> Further, some commentators noted that the CTB regulations did nothing to address the key issue of whether the federal tax system should retain multiple tax regimes for business entities.<sup>107</sup> In addition to these words of caution (many of which still resonate today, as will be discussed in the remainder of this Article), some commentators questioned whether the Treasury had the statutory authority to promulgate the CTB regulations.<sup>108</sup> Nevertheless, the final CTB regulations were adopted effective as of the beginning of 1997. The regulations were upheld recently,<sup>109</sup> and today, entity classification continues to be determined under these largely elective entity classification regulations.

### III. EXAMINING THE CTB REGULATIONS AS APPLIED OVER THE PAST DECADE

Between 1997 and 2007, over 326,000 valid CTB elections were filed with the IRS, and the number of CTB elections has increased almost every year.<sup>110</sup> Further, millions of other entities have been

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be ineligible to make the classification election[.]” and why “private business firms [should] be entitled to choose among Subchapters C, S, and K as their applicable method of taxation”).

106. See, e.g., Association of the Bar of the City of New York, *supra* note 87, at 666–70 (criticizing transition rules, default rules, and treatment of changes in classification by election).

107. Daniel S. Goldberg, *The Tax Treatment of Limited Liability Companies: Law in Search of Policy*, 50 BUS. LAW. 995, 998, 1006–17 (1995) (arguing that, even under an elective entity classification regime, the federal tax system still lacks a coherent policy objective in distinguishing entities that are subject to an entity level tax and entities that are taxed as pass-through); Hamill, *Taxation*, *supra* note 90, at 607–08 (arguing that the “problem at the center of business taxation” is that there are “two extremely different tax regimes, the corporate and partnership provisions, [that] arbitrarily apply to entities that often have almost identical business characteristics”); Yin, *supra* note 87, at 136.

108. See, e.g., JOINT COMM. ON TAXATION, *supra* note 88, at 13–17, 26–27 (discussing the legal authority for the CTB regulations and suggesting legislative action); Fleischer, *supra* note 66, at 520 (addressing such concern but arguing that the CTB regulations “satisfie[d] administrative law standards as a reasonable implementation of the congressional mandate to impose the corporate tax on those entities that resemble corporations”). Commentators continue to dispute the Treasury’s authority to promulgate these regulations. See, e.g., Brant J. Hellwig & Gregg D. Polsky, *The Employment Tax Challenge to the Check-the-Box Regulations*, 111 TAX NOTES 1039 (2006).

109. *Litriello v. United States*, 484 F.3d 372 (6th Cir. 2007), *cert. denied*, 128 S. Ct. 1290 (2008).

110. I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author). With respect to all data referenced herein, note that 2007 data is preliminary, that the counts include Form 8832s processed by Statistics of Income through June 2008, that the counts only include filings with valid and complete information, and that calendar year counts are based on the election date reported by the taxpayer and any corrections made by the Internal Revenue

classified under the default entity classification rules contained in the CTB regulations.<sup>111</sup> This experience with the CTB regulations can be used to help evaluate to what extent the CTB regulations have achieved their goals, as articulated by the Service and commentators.

### A. *Simplicity, Administrability, & Certainty*

#### 1. Benefits from the CTB Regulations

The CTB regulations make it simpler for business entities to achieve their desired tax classification with certainty. The CTB regime reduced the number of concepts that have to be evaluated in order to determine entity classification and eliminated the concepts that created the most uncertainty and required the greatest amount of analysis under the Kintner regulations (the four factors discussed above).<sup>112</sup> Now, the mere choice of a particular form of entity is sufficient to dictate the default entity classification;<sup>113</sup> no longer must taxpayers include tax-motivated terms into the operating agreements of domestic business entities in order to achieve a particular tax status.<sup>114</sup> This allows taxpayers, particularly those who are seeking pass-through treatment, to achieve their desired tax classification

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Service at the time of filing relative to the filing requirements. The number of elections dipped in 1998, 2000, and 2007; the numbers of elections increased during all other years, with the biggest increase in elections in 2002 (a 236 percent increase on the number of elections for 2001). The numbers of annual CTB elections for each calendar year (CY) during the period from 1997 to 2007 are as follows: CY 1997 – 10,016; CY 1998 – 7,481; CY 1999 – 11,890; CY 2000 – 11,808; CY 2001 – 13,273; CY 2002 – 31,329; CY 2003 – 40,650; CY 2004 – 49,847; CY 2005 – 50,796; CY 2006 – 64,119; and CY 2007 – 35,124. *Id.* See *infra* Appendix A (illustrating the trends in number and type of CTB elections from 1997 to 2007).

111. All business entities, including millions of businesses formed since 1997 and the millions of pre-existing businesses, must be classified (as corporations, partnerships, or disregarded entities) for federal income tax purposes. Cf. Marty Harris & Ken Szefflinski, *Celebrating Ninety Years of SOI: Selected Corporate Data, 1916–2004*, in STATISTICS OF INCOME BULLETIN, FALL 2007, at 279, 286, 289, available at <http://www.irs.gov/pub/irs-soi/07cobulhis.pdf> (noting that in 2004, there were approximately 5.5 million corporate businesses, 3.5 million S corporations, 2.5 million partnerships, and 20.6 million non-farm sole proprietorships).

112. Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 442–43 (2005).

113. If a state law corporation is chosen, the entity will be taxed as a corporation for tax purposes, but if an LLC, limited partnership, limited liability partnership, or general partnership is chosen, the entity will be taxed as a partnership (or disregarded entity) for tax purposes unless an election is made. Treas. Reg. §§ 301.7701-2 (as amended in 2008) to -3 (as amended in 2006).

114. Foreign entities are not quite as simple, as the default classification for foreign eligible entities depends in part on whether any member of the entity has unlimited liability for the business's debts. *Id.* § 301.7701-3(b) (as amended in 2006).

while having more latitude to organize their business arrangement in accordance with their business, rather than tax, needs.<sup>115</sup> Moreover, if the default entity classification is not desired or if there remains some question as to the appropriate default classification,<sup>116</sup> eligible entities can simply file an entity classification election in order to achieve the desired classification with a high degree of certainty. The default rules seem to work reasonably well, given that, since 1997, only approximately 174,000 newly formed domestic entities<sup>117</sup> (out of millions of businesses entities formed since 1997)<sup>118</sup> filed entity classification elections. Frankly, it is surprising that even this many CTB elections were filed for newly formed entities given that: (1) with respect to entities electing to be treated as partnerships or disregarded entities, any newly formed eligible entity will receive this classification by default,<sup>119</sup> and (2) with respect to entities electing corporate treatment (approximately 87 percent of initial classification elections filed by domestic entities),<sup>120</sup> the total number of C corporations actually declined significantly over the period since 1997.<sup>121</sup> Moreover, even for entities desiring corporate status,

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115. See generally Dean, *supra* note 112, at 443–45 (discussing how the demise of the Kintner four factor test has benefited taxpayers). Taxpayers forming business entities still must make business decisions about management control, restrictions on the ability to transfer interests, liability of the owners for the business entity's debts, and events upon which the enterprise will terminate. However, under the CTB regulations, these decisions can be made solely for business reasons, without influence from the tax regime.

116. This could arise, for example, for foreign entities, if the taxpayer is not completely sure whether the owners of the business entity will have limited or unlimited liability under the applicable foreign law.

117. I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author). See *infra* Appendix A, Figure 2 (illustrating the number and type of CTB elections made by domestic entities from 1997 to 2007).

118. Kelly Luttrell et al., *Integrated Business Data, 2003*, in STATISTICS OF INCOME BULLETIN, FALL 2006, at 47, 53–55, available at <http://www.irs.gov/pub/irs-soi/03intbus.pdf>.

119. A domestic “eligible entity” (i.e., one that can make a CTB election) is, by definition, not mandatorily taxed as a corporation, meaning that an election for an eligible entity to be taxed as a partnership or disregarded entity seems unnecessary. Treas. Reg. § 301.7701-3(a) (as amended in 2006). These may be protective elections, elections involving new types of entities (like Series LLCs), or elections by business arrangements where it is unclear whether or not there is a separate business entity.

120. I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author). See *infra* Appendix A, Figure 2 (illustrating the number and type of CTB elections made by domestic entities from 1997 to 2007). See also *supra* note 119 (explaining why very few domestic eligible entities make initial classification elections to be treated as partnerships or disregarded entities).

121. JOINT COMM. ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY, No. JCX-48-08, at 8 (Comm. Print 2008). This might be explained if the number of newly formed corporations was just less than the number of

such classification is easily obtained without an election, by use of an entity incorporated under state or federal law.<sup>122</sup>

The increased simplicity and certainty created by the CTB regulations also eases administrability by making it easier for the Service to identify which entities will be treated as corporations and which will be treated as partnerships (or disregarded entities). The Service is relieved from having to inquire into the specific state law rights and responsibilities of the entity and its members and from having to examine the specific terms included in the entity's operating agreement.<sup>123</sup>

Further, the CTB regime's disentanglement from applicable state law allows state legislatures to design business statutes with only business goals in mind. State legislatures' tasks are simplified because the CTB rules relieve legislators from the burden of potentially designing business laws to satisfy tax law requirements.<sup>124</sup>

## 2. Detriments from the CTB Regulations

The CTB regulations, though simplifying in some ways, have added complexity in others. A sign of that complexity is the fact that the CTB regulations have been amended more than ten times in the twelve years since their effective date.<sup>125</sup> Further, the Service has

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corporations that changed classifications or dissolved. However, given the growth in the number of S corporations, the almost 200,000 domestic entities electing to be taxed as corporations may be, at least to some extent, eligible entities electing corporate status so that they could further elect S corporation status. *Id.* Cf. Treas. Reg. 301.7701-3(c)(1)(v)(C) (as amended in 2006) (eligible entities that elect S corporation status are deemed to make a check-the-box election). However, at least as of 2003 (the last year for which S corporation data is published), "the number of [S corporation] returns with an 'LLC' designation in the Statistics of Income corporate file is unpublished and small." Kelly Luttrell, *S Corporation Returns, 2003*, in STATISTICS OF INCOME BULLETIN, SPRING 2006, at 91, 103, available at <http://www.irs.gov/pub/irs-soi/03scorp.pdf>.

122. Treas. Reg. § 301.7701-2(b)(1) (as amended in 2008). The domestic eligible entities initially electing corporate status may want to be taxed as a corporation initially, but may also want to preserve the ability to change tax classification easily later and without the hassle of actually undertaking the necessary state law steps to effectuate a corporate liquidation and partnership formation. Additionally, it has been suggested to me that some of these elections may result from state law tax planning—an entity can form as a state law partnership and then check the box in order to be treated as a corporation for federal income tax purposes while avoiding the state income or franchise tax levied on state law corporations.

123. The Kintner regulations looked to the state law governing the particular type of entity and to the operating agreement for the particular entity in order to determine which corporate-like characteristics were present. 26 C.F.R. §§ 301.7701-2 to -3 (1960). The CTB regulations do not require this inquiry. Treas. Reg. §§ 301.7701-2 (as amended in 2008) to -3 (as amended in 2006).

124. See *supra* notes 61–62 and accompanying text.

125. A number of these amendments merely added additional entities to the list of foreign per



issued numerous revenue rulings, revenue procedures, and private letter rulings issued over the last decade dealing, at least in part, with entity classification or how other tax provisions are applied in light of the entity classification rules.<sup>126</sup>

The complexity created by the CTB regulations arises largely from the existence of the election itself, the widespread introduction of “disregarded entities,”<sup>127</sup> the Service’s inclination to use a substantive, standards-based approach to applying a purportedly formalistic rule-based system, and the application of the CTB rules to foreign entities.<sup>128</sup> Issues posed by the application of the CTB regulations to foreign entities will be discussed in Part III.D, and each of the other main sources of complexity will be addressed in turn.

### *a. The existence of the election itself*

Elections are often regarded as “inherently costly and complex.”<sup>129</sup> This view derives partly from the fact that, when an election is available, there are necessarily multiple possible tax outcomes, and thus taxpayers must analyze (and often incur the costs

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se corporations. *See, e.g.*, T.D. 9197, 2005-1 C.B. 985. In comparison, the entity classification regulations were amended only five times during their thirty-six years of applicability. *See* T.D. 6797, 1965-1 C.B. 553; T.D. 7515, 1977-2 C.B. 482; T.D. 7889, 1983-1 C.B. 362; T.D. 8475, 1993-23 I.R.B. 11, *corrected* 1993-1 C.B. 236; T.D. 8632, 1996-1 C.B. 85. That said, the complexity of the pre-CTB entity classification regulations did involve significant uncertainty, generating over one thousand articles. *See* Richard M. Lipton & John T. Thomas, *Proposed Check-the-Box Business Classification Regulations Simplify Rules*, 13 J. PARTNERSHIP TAX’N 195, 199 (1996).

126. A May 6, 2008, Westlaw search for (“301.7701-1” or “301-7701-2” or “301.7701-3”) in the Cumulative Bulletin since January 1, 1997, yielded 78 results. Granted, several of these results were revenue procedures articulating procedures for requesting private letter rulings or indicating areas in which private letter rulings would not be granted. *See, e.g.*, Rev. Proc. 2008-1, 2008-1 I.R.B. 1. However, a majority of the results did discuss a substantive issue regarding the entity classification rules or regarding the application of other tax provisions in light of the entity classification rules. *See, e.g., infra* notes 146–45, 149–49, and 153. This is a very rough (and admittedly unscientific) measure of complexity. The same Westlaw search in private letter rulings and technical advice memoranda in the last 10 years yielded 1204 results.

127. The concept of disregarded entities did exist before the CTB regulations (e.g., qualified REIT subsidiaries), but with a much more limited applicability. I.R.C. § 865(i) (1999); *see also* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, No. JCS-10-87 Pt. 2, at 384–401 (Comm. Print 1987).

128. In addition to these sources of complexity at the federal level, states had to decide whether or not to conform their state law entity classification rules to the new federal CTB regulations. *See* Smith, *supra* note 104.

129. *See* Yin, *supra* note 87, at 130.

to obtain advice regarding) which alternative is preferable.<sup>130</sup> However, even absent an explicit entity classification election, as long as the federal income tax retains multiple regimes for taxing businesses, a taxpayer forming a new business enterprise still has to determine whether an entity taxed as a corporation or an entity taxed as a partnership would be preferable. Absent an explicit election, the only meaningful difference would be that taxpayers would have less flexibility in choosing their preferred state law business form.<sup>131</sup> Hence, in that narrow sense, the existence of the election does not add any complexity.

Nevertheless, one commentator argued that the vast majority of the simplification benefits of the CTB regime could have been obtained by merely moving away from the multi-factored Kintner regulations but without introducing an election (i.e., by making the CTB default rules mandatory).<sup>132</sup> The commentator also argued that the inclusion of an explicit election actually reverses some of the simplification benefits that could have been obtained by adopting a mandatory classification regime.<sup>133</sup> For example, the elective nature of the CTB regulations makes it relatively easy for a business entity to switch between partnership and corporate classification,<sup>134</sup> but such changes "mimic[] a variety of transactions,"<sup>135</sup> meaning that elective changes in entity classification caused uncertainty (and hence complexity) until regulations<sup>136</sup> were issued explaining how

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130. *See id.*

131. For example, if the default rules under the CTB regulations were mandatory (and taxpayers could not elect different tax treatment), a taxpayer wanting to form a domestic business entity that would be taxed as a corporation would need to incorporate under state or federal law; the taxpayer could not use an LLC and elect corporate tax treatment (even if the LLC was otherwise the taxpayer's desired business form under state law).

132. Dean, *supra* note 112, at 449–57.

133. *Id.*

134. From 1997 to 2007, over 96,000 entities have filed CTB election forms that indicate that the filing changes the classification under the CTB regulations. I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author). *See infra* Appendix A, Figures 2 & 3 (illustrating the number of initial elections and status change elections for domestic and foreign entities filing CTB elections from 1997 to 2007). Changing entity classification under an elective regime only requires the filing of a sheet of paper. Entity Classification Election, I.R.S. Form 8832 (rev. Mar. 2007). However, the frequency of allowable elective changes in classification is limited. *See* Treas. Reg. §301.7701-3(c)(1)(iv) (as amended in 2006); *see also infra* Part IV.B.3. In contrast, under a mandatory entity classification regime, changing from a partnership to a corporation would require an actual incorporation, and changing from a corporation to a partnership would require an actual liquidation followed by a contribution to a new partnership.

135. Dean, *supra* note 112, at 454.

136. T.D. 8844, 1999-2 C.B. 661 (adopting final regulations regarding the taxation of elective

such elective changes in classification would be taxed. Furthermore, the availability of an explicit entity classification election means that taxpayers wanting to make the election must comply with the technical requirements for making an effective election.

In addition, while the entity classification form itself is straightforward,<sup>137</sup> the form must be filed timely (not more than seventy-five days prior to and not more than twelve months after the date on which the election is to be effective).<sup>138</sup> There needs to be some deadline for making the election so that the Service can administer the tax laws, but the timing requirement adds complexity because many taxpayers fail to make the election on time. Then, the taxpayers petition the Service to allow a late filing,<sup>139</sup> and the Service must spend time and resources determining whether a late election should be allowed. Since the adoption of the final CTB regulations, the Service has issued numerous private letter rulings allowing late entity classification elections<sup>140</sup> and has issued revenue procedures explaining how to obtain relief for late CTB filings.<sup>141</sup> Further, there are other potential technical deficiencies that could cause an entity classification election to be ineffective<sup>142</sup> or inadvertently changed,<sup>143</sup>

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changes in entity classification). These final regulations generally adopted the approach reflected in the 1997 proposed regulations regarding the taxation in elective entity classification. *See* Treatment of Changes in Elective Entity Classification, 62 Fed. Reg. 55,768 (proposed Oct. 28, 1997).

137. Entity Classification Election, I.R.S. Form 8832 (rev. Mar. 2007).

138. Treas. Reg. § 301.7701-3(c)(1)(iii) (as amended in 2006).

139. *Id.* § 301.9100-1 (as amended in 1997).

140. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2008-24-003 (June 13, 2008); I.R.S. Priv. Ltr. Rul. 98-35-012 (Aug. 28, 1998).

141. *See, e.g.*, Rev. Proc. 2007-62, 2007-41 I.R.B. 786; Rev. Proc. 2002-59, 2002-2 C.B. 615. These revenue procedures are in addition to the existing regulations that generally apply to late filings. Treas. Reg. § 301.9100-1 (as amended in 1997).

142. For example, an entity cannot change its classification election more than once every five years (absent consent by the Service). In order to make sure that this limitation is followed, the Service's revision to the entity classification election form added new questions to "highlight" this limitation. *See* Instructions for Entity Classification Election, I.R.S. Form 8832 (rev. Mar. 2007), at 3. Another example is that the entity classification election form must be signed by the right people under Treas. Reg. § 301.7701-3(c)(2) (as amended in 2006), and the form must be attached to the entity's federal tax return for the year in which the election is made (or if the entity is not required to file a return, attached to the tax returns filed by the direct or indirect owner of the entity). *Id.* § 301.7701-3(c)(1)(ii) (as amended in 2006).

143. *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*, 2005 TAX NOTES TODAY 87-45 (May 6, 2005) (discussing the entity classification consequences when a corporation has its charter revoked for failure to violations of state corporation law).

resulting in the taxpayer's petition for relief and the Service's resources spent determining whether to grant such relief.

*b. The introduction of disregarded entities*

The CTB regulations' widespread introduction of the concept of disregarded entities also created complexity, both in determining which entities will be treated as disregarded entities and in determining how existing tax rules apply to these "tax nothings." The CTB regulations provide that a domestic eligible entity with a single owner will be disregarded as separate from its owner,<sup>144</sup> but the "single owner" determination proved to be more complex than anticipated.<sup>145</sup> For example, the Service had to determine whether an entity has a "single owner" if two spouses living in a community property state each hold interests in the entity<sup>146</sup> and whether an entity has a "single owner" if it is owned by a corporation and a disregarded entity that is owned by that corporation.<sup>147</sup> Even for entities identified as disregarded entities, taxpayers and the Service encountered difficulties in applying the discharge of indebtedness rules to them;<sup>148</sup> in analyzing how to tax transactions in which disregarded entities become partnerships (and vice versa);<sup>149</sup> in determining how the partnership audit provisions apply when a disregarded entity was a partner in a partnership;<sup>150</sup> in identifying what employer identification number should be used by a disregarded entity;<sup>151</sup> and in determining how employment taxes would apply to disregarded entities,<sup>152</sup> among other issues.<sup>153</sup>

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144. Treas. Reg. § 301.7701-3(b)(1)(ii) (as amended in 2006); *see also id.* § 301.7701-3(b)(2)(i)(C) (as amended in 2006) (providing that a foreign eligible entity will be treated as disregarded "if it has a single owner that does not have limited liability").

145. *See, e.g.*, Rev. Rul. 2004-77, 2004-2 C.B. 119.

146. Rev. Proc. 2002-69, 2002-2 C.B. 831 (following the taxpayers' choice as to the answer of this question).

147. Rev. Rul. 2004-77, 2004-2 C.B. 119 (treating the entity as only having a single owner); *see, e.g.*, I.R.S. Priv. Ltr. Rul. 1999-14-006 (Apr. 9, 1999).

148. *See* Stephanie R. Hoffer, *Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities*, 107 TAX NOTES 327 (2005).

149. Rev. Rul. 99-6, 1999-1 C.B. 432 (partnership to a disregarded entity); Rev. Rul. 99-5, 1999-1 C.B. 434 (disregarded entity to a partnership); *see also* I.R.S. Priv. Ltr. Rul. 2002-22-026 (May 31, 2002).

150. Rev. Rul. 2004-88, 2004-2 C.B. 165; *see also* Alice G. Abreu, *Paradise Kept: A Rule-Based Approach to the Analysis of Transactions Involving Disregarded Entities*, 59 SMU L. REV. 491 (2006).

151. Rev. Rul. 2001-61, 2001-2 C.B. 573.

152. *See generally* Littriello v. United States, 484 F.3d 372 (6th Cir. 2007), *cert. denied*, 128

*c. The return to a substantive, standards-based analysis*

In grappling with some of the above complications (namely the “single owner” problem and the analysis of inadvertent classification changes), the Service deviated from the formalistic rule-based approach embodied in the CTB regulations and adopted a more substantive analysis. Commentators argue that the simplicity and certainty benefits afforded by the CTB regulations are eroded as and to the extent that the Service reintroduces a substantive or standards-based approach back into an otherwise bright-line rule-based regime.<sup>154</sup>

3. Issues on Which the CTB Regulations Had No Effect

Some complexity inherent in the entity classification determination was left unchanged by the CTB regulations. The CTB regulations did not attempt to solve, and had no effect on, a few threshold aspects of entity classification. Before classifying a business entity, there must still be a determination as to whether a separate entity exists at all.<sup>155</sup> The CTB regulations did not change that requirement, although query whether the elective nature of the CTB regulations may make it easier for a business arrangement to

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S. Ct. 1290 (2008) (involving a dispute regarding employment taxes); *see also* Hellwig & Polsky, *supra* note 108.

153. *See, e.g.*, Rev. Rul. 2003-125, 2003-2 C.B. 1243 (analyzing whether a worthless security deduction is available when an entity classification election is made to change the classification of an entity from a corporation to a disregarded entity).

154. *See* Abreu, *supra* note 150, at 516–45 (discussing the Service’s deviation from the bright-line CTB regulations when the Service used a substance-focused analysis to conclude that an LLC with two state law members could be treated as a disregarded entity and to conclude that debt held by a corporation was not “modified” (and therefore did not cause the realization of gain or loss) when the corporation became a disregarded entity); Bragonje, *supra* note 143 (discussing the Service’s use of the substance-focused “de facto corporation doctrine” to conclude that a corporation had not liquidated for tax purposes, and thus would not be subject to the double corporate tax upon liquidation, despite the fact that the state had revoked the corporation’s charter for technical violations of corporation law, meaning that the entity would have ceased to be classified as a corporation under the literal application of the CTB regulations).

155. Treas. Reg. § 301.7701-1 (as amended by T.D. 8697, 1997-1 C.B. 215) (requiring the identification of a separate entity before the entity classification rules can be applied); *cf.* Rev. Proc. 2002-22, 2002-1 C.B. 733 (undivided fractional interest in property may not be a business entity to which the Treas. Reg. § 301.7701-3 classification regulations apply). For an extremely useful summary of primary authorities addressing the issue of whether a separate entity exists, *see generally* Bradley T. Borden, *Catalogue of Legal Authority Addressing the Federal Definition of Tax Partnership*, in 746 TAX PLAN. DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 477 (PLI Tax Law and Estate Planning, Course Handbook Series, No. 11539, 2007). *See generally* Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925 (2006).

opt into corporate or partnership taxation even if there is a question about the threshold issue of whether there is a separate entity.<sup>156</sup> Similarly, before applying the CTB regulations, there must be a determination as to *how many* separate entities exist;<sup>157</sup> again, this requirement was not changed by the CTB regulations.

Moreover, even though the CTB regulations made it easier for taxpayers to achieve their desired entity classification, taxpayers must still make the initial determination as to whether the corporate tax regime or a pass-through tax regime is desired. The complexity associated with that determination stems from the continued existence of multiple different regimes for taxing business entities. The Treasury acknowledges that this complexity remains despite the adoption of the CTB regulations and further admits that the existence of multiple tax regimes for business entities "may induce taxpayers to alter their behavior, at the possible cost of other economic business considerations, to obtain the maximum tax benefits or avoid adverse consequences of one or another form."<sup>158</sup> Neither the corporate resemblance test nor the CTB regulations (or any other entity classification system) can avoid this inefficiency, distortion, and complexity. The only likely opportunity to eliminate the source of these problems is to unify the federal income tax's approach to taxing business entities.

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156. For example, if the owners of undivided fractional interests in property actually file a CTB election, query whether that election might not be respected by the IRS even if, absent the election, it was more likely than not that the arrangement did not constitute a "business entity." *Cf.* Rev. Proc. 2002-22, 2002-1 C.B. 733 (indicating that the IRS will not ordinarily issue a ruling that undivided interests in property do not constitute interests in a business entity if the co-ownership has filed a partnership or corporate tax return). A similar issue is presented if the owners of the undivided fractional interests in property just contribute the interests in the property to an LLC and then treat the LLC as a partnership for tax purposes.

157. This problem is illustrated by the attempt to apply the entity classification rules to a Series LLC, which is a relatively new type of entity authorized by Delaware (and a few other states). Much of the uncertainty with the classification of Series LLCs comes from the question of defining the appropriate "separate business entity" (or entities) to which the CTB regulations would apply. That is, the complexity appears to be in determining whether the entire LLC is a single separate business entity, whether each series is a separate business entity, or whether the LLC consists of an entity of entities. *See, e.g.,* Michael E. Mooney, *Series LLCs: The Loaves and Fishes of Subchapter K*, in 813 TAX PLAN. FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 355 (PLI Tax Law and Estate Planning Course Handbook Series, No. 14290, 2008).

158. JOINT COMM. ON TAXATION, *supra* note 121, at 3.

### B. Transaction Costs, Efficiency & Equity

The simplicity and administrability improvements discussed in Part III.A.1 all reduce transaction costs, which was one of the objectives that prompted the adoption of the CTB regulations.<sup>159</sup> Taxpayers no longer have to waste resources carefully designing their business arrangements to satisfy the Kintner regulations' tax factors. Additionally, the CTB regulations improve efficiency by reducing the tax incentives to choose suboptimal business structures or terms to achieve a particular tax classification. Further, the certainty conferred by the CTB regulations eliminates the need to analyze the consequences of subsequent transactions in light of the possibility that an alternative entity classification could apply. These changes may benefit small business owners in particular because of the reduced premium placed on knowledge, sophistication, and ability to afford advice for the careful tax planning that was needed under the Kintner regulations. The reduced transaction costs allow better allocation of resources otherwise spent on tax planning and lower the hurdles to the formation of new business entities. Similarly, the CTB regime allows the Service to allocate its limited resources better because the CTB regulations make it easier for the Service to determine an entity's classification; the Service no longer has to spend time inquiring into the applicable state law and particular business arrangements in order to determine whether a majority of the Kintner corporate resemblance characteristics are present.

That said, the increases in complexity described in Part.III.A.2 reduce the benefits otherwise created by the CTB regulations. Commentators suggest that the existence of the election itself leads to deadweight loss because of the unproductive time and money spent weighing the alternatives and determining whether or not to elect.<sup>160</sup> Although these problems are created because of the

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159. See Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,990 (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301) (explaining that under the old regime, both taxpayers and the IRS had to expend considerable time and resources on classification issues); see generally JOINT COMM. ON TAXATION, *supra* note 88, at 17 (citing lower compliance costs as one of the principal intended impacts of the CTB regulations).

160. See George K. Yin, *The Future of Taxation of Private Businesses*, 4 FLA. TAX REV. 141, 149-50 (1999); GEORGE K. YIN & DAVID J. SHAKOW, REPS., AM. LAW INST., FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES AT 45-48 [hereinafter A.L.I., TAXATION OF PRIVATE BUSINESS ENTERPRISES].

existence of different tax regimes under which businesses can be taxed (and not because of the existence of the election itself), it is true that taxpayers wishing to make the election must spend the time and money preparing the election,<sup>161</sup> and the Service must spend time processing the CTB election forms.<sup>162</sup> Nevertheless, only a small percentage of entities actually make the CTB election,<sup>163</sup> so the default rules seem to operate fairly effectively and efficiently. Even so, as evidenced by the number of rulings issued,<sup>164</sup> the Service spends significant amounts of time and resources answering questions about how the CTB entity classification rules work and about how existing tax provisions apply in light of the CTB regulations. Surely, some of these costs were mirrored by taxpayers dealing with the same issues before and after the rulings.

In addition, as discussed below in Parts III.C. and III.D, the CTB election allows for increased flexibility in choice of entity and in structuring business transactions, and while this increased flexibility may confer benefits, it also can lead to wasteful tax planning, particularly with foreign entities. These tax planning opportunities, along with both the need for taxpayers to decide whether taxation as a corporation or as a partnership would be preferable and the growth of the LLC as another business organization alternative, mean that there continues to be a premium on obtaining knowledgeable, sophisticated (and likely costly) tax and business advice.

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161. I.R.S. Form 8832 estimates that although "[t]he time needed to complete and file this form will vary depending on individual circumstances[, t]he estimated average time is: Recordkeeping . . . 1 hr., 49 min., Learning about the law or the form . . . 2 hr., 7 min.[, and] Preparing and sending the form to the IRS . . . 23 min." Instructions for Entity Classification Election, I.R.S. Form 8832 (rev. Mar. 2007), at 6. Approximately 326,333 valid CTB elections were filed between 1997 and 2007, so using the time estimates stated on the CTB election form (which vary depending on the particular taxpayer), taxpayers spent roughly 1.4 million hours making CTB elections over the course of 11 years. I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author).

162. If the IRS takes at least as much time to process and acknowledge each CTB election form as it is estimated to take a taxpayer to prepare and send the form to the IRS (23 minutes), then in 2006 alone, IRS employees would have spent over 24,000 hours processing CTB elections. Instructions for Entity Classification Election, I.R.S. Form 8832 (rev. Mar. 2007), at 6. Again, this is a very rough estimate.

163. See *supra* notes 110–09.

164. See *supra* note 126.



### C. Flexibility & Neutrality

#### 1. Business Operations

With the adoption of a largely elective entity classification regime and the elimination of the multi-factor *Kintner* corporate resemblance test, taxpayers using unincorporated entities became free to agree to whatever management, liability, interest transferability, and continuity terms they deem appropriate for business purposes, without regard to the desired tax classification.<sup>165</sup> This additional freedom conferred by the CTB regulations reduces the influence that the tax system wields on taxpayers' choice of entity and choice of business terms. In turn, this increase in neutrality may increase efficiency, in that taxpayers are freer to use the type of entity that best fits their business needs, and taxpayers are released from inefficient constraints on the terms governing that entity.<sup>166</sup>

This additional flexibility in business structuring, and resultant neutrality and possible efficiency benefits contributed to the increased use of LLCs. Freed from the tax constraints on the business terms for LLCs and assured of certainty with regard to tax classification, LLCs (which have the economic benefit under state law of affording limited liability to all of their members) rapidly became a popular choice for newly formed entities after the adoption of the CTB regulations. The number of LLCs increased by 1,135.9 percent from 1995 (when the Service first announced that it was considering an elective classification scheme) to 2005.<sup>167</sup> Further, in light of the CTB regulations, some states that had adopted "bullet

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165. JOINT COMM. ON TAXATION, *supra* note 121, at 26 ("The Code generally affords business enterprises and their owners the effective flexibility to elect one form or another without varying any of the meaningful non-tax substantive relationships among an enterprise and its owners."). Taxpayers still have to make decisions about these issues, but they can do so without taking the tax consequences into consideration.

166. *See supra* notes 97–98 and accompanying text.

167. Tim Wheeler & Nina Shumofsky, *Statistics of Income, Partnership Returns, 2005*, STATISTICS OF INCOME BULLETIN, FALL 2007, at 69, 75, available at <http://www.irs.gov/pub/irs-soi/05partnr.pdf>. *See also* JOINT COMM. ON TAXATION, *supra* note 121, at 11. In comparison to the meteoric rise in LLCs taxed as partnerships, over the same 1995–2005 period, the number of limited partnerships increased by 40.1 percent, and the number of general partnerships decreased 37.5 percent. Wheeler & Shumofsky, *supra*. These counts only include LLCs that are treated as partnerships for tax purposes. The increase in the number of LLCs would likely be much higher if the counts also included LLCs that are treated as disregarded entities.

proof" LLC statutes<sup>168</sup> revised their LLC statutes to afford businesses greater freedom in the terms of their LLC operating agreements,<sup>169</sup> commensurate with the freedom allowed under the CTB regulations. Moreover, as greater numbers of businesses operated in LLCs, courts spent more time interpreting the LLC statutes.<sup>170</sup> And, as more state business law regarding LLCs developed, prospective formers of LLCs had increased amounts of information about the rights and responsibilities associated with using LLCs and hence may have felt more comfortable with that possibility.

Similarly, after the switch to an explicitly elective entity classification regime that contemplated "disregarded entities," states increasingly modified their LLC statutes to allow for single-member LLCs.<sup>171</sup> With a relatively clear understanding of how single-member LLCs would be treated for tax purposes,<sup>172</sup> businesses began using single- and multi-member LLCs to deliberately create corporate groups that more precisely reflected their business operations. For example, a corporation could segregate the assets and liabilities of its three different divisions into three different, wholly-owned LLCs.<sup>173</sup> While some of this flexibility removes the tax hurdles to creating optimal organizational forms,<sup>174</sup> it also poses the threat of enabling wasteful tax planning.<sup>175</sup>

## 2. Business Transactions

The entity classification certainty afforded by the CTB regulations, particularly with respect to the treatment of disregarded

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168. See *supra* note 61 and accompanying text.

169. See, e.g., A.B. 2875, 207th Leg., 1996-97 Sess. (N.J. 1997).

170. See, e.g., CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW, ¶ 6.03 (2002) (discussing the development of case law regarding piercing the corporate veil for LLCs).

171. See *generally id.* ¶ 7.09 (noting, among other things, that states like Kansas and Michigan modified their LLC statutes after 1997 to allow single-member LLCs).

172. *But see supra* Part III.A.2.b.

173. Taxpayers also used single-member LLCs to create bankruptcy remote entities. See *generally* BISHOP & KLEINBERGER, *supra* note 170, at ¶ 1.04[5]. Further, practitioners developed strategies to use single and multi-member LLCs to achieve or break affiliation for purposes of the consolidated return tax rules. See I.R.C. § 1504 (2007); Treas. Reg. § 1.1502-1 (as amended in 1999); see also Lawrence M. Axelrod, *Consolidated Return Planning Opportunities Using LLCs*, in 813 TAX PLAN. FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 677 (PLI Tax Law and Estate Planning Course Handbook Series, No. 14290, 2008).

174. See *supra* note 97 (describing some inefficiencies).

175. See *also supra* Part III.B.

entities, also increased flexibility in structuring business transactions. Flexibility is not a virtue in and of itself, but flexibility in structuring can confer policy benefits. As the Joint Committee on Taxation noted, “The check-the-box regulations facilitate transactions that could not usually be done (or could be done only in a convoluted or expensive manner) under prior law, but now [under the CTB regulations] may be accomplished more simply, efficiently or cheaply.”<sup>176</sup> Thus, the CTB regulations alleviate some of the tax constraints that interfered with the effectuation of business transactions in their optimal forms. An example involving corporate divisions under Code section 355 may help illustrate this benefit.

For a corporate division to qualify as tax-free under Code section 355, both the distributing corporation and the controlled corporations must be engaged in the active conduct of a trade or business immediately following the division.<sup>177</sup> When the CTB regulations were adopted, a corporation could satisfy the “active conduct of a trade or business” requirement only if the corporation itself was directly engaged in the active conduct of a trade or business or if the corporation was a holding company and substantially all of its assets consisted of stock of controlled corporations engaged in the active conduct of a trade or business.<sup>178</sup> Because of this “active conduct of a trade or business” requirement, businesses organized with a top-tier holding corporation often had to alter their corporate structures in order to satisfy the requirement by, for example, liquidating<sup>179</sup> one of the holding corporation’s subsidiaries so that, after the liquidation, the top-tier former holding company was directly engaged in the conduct of an active business and held the stock of the other lower-tier subsidiaries. One problem with this restructuring approach was that it undermined the holding company business strategy of having different aspects of the conglomerated business segregated into different subsidiaries at the same level (i.e., where each segregated business was on equal

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176. JOINT COMM. ON TAXATION, *supra* note 88, at 18.

177. I.R.C. § 355(a)(1)(C), (b) (2007).

178. *Id.* § 355(b) (1996).

179. This result could also be accomplished by having the subsidiary merge upstream into the top-tier holding corporation. *Id.* § 368(a) (2008).

footing with the others, no business owned any other business, and no business was structurally subject to the liabilities of another).<sup>180</sup>

The treatment of single-member LLCs as disregarded entities under the CTB regulations allowed the "active conduct of a trade or business" requirement to be satisfied while preserving the business benefits of the holding company structure. Specifically, rather than having one of the subsidiaries liquidate or merge into the top-tier holding company, the holding company could create a newly formed, wholly-owned single-member LLC into which the (formerly liquidating) subsidiary would merge. The merger of the subsidiary into a single-member LLC wholly owned by the top-tier holding corporation was treated, for tax purposes, as a merger of the subsidiary into the top-tier holding corporation.<sup>181</sup> Further, since the single-member LLC would be disregarded for federal tax purposes, the top-tier holding company would be treated as directly operating the active trade or business formerly conducted by the subsidiary, thus satisfying the "active conduct of a trade or business" requirement of Code section 355 while still achieving the business goal of segregating the subsidiary's business for state law purposes.<sup>182</sup> This result is in accord with the policy goals of Code section 355 because the top-tier holding company operates (directly or indirectly) an active business (regardless of whether the single-member LLC is used) and because the use of the single-member LLC makes it no more likely that the corporate division is a device for distributing corporate earnings and profits. This conclusion is validated by the recent changes to the "active conduct of a trade or business" requirements that make it easier for businesses with complex multi-entity structures to satisfy this requirement without having to undertake formalistic restructurings that may be to the business detriment of the enterprise.<sup>183</sup> Although this change to the

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180. For purposes of this example, it is assumed that this holding company structure, which segregates the different divisions of the business in different business entities at the same level is the optimal structure for this business.

181. Treas. Reg. § 1.368-2(b) (as amended in 2008).

182. While the optimal structure for the corporate division likely would not have involved any restructuring at all, the CTB regulations and the availability of the single-member LLC allow the corporate division to be undertaken in a business structure that preserves the benefit of the holding company structure. Thus, while not the absolute best structure, the single-member LLC is certainly better, from a business perspective, than the structure that was required prior to the CTB regulations.

183. I.R.C. § 355(b)(3) (2007) (as amended by Pub. L. No. 110-72).

“active conduct of a trade or business” requirement makes the use of the single-member LLC merger technique less necessary, the CTB regulations, which made the single-member LLC merger alternative possible, effectively provided more flexibility in, and reduced the tax hurdles to, accomplishing corporate divisions.

A similar story could be told about how single-member LLCs increase business flexibility and decrease tax hurdles with respect to tax-free reorganizations under Code section 368 and like-kind exchanges under Code section 1031.<sup>184</sup> These uses of single-member LLCs afford favorable tax treatment to business transactions, while simultaneously making the tax law more neutral among business transaction structures and increasing efficiency by removing the tax barrier to structuring business transactions in accordance with the exigencies of business. This is a positive development as long as affording this favorable tax treatment does not lead to excessive tax planning and does not violate the policy goals underlying the applicable tax provisions.<sup>185</sup> Hence, in this sense, the CTB regulations improve upon the Kintner regulations.

The flexibility conferred by the CTB regulations, however, does more than just reduce tax hurdles to optimal business transaction structuring; it also provides many planning opportunities. Numerous articles have been written detailing the transactional opportunities available in a CTB world.<sup>186</sup> The planning opportunities can lead to wasted resources and may actually encourage the use of single-member LLCs in situations where other entity forms may have been preferable from a business perspective, thus reversing some of the efficiency and neutrality benefits described above. Moreover, the increased flexibility in structuring business transactions afforded by

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184. See generally Mark J. Silverman & Lisa M. Zarlenga, *Use of Limited Liability Companies in Corporate Transactions*, in 772 TAX STRATEGIES FOR CORP. ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1059 (PLI Tax Law and Estate Planning, Course Handbook Series, No. 11569, 2007).

185. See JOINT COMM. ON TAXATION, *supra* note 88, at 18 (noting that the CTB regulations afford greater transactional flexibility, but asserting that this result is only preferable if the purpose of the underlying tax rules is not violated by applying them at the taxpayer's choice).

186. See, e.g., Warren P. Kean, *M&A Transactions Involving Partnerships and LLCs, Including Conversions, Mergers and Divisions*, in 812 TAX PLAN. FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 471 (PLI Tax Law and Estate Planning, Course Handbook Series, No. 14290, 2008) (discussing how diving or combining partnerships or LLCs with other taxable entities will be taxed); Silverman & Zarlenga, *supra* note 184, at 1059 (discussing the use of LLCs in corporate transactions).

the CTB regulations could lead to potentially abusive tax planning if affording favorable tax treatment is contrary to the policy goals of the underlying tax provisions. The Service was aware of this risk when the CTB regulations were adopted,<sup>187</sup> and this issue has proven to be particularly problematic in the cross-border context (as discussed below in Part III.D). Nevertheless, as long as inappropriate treatment can be curbed by changing the underlying partnership or corporate tax rules,<sup>188</sup> the explicitly elective entity classification system (and the benefits described herein) can and should be retained, at least in the domestic context.<sup>189</sup>

#### D. CTB Regulations as Applied to Foreign Entities

When initially considering an elective entity classification regime, the Service noted that the tax classification analysis under the Kintner regulations posed similar problems for foreign entities as for domestic entities.<sup>190</sup> However, the Service expressed reservations about applying an explicitly elective regime to foreign entities because there are "a number of special considerations that arise in the foreign area," including (1) the fact that under then-existing law there was "no foreign organization that [was] automatically treated as a corporation for federal tax purposes," (2) "the possibility of inconsistent, or hybrid, entity classification," and (3) the concern that "a purely elective approach could have a substantive effect on entity classification by increasing taxpayers' flexibility to achieve their desired classification of certain foreign organizations."<sup>191</sup> The Service solicited comments on the potential application of an elective entity classification regime to foreign entities,<sup>192</sup> and many commentators encouraged the Service to extend the application of an

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187. See Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989-90 (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301); T.D. 8697, 1997-1 C.B. 215 (1996).

188. The Joint Committee on Taxation has proposed some such changes. See JOINT COMM. ON TAXATION, *supra* note 88, at 27-56.

189. *But see infra* Part III.D (regarding foreign entities).

190. I.R.S. Notice 95-14, 1995-1 C.B. 297. In fact, the Service suggested that, under the Kintner regulations, the classification determination for foreign entities was even more complex than the classification determination for domestic entities because, for example, "the classification of a foreign organization involves not only a review of organizational documents, but also a thorough understanding of the controlling foreign law." Simplification of Entity Classification Rules, *supra* note 187.

191. I.R.S. Notice 95-14, 1995-1 C.B. 297.

192. *Id.*

elective regime to foreign entities.<sup>193</sup> The Service ultimately decided to make the classification of foreign entities elective but noted that “Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.”<sup>194</sup> Shortly after the finalization of the CTB regulations, the Joint Committee on Taxation echoed some of the Service’s concerns that “[p]otentially significant issues are raised by the check-the-box regulations in the international context”<sup>195</sup> and suggested that monitoring the application of the CTB regulations to foreign entities may help to identify issues where the electivity afforded by the CTB regulations “is inconsistent with the underlying rationale for any particular present-law rules that are affected.”<sup>196</sup> In such situations, the Joint Committee on Taxation suggested that “it would be appropriate to consider addressing the issue, for example, by eliminating the electivity of those rules or modifying the rules.”<sup>197</sup>

As predicted, the Service revisited the application of the CTB rules to foreign entities for a variety of reasons. One common reason for revision was the need to add additional foreign entities to the Treasury Regulation section 301.7701-2’s list of per se foreign corporations.<sup>198</sup> In addition, because “[t]he Service has had significant difficulties administering the relevant provisions of the tax law because the information reporting requirements still date from a time when the substantive entity classification rules did not contemplate disregarded entities,”<sup>199</sup> the Service created a new Form 8858 to obtain information from U.S. persons who own a foreign disregarded entity, in the hope of “identify[ing] issues more

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193. See, e.g., N.Y. State Bar Ass’n Tax Section, *supra* note 88 (“[T]he report strongly urges that the elective classification system be extended to foreign entities.”); *ABA Tax Lawyers*, *supra* note 90.

194. T.D. 8697, 1997-1 C.B. 215 (1996).

195. JOINT COMM. ON TAXATION, *supra* note 90, at 19.

196. *Id.* at 21.

197. *Id.*

198. T.D. 9197, 2005-1 C.B. 985; T.D. 9235, 2006-1 C.B. 338; I.R.S. Notice 2004-68, 2004-2 C.B. 706 (dealing with certain European public limited liability companies); I.R.S. Notice 2007-10, 2007-4 I.R.B. 354 (adding a Bulgarian entity); see also Rev. Rul. 2006-3, 2006-1 C.B. 276 (addressing treatment of certain Japanese entities).

199. I.R.S. Announcement 2004-4, 2004-1 C.B. 357.

efficiently, ensuring that the Service can better focus resources and reduce exam cycle time."<sup>200</sup>

The Service also attempted to address substantive issues as well. The Service tried to address the subpart F consequences of hybrid arrangements,<sup>201</sup> to curb "abusive transactions [some of which involve the use of disregarded entities] that are designed to generate foreign tax credits,"<sup>202</sup> to thwart elective changes in the entity classification of foreign entities where the change is made "merely to alter the tax consequences" of a subsequent disposition of the entity ("check and sell transactions"),<sup>203</sup> and to prevent taxpayers from using the entity classification election to effectuate "tax-avoidance transactions" in which taxpayers import a loss but not the corresponding gain.<sup>204</sup> These and other efforts undertaken by the Service are indicative of the many issues encountered over the last decade or so in applying the provisions regarding the taxation of foreign income in the context of explicitly elective classification of foreign entities. The majority of these issues come from the ability to classify foreign entities as disregarded entities, and the threat posed by these types of transactions may be significant given that almost 70 percent of the CTB elections made by foreign entities are elections to classify the foreign entity as disregarded.<sup>205</sup>

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200. *Id.*

201. I.R.S. Notice 98-11, 1998-1 C.B. 433; T.D. 8767, 1998-1 C.B. 875 (both revoked by I.R.S. Notice 98-35, 1998-2 C.B. 34). *But see* I.R.C. § 954(a)(6) (2007) (for a three year period, enacting a look-through rule for determination of subpart F income, thereby possibly signifying Congressional blessing of at least part of the way in which disregarded entities facilitate subpart F tax planning). *See generally* Andrew H. Braiterman, *Intragroup Transactions: The Kinder, Gentler Subpart F*, 115 TAX NOTES 567 (2007) (discussing whether the Service considered the effects of subpart F); David R. Sicular, *The New Look-Through Rule: W(h)ither Subpart F?*, 115 TAX NOTES 349 (2007) (discussing the Service's attempts to amend Subpart F to address tax planning that uses the check-the-box regulations).

202. I.R.S. Notice 2004-19, 2004-1 C.B. 606 (withdrawing I.R.S. Notice 98-5, 1998-1 C.B. 334); I.R.S. Notice 2004-20, 2004-1 C.B. 608.

203. I.R.S. Notice 2003-46, 2003-2 C.B. 53; I.R.S. Announcement 2003-78, 2003-2 C.B. 1172; Changes in Entity Classification: Special Rule for Certain Foreign Eligible Entities, 64 Fed. Reg. 66,591-02; 1999-2 C.B. 670 ("extraordinary transaction" provisions withdrawn in 2003). *Cf.* *Dover Corp. v. Commissioner*, 122 T.C. 324, 353 (2004) (concluding that this "check- and-sell" technique achieved the taxpayer's desired result of avoiding the creation of subpart F income).

204. I.R.S. Notice 2007-57, 2007-29 I.R.B. 87.

205. I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author). Of a total of 97,922 elections made by foreign entities, 68,218 such elections were made to classify entities as disregarded. *Id.* *See infra* Appendix A, Figure 3 (illustrating the number and type of CTB elections made by foreign entities from 1997 to 2007). The data does not explain why these elections were made, so many of these elections may not pose the type of abuse



Based on the foregoing, commentators generally conclude that the application of the CTB rules to foreign entities is complex and difficult to administer, and is revenue reducing as a result of potentially inefficient tax planning activity that is contrary to the objectives of the Code provisions for taxing foreign income.<sup>206</sup> In light of these issues, the Joint Committee on Taxation and numerous other practitioner and academic commentators have argued for revision of the entity classification rules as applied to foreign entities. Specifically, the Joint Committee on Taxation found the use of foreign disregarded entities sufficiently problematic that it recommended that single-member foreign business entities be treated as corporations (rather than disregarded entities) for federal tax purposes.<sup>207</sup> The American Bar Association explained that the Joint Committee on Taxation's proposal:

would preclude: (1) disregarded entity planning to separate income and credits in a disregarded parent structure, (2) disregarded entity planning to permit a foreign entity to incur debt from a related party and take a deduction for foreign purposes without triggering subpart F, and (3) check and sell transactions, [but] would not affect the use of a local law partnership classified as a corporation for U.S. tax purposes (a so-called "reverse hybrid") to separate income and credits and other techniques that use inconsistent classification with respect to local law pass-through entities.<sup>208</sup>

The American Bar Association has made an even more sweeping proposal to "classify a foreign business entity as a corporation if the entity is subject to an entity-level income tax (under U.S. foreign tax credit principles) under the law of its country of tax residence," and otherwise, classify the foreign business entity as a pass-through entity.<sup>209</sup> The American Bar Association proposal

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problems discussed above. The sheer number of such elections, however, suggests that taxpayers believe that there is something particularly desirable about having foreign entities classified as disregarded from their owners. That level of attractiveness may be suspicious.

206. See, e.g., David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 n.12 (1999).

207. JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, No. JCS-02-05, at 182-85 (2005).

208. A.B.A., *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 669 (2006).

209. *Id.*

aligns the U.S. tax treatment and the foreign tax treatment of business entities in an effort to minimize deferral currently allowed to foreign entities and to eliminate inconsistencies that arise from the use of hybrids and reverse hybrids. While the Joint Committee on Taxation and American Bar Association proposals differ, both reduce the amount of electivity allowed in the classification of foreign business entities, thereby reflecting the view of many commentators<sup>210</sup> that, despite the certainty and flexibility afforded under the CTB regime, the elective nature of the CTB regulations as applied to foreign business entities undermines the appropriate application of the Subpart F and foreign tax credit regimes. Accordingly, adopting one of these proposals may be appropriate given that the risk of abuse enabled by the application of CTB regulations to foreign entities seems to outweigh the benefits.

### *E. Fiscal Impact*

When the CTB regulations were adopted, some commentators<sup>211</sup> concluded that the regulations were unlikely to significantly erode the corporate tax base or substantially reduce tax revenues for a variety of reasons, including: (1) that entity classification and the imposition of corporate tax was already largely elective (at least for the well-advised); (2) existing corporations were largely locked into Subchapter C;<sup>212</sup> (3) growing businesses typically need access to the capital markets (which often required that they be structured and taxed as corporations);<sup>213</sup> (4) the publicly traded partnership rules of Code section 7704 protect the corporate tax base by treating certain

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210. See, e.g., *id.* at 649 (reflecting the views of many commentators).

211. See, e.g., Hamill, *Taxation*, *supra* note 90, at 600. *But see* Sheffield, *supra* note 99, at 151 n.138.

212. To change from a C corporation to a partnership, the C corporation would actually have to liquidate and pay corporate-level tax on the appreciation inherent in its assets. I.R.C. § 336 (2007). Alternatively, a C corporation could switch to a pass-through regime by electing to be taxed as a Subchapter S corporation (assuming the corporation was eligible for such election) and avoid the corporate-level tax on its appreciated assets, but only if the corporation was willing to hold its assets for ten years to avoid the imposition of corporate-level tax on the built-in gains. I.R.C. §1374.

213. Various investors, like tax-exempt investors and foreign investors, typically do not want to invest in entities that are subject to flow-through taxation due to unrelated business taxable income concerns (for tax-exempt investors) or effectively connected income concerns (for foreign investors). I.R.C. §§ 511–512, 864(c), 871(b), 882 (2007). In contrast, investing in corporate stock generally does not create the same problems because dividends and gain from sale of stock are generally not UBTI or ECI. *Id.*

partnerships as corporations; and (5) state corporate law was much more well-developed than state LLC law (and hence, businesses desiring limited liability may have been more comfortable using a state law corporation rather than a state law LLC).

However, the passage of time erodes these reasons for confidence in the continuing strength of corporate tax collections. State LLC law has developed over the last decade as more LLCs are formed and as disputes involving LLCs are adjudicated by courts;<sup>214</sup> this increases certainty about how LLC statutes apply and makes businesses less reluctant to use LLCs. Further, pass-through entities' access to capital markets is not as restricted as originally anticipated because of strategies that allow tax-exempt entities and foreign investors to invest in entities taxed as pass-throughs without fear of unrelated business taxable income or effectively connected income, and with minimal additional tax cost.<sup>215</sup> Moreover, some partnerships that are involved primarily in asset management and investment in other companies have been able to access the public markets without paying corporate tax despite the publicly traded partnership rules.<sup>216</sup>

In addition, although C corporations in existence in 1996 were largely locked into the corporate tax,<sup>217</sup> entities formed beginning in 1997 could take advantage of the flexibility that the CTB regulations provided with respect to the structuring of business operations.<sup>218</sup> Since the mid-1990s, the number of new partnerships formed

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214. See, e.g., BISHOP & KLEINBERGER, *supra* note 170, ¶ 6.03.

215. See, e.g., Adele M. Karig, *Taxation of Tax-Exempt and Foreign Investors in U.S. Private Investment Funds*, in 756 TAX PLAN. FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2007, at 331–42 (PLI Tax Law and Estate Planning Course Handbook Series, No. 11539, 2007) (discussing corporate blocker strategies, including leveraged blockers, for avoiding ECI and UBTI to enable investments in U.S. partnerships by foreign investors and tax-exempt investors, respectively); see also Robert D. Blashek & Scot A. McLean, *Investments in "Pass-Through" Portfolio Companies by Private Equity Partnerships: Tax Strategies And Structuring*, in TAX PLAN. FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2008, at 477, 546–92 (PLI Tax Law and Estate Planning Course Handbook, Series No. 14290, 2008).

216. See The Blackstone Group L.P., Prospectus (Form 424B4), at 240–56 (June 21, 2007); Fortress Investment Group LLC, Prospectus (Form 424B4), at 216–29 (Feb. 21, 2007). See generally Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008) (discussing a proposed amendment to the publicly traded partnership rules in order to prevent entities like The Blackstone Group L.P. and Fortress Investment Group LLC from avoiding taxation as corporations).

217. See *supra* note 212.

218. See *supra* Part III.C.1.

(including LLCs taxed as partnerships) significantly exceeded the number of new C corporations formed,<sup>219</sup> and LLCs are the most rapidly increasing entity type<sup>220</sup> (increasing in number by over 1100 percent between 1995 and 2005).<sup>221</sup> This growth rate in number of businesses is largely mirrored by the growth rate in business receipts; since the mid-1990s, LLCs taxed as partnerships experienced the highest annual growth in business receipts.<sup>222</sup> Moreover, as a percentage of total business income, taxable income from C corporations has declined, while income from pass-throughs has increased, primarily as a result of the availability of the LLC as an entity choice.<sup>223</sup> This data reflects an uptick in economic activity conducted by pass-through entities in general, and in LLCs in particular, as opposed to C corporations. Moreover, the Treasury Department recently acknowledged that "[t]he importance of the non-corporate business sector has grown substantially over time"<sup>224</sup> and that "[c]ompared to other OECD countries, non-corporate businesses play an unusually important role in the U.S. economy," both in number and in the magnitude of the economic activity of such business.<sup>225</sup> Together, this suggests that there may be merit in the concern about the erosion of the corporate tax base as a result of the increased use of unincorporated business entities.<sup>226</sup>

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219. Kelly Luttrell et al., *Integrated Business Data, 2003*, in 47 I.R.S. STATISTICS OF INCOME BUREAU 47, 53 (2006), available at <http://www.irs.gov/pub/irs-soi/03intbus.pdf>.

220. *Id.*; see also Petska, *supra* note 54, at 13. As noted earlier, these counts only include LLCs that are treated as partnerships for tax purposes. The increase in the number of LLCs would likely be much higher if the counts also took into account LLCs that are treated as disregarded entities for tax purposes.

221. Wheeler & Shumofsky, *supra* note 167, at 75–76. While still eclipsed by the number of sole proprietorships and S corporations, LLCs represent the most numerous type of entity taxed as a partnership. *Id.*

222. Petska, *supra* note 55, at 15–17.

223. Peter R. Merrill, *The Corporate Tax Conundrum*, 117 TAX NOTES 174 (2007). The ratio of business income earned by C corporations to the business income earned by pass-throughs was approximately 60:40 throughout the early to mid-1990s, but by 2004, the ratio shifted to approximately 49:51. See also Ellen Legel et al., *The Effects of Tax Reform on the Structure of U.S. Business*, in I.R.S., STATISTICS OF INCOME BUREAU 63, 67 (2007), available at <http://www.irs.gov/pub/irs-soi/03legal.pdf>. The decline in corporate taxable income also likely reflects, at least in part, the tax shelter phenomenon, which artificially reduced C corporation taxable income.

224. U.S. DEPARTMENT OF THE TREASURY, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS: BACKGROUND PAPER 3 (2007), available at [www.treas.gov/press/releases/reports/07230%20r.pdf](http://www.treas.gov/press/releases/reports/07230%20r.pdf).

225. *Id.* at 16.

226. In addition, at least one commentator suggests that inappropriate revenue losses are at

That said, the vast majority of CTB elections made by domestic eligible entities actually choose corporate (and not partnership or disregarded entity) tax classification,<sup>227</sup> meaning that domestic entities do not appear to be using the CTB *election* to flock to non-corporate tax status<sup>228</sup> (though they may be using the *default rules* in the CTB regulation to do so). Some of these elections for entities to be treated as corporations may be coupled with S corporation elections,<sup>229</sup> such that the electing entities avail themselves of a pass-through tax regime and avoid corporate-level tax, but S corporation treatment was available prior to the CTB regulations. Thus, in this sense, the existence of the *election* (as opposed to the existence of the CTB regulation *default rules*) does not appear to contribute significantly to the erosion of the corporate tax base.<sup>230</sup>

Moreover, corporate income tax revenue as a percentage of both gross domestic product and total tax revenue was more than 20 percent higher in both 2006 and 2007 than it was in 1996. However, corporate income tax revenue as a percentage of both gross domestic product and total tax revenue declined slightly in the late 1990s and dropped significantly between 2001 and 2003, before rising again over the last few years.<sup>231</sup> Although there may be a variety of explanations for these data trends,<sup>232</sup> this data<sup>233</sup> may suggest that,

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least part of the motivation behind the Service's moves to curtail the use of hybrid foreign entities. See Weisbach, *supra* note 206, at n.12; see generally *supra* Part III.D for a discussion of the Service's actions regarding the use of the CTB election as applied to foreign entities.

227. See I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author); see *infra* Appendix A, Figure 2 (illustrating the number and type of CTB elections made by domestic entities from 1997 to 2007); see also *supra* note 120 and accompanying text.

228. However, entities electing corporate status may be trying to preserve the ability to change to flow-through tax treatment easily.

229. See *supra* note 121.

230. The distinction between the use of the *default rules* and the *election* may be important to the extent that one option for reforming the CTB regulations is to adopt a mandatory classification regime in which the election is eliminated and the current default rules are made mandatory.

231. CONGRESSIONAL BUDGET OFFICE, HISTORICAL BUDGET DATA, available at <http://www.cbo.gov/budget/data/historical.shtml>.

232. For example, the precipitous drop in corporate tax revenues between 2001 and 2003 could be explained, at least in part, by the difficult economic environment experienced by corporations after 9/11 (rather than by businesses fleeing the corporate form), coupled with the relative stability of social insurance tax collections. Similarly, the relative increase in corporate tax revenue between 2005 and 2007 could be explained, at least in part, by the surge in the economy during that period, coupled with lowered individual income and capital gains tax rates. Additionally, the drop in corporate tax collections in the late 1990s and early 2000s followed by an increase in such collections may also reflect corporate tax sheltering followed by increased enforcement.

even if the adoption of the CTB regulations caused some erosion of the corporate tax base (as the late 1990s data may suggest), it has not been particularly damaging to the fisc. Nevertheless, it is difficult to estimate what the data would have been had the corporate resemblance test not been eliminated.<sup>234</sup> Businesses that chose LLCs might have opted for the limited liability protection of traditional C corporations (in which case corporate tax revenue might have been higher); they might have opted for a different pass-through entity (in which case the owners might have had greater liability exposure,<sup>235</sup> but business revenues would still not have been subject to corporate tax); and some businesses may not have been formed at all. Under any alternative, efficiency might have suffered had the businesses chosen a less appropriate business form or had the businesses used an LLC that was inefficiently constrained in its business terms in an effort to achieve partnership tax treatment under the Kintner regulations.

#### *F. Conclusion Regarding the CTB Regulations, As Applied*

For domestic entities, the result of this analysis leaves neither a strong condemnation nor whole-hearted endorsement of the CTB regulations. The CTB regulations are better than the four-factor Kintner regulations, but there remains room for improvement in the area of entity classification, particularly for foreign entities. For domestic entities, a mandatory classification regime, in which the election is removed and the current default rules are made compulsory, could be slightly preferable to the current CTB regulations because a mandatory regime preserves much of the simplicity, administrability, and certainty benefits of the CTB

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233. CONGRESSIONAL BUDGET OFFICE, *supra* note 231. This data focuses on the trends regarding corporate tax collections and implicitly assumes that investor-level taxation remains steady. However, that is unlikely to be the case given that a profitable corporation can avoid current shareholder-level taxation by retaining earnings, whereas a profitable pass-through entity yields a current investor-level tax. Thus, the data may overstate relative declines in corporate tax collections given that shifts to pass-through entities may increase the total tax collections (including the investor-level tax collections) to which the corporate tax collections are compared.

234. Similarly, it is difficult to estimate what the data would have been had the CTB regulations been enacted as mandatory rather than elective.

235. Increased liability exposure would not be a problem if the pass-through vehicle chosen is an S corporation.

regime,<sup>236</sup> but avoids the complications that stem from the requirement to file the election<sup>237</sup> and may reduce tax planning.<sup>238</sup> A mandatory regime may hinder flexibility and thus lessen the neutrality benefits of the CTB regime,<sup>239</sup> but making the classification rules mandatory is unlikely to have a significant impact on newly formed domestic entities given that the vast majority of initial entity classification elections represent eligible entities electing corporate tax treatment,<sup>240</sup> which is easily obtainable through the use of an incorporated entity.<sup>241</sup>

However, all of these approaches to entity classification assume that business entities do, in fact, need to be classified as either partnerships or corporations for tax purposes. And, of course, this classification remains necessary only as long as there are multiple regimes for taxing businesses. Thus, the benefits of adopting a mandatory classification system to replace the CTB regulations would be limited because such a change still does nothing to address the fundamental issue presented by the federal income tax's use of multiple different regimes for tax businesses.

Moreover, the likelihood that Congress will resolve this problem of multiple business tax regimes may have been adversely affected by the mere promulgation of the CTB regulations. By providing an elective entity classification regime (particularly for LLCs), the Treasury allowed self-help integration, thereby enabling taxpayers easier opportunities to lessen the sting of the corporate double tax. As a result, the CTB regulations may have reduced taxpayers' incentives to pressure Congress for a revision to the corporate double tax, thus serving to entrench the multi-regime system for taxing businesses.

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236. See *supra* Part III.A.1.

237. See *supra* Part III.A.2.a.

238. For example, a mandatory regime makes changing entity classification more difficult. See *supra* note 134 and accompanying text.

239. See *supra* note 131 and accompanying text; see *supra* Part III.C.

240. See Treas. Reg. § 301.7701-2(b)(1) (as amended in 2008) and *supra* text accompanying note 122. See also I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author) and *supra* text accompanying notes 122.

241. See Treas. Reg. § 301.7701-2(b)(1) (as amended in 2008). Particularly, to the extent that the CTB regulations were being used for state tax planning purposes, it is hard to be sympathetic to arguments against removing this benefit.

## IV. EXAMINING THE CTB ELECTION ITSELF

The foregoing discussed the CTB regulations *as applied* based on their impact and suggested, at best, a lukewarm endorsement of the CTB regulations for domestic entities only. However, for purposes of evaluating the CTB regulations and the tax regimes into which the regulations classify businesses, it is also helpful to analyze the CTB election, *in and of itself*, from a more conceptual perspective, asking why the regulations allow taxpayers to make an explicit choice of business tax regime and seeking to understand the election by analyzing the situations in which that choice is, and is not, allowed.

## A. Allowing an Explicit Election

Although commentators often criticize the use of explicit elections in general,<sup>242</sup> one commentator praised the Treasury's use of an explicit election for entity classification on efficiency grounds,<sup>243</sup> arguing that an explicit election is a simple and efficient approach to an otherwise difficult and costly exercise in drawing a line between different regimes.<sup>244</sup> This efficient line-drawing theory is consistent with the Treasury's initial decision to replace the Kintner regulations with the CTB regulations given that, when considering the adoption of an explicitly elective approach to entity classification, the Treasury cited the cost and difficulty of differentiating between "virtually indistinguishable" business entities.<sup>245</sup> However, the efficient line-drawing justification for the use of an explicit election for entity classification suffers from the same problem encountered in Part III: it assumes that there is a good policy rational for the multiple different taxing regimes between which the lines are drawn.<sup>246</sup> Moreover, the Treasury's argument that

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242. See, e.g., H. David Rosenbloom, *Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt*, 26 SYDNEY L. REV. 17 (2004); Yin, *supra* note 87, at 130.

243. Weisbach, *supra* note 204, at 1630.

244. *Id.*; see also Abreu, *supra* note 150, at 493–94 (supporting a full embrace of the CTB regulations in the interest of simplicity and administrability, even though this approach necessarily foregoes "substantive accuracy"). This praise for the use of explicit elections assumes that the baseline for comparison is a multi-regime world where the choice is implicit.

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

246. *Cf.* Weisbach, *supra* note 206, at 1679 (stating that one important consideration in the line-drawing analysis is "whether transactions are taxed appropriately when considered by themselves (i.e., without regard to line drawing)"). See also *supra* Parts III.A.3, III.F and text



the costs of differentiating between virtually indistinguishable business entities justifies the adoption an elective approach for entity classification<sup>247</sup> can be turned around and used to argue that if the business entities really are virtually indistinguishable, the proper course of action is to eliminate the existence of a multi-regime business tax system, thereby obviating the need to distinguish the virtually indistinguishable entities from each other. Thus, to justify the CTB election as a simple and efficient approach to line-drawing between business tax regimes applicable to virtually indistinguishable forms of business, the existence of each separate business tax regime must be defended. As many commentators have argued, this has proven quite difficult.<sup>248</sup>

There are many other reasons why explicit elections are (and should be) used in the federal income tax, and fundamentally, many explanations, at some level, involve the concept of “sameness”—where the substantive economics or facts of situations that merit the application of one tax regime or another are sufficiently similar so as to merit a choice between the applicable tax regimes.<sup>249</sup> The flip side to this is that the limitations on the availability of that choice should define situations that are sufficiently different such that no choice should be allowed. Thus, for an explicit election to be justifiable in the affirmative (justifying the allowance of choice in situations where choice is available), it must also be justifiable in the negative (justifying the denial of choice in situations where choice is

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accompanying notes 160–161.

247. Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,990 (1996) (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301).

248. See, e.g., American Law Institute, Federal Income Tax Project: Integration of the Individual and Corporate Income Taxes: Reporter’s Study of Corporate Tax Integration 21–40 (1993) (Alvin C. Warren, Jr., rep.) [hereinafter A.L.I., INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAX]; U.S. DEP’T OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992); Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265, 266–67 (1995); Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1776 (1999); Daniel Halperin, *Fundamental Tax Reform*, 48 EMORY L.J. 809, 820–22 (1999). But see, e.g., Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 VA. TAX REV. 1193 (2004); Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C.L. REV. 613 (1990).

249. See Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. (forthcoming 2009). The concept of “sameness” is inherent in the efficient line-drawing theory, in that, a reason it is difficult and inefficient to draw lines based on substance and other “traditional concerns” is the similarity of the factual scenarios involved.

prohibited). Defending the boundaries of an election help defend the election itself, and as much can be learned from the situations in which the election is not allowable as can be learned from an analysis of the application of the election in situations where it is available. For example, by not allowing a Code section 338 election in situations where less than 80 percent of the target corporation's stock is purchased,<sup>250</sup> the Code section 338 election (which, very generally, allows a stock purchase to be taxed as an asset purchase)<sup>251</sup> is limited to only those situations where a large enough amount of target stock is purchased so as to make the stock purchase economically similar to the purchase of the target's underlying assets. Thus, even short of a comprehensive affirmative analysis of where and when explicit elections are appropriate in the federal income tax system, stress-testing the limitations of the explicit CTB election should provide insight into the CTB election itself.

### *B. Examining the CTB Election by Analyzing Its Limitations*

As mentioned above, to be eligible to make a CTB election, there must be an entity separate from its owner,<sup>252</sup> the separate entity must be a business entity (rather than a trust or entity otherwise subject to special treatment under the Code),<sup>253</sup> the entity generally cannot have changed its tax classification in the previous five years,<sup>254</sup> and the entity must not be incorporated under state or federal statute or otherwise be a per se corporation.<sup>255</sup> Further, if a partnership's interests are publicly traded, it generally does not have a choice of entity classification,<sup>256</sup> under the publicly traded partnership rules, the entity generally will be treated as a corporation unless an exception to those rules applies.<sup>257</sup> These limitations (plus

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250. I.R.C. §§ 338(a), (d)(3) (2007).

251. *Id.* §§ 338(a), (h)(10)(A) (2007).

252. Treas. Reg. § 301.7701-1(a) (as amended in 2006).

253. *Id.* § 301.7701-2(a) (as amended in 2008).

254. *Id.* § 301.7701-3(c)(iv) (as amended in 2006).

255. *Id.* § 301.7701-2(b)(1), (3)–(8) (as amended in 2008). This limitation (unlike the separate entity limitation, business entity limitation and limitation on changes in elective classification) is required by the statute. *See* I.R.C. § 7701(a)(3) (2008) (defining "corporation").

256. I.R.C. § 7704(a) (2008). As with the limitation that incorporated entities cannot elect their entity classification, the mandatory taxation of PTPs as corporations is imposed by the statute, and not by the regulations.

257. *Id.* §§ 7704(a), (c) (2008).

a few other technical requirements regarding the time for filing and the required signatories) establish the parameters for the CTB election.<sup>258</sup> To the extent that these limitations (such as the “separate entity,” “business entity,” and limitation on changing elections) are justifiable, that may help explain the rationale for the existence of the election, but to the extent that the other limitations are difficult to defend, the existence of the election and the choices provided thereunder may be undermined.

### 1. Separate Entity

To apply the CTB regulations, there must be an entity separate and distinct from its owner for federal tax purposes.<sup>259</sup> The determination of whether a separate entity exists depends on federal tax law and not state or local law; an entity can be created for federal tax purposes through a contractual agreement or joint undertaking, even without the formation of a local law entity. Similarly, the mere formation of a local law entity is insufficient to create a separate entity for federal tax purposes.<sup>260</sup>

Absent the existence of an entity for federal tax purposes, the question of classification of that entity is irrelevant. The concept of an “entity” is, however, an artificial construct, which need not be employed if the relevant economic arrangement is otherwise easily and appropriately taxed under general income tax principles.<sup>261</sup> Accordingly, non-entities, like mere co-ownership arrangements, mere cost sharing arrangements, and lessor/lessee arrangements,<sup>262</sup>

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258. See, e.g., Treas. Reg. §§ 301.7701-3(c)(1)-(2) (as amended in 2006).

259. *Id.* § 301.7701-1(a) (as amended in 2006).

260. *Id.*

261. Nevertheless, some proposals for taxing businesses contemplate applying a business tax regime to sole proprietorships, which are generally not regarded as entities separate and apart from their owners. See, e.g., U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992), available at <http://www.ustreas.gov/offices/tax-policy/library/integration-paper/integration.pdf> (“examin[ing] in detail several different integration prototypes”). Cf. Edward D. Kleinbard, *The Business Enterprise Income Tax: A Prospectus*, 106 TAX NOTES 97 (2005) (proposing an income tax model that applies to all businesses uniformly, treating all businesses as “separate entities” regardless of whether they are “organized as a corporation, a partnership, or an unincorporated activity of an individual”). Note that, under the CTB regulations, sole proprietorships can effectively opt-in to entity treatment and elect their tax classification. Treas. Reg. § 301.7701-1(a)(4) (as amended in 2006).

262. See Treas. Reg. § 301.7701-1(a)(2) (as amended in 2006) (giving these as examples of certain joint undertakings that may not give rise to entities for federal tax purposes). See generally Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925,

ought to be taxed as such and ought not to be subjected to the entity classification regulations that would result in taxing the arrangement as a business.<sup>263</sup> Thus, the "separate entity" requirement is a reasonable limitation on the CTB election: no election regarding an entity's federal tax classification can or should be made without the existence, for federal tax purposes, of the entity itself.

## 2. Business Entity

The CTB regulations only apply to *business* entities and not to a variety of other types of entities that, for one reason or another, are subject to a different taxing regime. The CTB regulations define the term "business entity" in the negative: "a *business entity* is any entity recognized for federal tax purposes . . . that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code."<sup>264</sup>

Trusts are excluded from the CTB regulations on the ground that trusts are arrangements "whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries"<sup>265</sup> and do not involve "associates in a joint enterprise for the conduct of business for profit."<sup>266</sup> The regulations make it clear that the determination of whether an entity is treated as a trust (taxed pursuant to Subchapter J) rather than as a business entity (subject to the CTB regulations and taxed pursuant to Subchapter C, K, or S) does not depend on the state law form of the entity or on the identity of the persons who supply the assets to the entity.<sup>267</sup> The key factors in distinguishing between a trust and a business entity are whether the entity has associates and whether the entity conducts a business for profit,<sup>268</sup> meaning that "business trusts"<sup>269</sup> are not treated as trusts

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933-41 (2006) (discussing the differentiation between tax partnerships and other types of business arrangements that do not rise to the level of creating a tax entity).

263. One nuance to this "separate entity" requirement involves the treatment of sole proprietorships, which are generally disregarded as separate from their owners. A business owned by a single owner, however, may choose to be treated as a separate business entity. Treas. Reg. § 301.7701-1(a)(4) (as amended in 2006).

264. *Id.* § 301.7701-2(a) (as amended in 2008).

265. *Id.* § 301.7701-1(b) (as amended in 2006); *id.* § 301.7701-4(a) (as amended in 1996).

266. *Id.* § 301.7701-4(a) (1996).

267. *Id.* § 301.7701-4(b) (as amended in 1996).

268. *Id.* § 301.7701-1(b) (as amended in 2006); *id.* § 301.7701-4(b) (as amended in 1996).

269. Business trusts are arrangements known as trusts under applicable trust law but are "created . . . as a device to carry on a profit-making business which normally would have been

for federal income tax purposes but rather treated as business entities and classified under the CTB regulations.<sup>270</sup> Although it is not always easy to make the distinction between an entity conducting a business for profit and an entity created primarily from a gratuitous transfer of assets that are to be protected or conserved for beneficiaries, it does seem appropriate not to subject the latter type of entity to a regime designed to tax businesses.<sup>271</sup> Thus, there is no need to give such an entity a choice among the regimes for taxing businesses.

The CTB regulations also do not apply to certain other entities subject to special treatment under the Code,<sup>272</sup> such as regulated investment companies (“RICs”)<sup>273</sup> and real estate mortgage investment conduits (“REMICs”)<sup>274</sup> that are engaged in some degree of business activity but that are afforded special (largely pass-through) tax treatment if they satisfy certain limitations on the nature of their operations. RICs and REMICs are fundamentally conduit structures that are organized primarily to hold particular types of investment assets and to facilitate ownership and investment by individuals in those assets. The scope of allowable assets held and income earned by these entities is sufficiently constrained to limit the extent of their business activity, distinguishing them from general businesses subject to taxation under Subchapters C, K, or S. Moreover, the CTB regulations were enacted against the backdrop of pre-existing policy decisions to afford special tax treatment to RICs and REMICs.<sup>275</sup> Thus, since these entities will not be subjected to

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carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code.” Treas. Reg. § 301.7701-4(b) (as amended in 1996).

270. *Id.*

271. See Boris I. Bittker & Lawrence Lokken, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 85.5 (2008); see generally Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559 (2003) (discussing the use of trusts as business entities).

272. Treas. Reg. § 301.7701-1(b) (as amended in 2006); *id.* § 301.7701-2(a) (as amended in 2008). There are a number of types of entities that are subject to special treatment under the Code, but are nevertheless within the scope of the CTB regulations. For example, insurance companies are subject to special taxation rules as provided under Subchapter L of the Code, but these entities are affirmatively classified as corporations pursuant to the CTB regulations. *Id.* § 301.7701-2(b)(4) (as amended in 2008).

273. See I.R.C. §§ 851–855 (2007).

274. See *id.* §§ 860(a)–860(g) (2007); see also T.D. 8697, 1997-1 C.B. 215 (specifically citing REMICs as examples of entities not subject to classification under the CTB regulations).

275. See generally Richard M. Hervey, *Taxation of Regulated Investment Companies*, 740 TAX MGMT. PORTFOLIO, at Part II (2008) (providing historical background regarding the regime

any of the general regimes for taxing businesses, these entities need not be classified or given a choice of classification under the CTB regulations.<sup>276</sup>

Ultimately, since the CTB regulations classify entities as generally subject to one of the regimes for taxing businesses, the limitation of the CTB regulations (and the availability of the CTB election) to entities engaged in business that are not otherwise classified by the Code seems implicit.<sup>277</sup>

### 3. Limitation on Ability to Electively Change Classifications

When considering an elective entity classification regime, the Service expressed concerns about the increased burden that could be imposed on taxpayers and the Service if business entities had complete freedom to elect to switch back and forth between different classifications.<sup>278</sup> Accordingly, the final CTB regulations generally restrict the ability of an entity to make an elective change in its entity classification more than once in a sixty-month period.<sup>279</sup>

This sixty-month limitation increases the administrability of the entity classification system by limiting the frequency of elective changes in classification. Over 96,000 elections to change an entity's classification have been filed since 1997, representing approximately 30 percent of all CTB elections filed.<sup>280</sup> That number,

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for taxing RICs); Gary J. Silversmith, *REMICs, FASITs and Other Mortgage-Backed Securities*, 741 TAX MGMT. PORTFOLIO, at Part III & Worksheet 2 (2008) (explaining the tax rules regarding REMICs and providing legislative history behind such rules).

276. While these entities are not afforded an explicit election under the CTB regulations, they do take advantage of an implicit election. By structuring their affairs to meet the RIC or REMIC rules, the entities opt into these taxing regimes and out of the CTB regulations.

277. It may be advisable to allow a broader collection of entities to choose their non-business tax classifications (an issue not addressed by this Article), but the choices afforded should be narrowly targeted so that the possible taxing regimes bear a substantive relationship to the entities provided with a choice. Here, entities engaged in business activity can elect among regimes intended to tax businesses. Admittedly, other entities that are engaged in some degree of business are denied their choice of classification under the CTB regulations, but that is because such entities, by structuring their affairs to meet the requirements of specific rules (such as the RIC or REMIC rules), affirmatively make an implicit election of their tax treatment and thus have no need for the CTB regulations.

278. I.R.S. Notice 95-14, 1995-1 C.B. 297.

279. Treas. Reg. § 301.7701-3(c)(1)(iv) (as amended in 2006); *see also* Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,996 (1996) (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301); T.D. 8697, 1997-1 C.B. 215 (1996).

280. I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author). *See infra* Appendix A, Figures 2 & 3 (illustrating the number of initial elections and status change

and the costs borne by the Service in processing CTB elections and tracking entities' classifications, would likely be higher absent the restriction on changes in entity classification.

Moreover, the restriction on elective classification changes serves an anti-abuse function. Under the Kintner regulations, an entity could change its classification by modifying the terms of its operating agreement to contain greater or fewer corporate-like characteristics.<sup>281</sup> Although this change was not particularly difficult, it had substantive implications. The CTB regulations eliminated any need to change the underlying business arrangement to change the entity's classification for tax purposes, making it even easier for an entity to change its classification. The CTB regulations' removal of these barriers to changing an entity's classification lessened the "frictions" that could help stymie inefficient and potentially abusive tax planning.<sup>282</sup> As a result, under a completely elective system without limits on the frequency of classification changes, an entity could make a series of elections to try to coordinate its status as a corporation or a partnership with its tax attributes. For example, the entity might elect to be classified as a partnership in years where it expects to have significant tax losses, so that the losses could be passed through and currently used by its high tax-bracket partners. Then the entity might elect to be classified as a corporation in years where it expects to have relatively low income, in order to take advantage of low corporate rates for the first \$50,000 to \$75,000 of income<sup>283</sup> (i.e., to obtain the benefits of income splitting). Of course, changing an entity's classification does have consequences:<sup>284</sup> a corporation that elects to be classified as a partnership is deemed to liquidate, which could create significant current tax costs;<sup>285</sup> a partnership that elects to be classified as a corporation is deemed to incorporate, but a deemed incorporation is unlikely to trigger current taxation.<sup>286</sup> However, in the limited circumstances where the deemed

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elections for domestic and foreign entities filing CTB elections from 1997 to 2007).

281. See *supra* Part II.A (discussing the Kintner regulations).

282. David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001).

283. I.R.C. § 11(b) (2006).

284. Treas. Reg. § 301.7701-3(g) (as amended in 2006).

285. See I.R.C. §§ 331, 336 (2006) (requiring, upon the liquidation of a corporation, recognition of gains and losses at both the corporate level and the shareholder level).

286. See *id.* § 351 (2006). Absent the receipt of boot, the incorporation of a partnership is

incorporation or deemed liquidation can be timed to minimize tax liability caused by such change, the ability to switch back and forth between corporate and partnership taxation could facilitate tax avoidance. Thus, the sixty-month limitation on an entity's ability to change classification limits potential abuse, in addition to serving an administrability purpose.<sup>287</sup> Thus, like the "separate entity" and "business entity" limitations, the sixty month<sup>288</sup> limitation seems appropriate and helpful for the process of classifying entities and administering the business tax regimes.

#### 4. No Election for Entities Incorporated Under State or Federal Statute

The CTB regulations deny a choice of entity classification for any "business entity organized under a Federal or State statute . . . if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic"<sup>289</sup> ("incorporated entities") and for a number of other specifically enumerated types of entities.<sup>290</sup> The Code mandates this result for incorporated entities,<sup>291</sup>

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generally tax-free. *Id.*

287. The sixty-month limitation on elective entity classification changes is not absolute. The regulations grant to the Commissioner, and the Commissioner has exercised, the discretion to allow elective changes in entity classification within sixty months if more than half of the interests in the entity as of the effective date of the change are owned by persons that did not own any interests in the entity as of the effective date of the entity's prior election. Treas. Reg. § 301.7701-3(c)(1)(iv) (as amended in 2006); *see, e.g.*, I.R.S. Priv. Ltr. Rul. 2006-03-021 (Jan. 20, 2006). Moreover, the sixty month limitation in the CTB regulations merely limits *explicitly* elective changes in entity classification; it does not preclude an entity from changing its entity classification by actually undertaking the formal legal steps to change its status, for example, by actually distributing its assets to its owners in liquidation and having its former owners contribute the assets to a newly formed (and differently classified) entity.

288. One could argue that the limitation period should be longer or shorter, but a sixty-month period seems reasonable given that this same five year period is used elsewhere in the Code for similar purposes. *See, e.g.*, I.R.C. § 1366(g) (2007) (providing that, if an S corporation's election terminates, the corporation is not eligible to re-elect S corporation status for 5 years), I.R.C. § 856(g)(3) (2006) (same with respect to a REIT election); *see also id.* § 1202 (2006) (requiring a five-year holding period for the partial exclusion of gain from the sale of qualified small business stock).

289. Treas. Reg. § 301.7701-2(b)(1) (as amended in 2008). Prohibiting incorporated entities from electing their tax classification places significant pressure on the specific language of the applicable state or federal statute, meaning that state legislatures can amend their business statutes giving more and more corporate rights and responsibilities to entities that are not technically "incorporated" under the statute. *See* Yin, *supra* note 87, at 134. This process further narrows the substantive differences between incorporated and unincorporated entities, making it even harder to justify mandatorily classifying the former as corporations while allowing the latter to choose their business tax regime.

290. Treas. Reg. § 301.7701-2(b)(1), (3)-(8) (as amended in 2008). While choice of entity classification is denied for a number of types of entities other than incorporated entities, the



and hence, the CTB regulations automatically classify these entities as corporations for federal income tax purposes.

Incorporated entities can avoid the double corporate tax by electing to be treated as Subchapter S corporations, but many incorporated entities are ineligible to make a Subchapter S election given that the Subchapter S election is available only if the incorporated entity has fewer than a hundred shareholders, only one class of stock, and no nonresident alien or other ineligible shareholders.<sup>292</sup> Further, the flow-through tax regime imposed by Subchapter S differs in significant respects from the flow-through tax regime imposed on partnerships by Subchapter K.<sup>293</sup> There is debate about whether the existence of the multiple pass-through business tax regimes should be retained.<sup>294</sup> However, as long as both Subchapter S and Subchapter K persist, the mere availability of one version of pass-through tax treatment for a subset of incorporated entities under Subchapter S should not in and of itself cause *all* incorporated entities to be denied the ability to make the CTB election (i.e., between Subchapter C and pass-through treatment under Subchapter K) available to most other business entities.

Thus, there must be another explanation as to why incorporated business entities are sufficiently different from business entities that can choose their tax classification under the CTB regulations, such that a choice of entity classification should be denied to *per se* corporations. Historical development of the regimes for business taxation may help explain how it came to be that incorporated entities *are* mandatorily taxed as corporations under the current entity classification rules,<sup>295</sup> but that path-dependent story does not

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discussion here focuses on the denial of choice based on incorporation under federal or state law.

291. I.R.C. § 7701(a)(3) (2006).

292. I.R.C. § 1361(b)(1) (2008).

293. See generally JOINT COMM. ON TAXATION, *supra* note 121, at 31–36 (describing principal differences between the taxation of partnerships and S corporations, including the treatment of business liabilities, the limitations on the type of interests, and the number of investors in the enterprise).

294. See generally *id.* at 44–46 (discussing the possibility of unifying the regime for taxing pass-through business); see A.L.I., TAXATION OF PRIVATE BUSINESS ENTERPRISES, *supra* note 160, at 125–272.

295. The federal income tax's treatment of business evolved over time, dating back to when there were fewer types of entities and there was a brighter (albeit still artificial) line between entities and aggregates. With the multiple regimes for taxing businesses in place, business entities evolved, and many developments introduced additional flexibility in the terms and organizational structures of business entities. See, e.g., Hamill, *Story of LLCs*, *supra* note 47 and

explain why incorporated entities *should* be treated differently than other business entities.<sup>296</sup> Arguments based on normative and positive theories explaining the corporate double tax<sup>297</sup> may, however, be useful in analyzing whether the double corporate tax should be mandatorily imposed on incorporated entities.<sup>298</sup> The denial of entity classification choice for incorporated entities may be justified if the rationale supporting the double corporate tax in general is particularly persuasive in the context of incorporated entities.<sup>299</sup> Accordingly, a brief description of several theories of the corporate tax<sup>300</sup> and a discussion of each theory's ability to justify the mandatory imposition of the corporate tax on incorporated entities are set forth below. It is important to note that the below discussion is not intended as a critique of the various theories offered to explain the corporate tax, nor is the discussion intended to argue for or against one such theory or another. The inquiry is primarily intended to ask whether, if credence is given to the particular theory, that theory can explain why the corporate tax is levied mandatorily on incorporated entities and only levied on other entities at their option.

As the below discussion demonstrates, however, attempts to justify mandatory corporate taxation for incorporated entities have been largely unsuccessful. Accordingly, it is difficult to explain why

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accompanying text. The tax rules developed in tandem with the evolving business entities, and thus the CTB regulations are only one page in the long story of the taxation of business. That is, the mandatory taxation of incorporated entities as corporations may be less a product of deliberate design and more a product of a series of developments along a path chosen years ago.

296. This critique does not fault the Treasury with deciding to tax incorporated entities as corporations; the responsibility for that decision falls on Congress. Note, however, that neither the proposed nor the final CTB regulations explain why incorporated entities should be denied the choice of entity classification. Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989 (1996) (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301); T.D. 8697, 1997-1 C.B. 215 (1996).

297. Some commentators have questioned the extent to which the corporate tax regime practically imposes a "double" tax. See, e.g., Lee, *supra* note 13, at 887. This discussion, however, assumes that there is generally some adverse economic impact from being subjected to the corporate tax regime, even if it is not an imposition of two full layers of taxation.

298. There is an extensive body of literature that criticizes the double corporate tax, and very little literature that argues in favor of the corporate tax. See *supra* note 248.

299. Commentators have argued that conduit taxation is the natural way to tax businesses. See, e.g., Bradley T. Borden, *The Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. (forthcoming 2009). Accordingly, this argument focuses on arguments that support the deviation from the aggregate/conduit approach.

300. The literature contains a number of additional theories that either positively or normatively explaining the corporate tax. In this discussion, however, I try to address the theories most likely to provide some explanation for the CTB election's limited availability.

incorporated entities should be denied the ability to choose their entity classification under the CTB election while other very similar business entities are allowed to elect their applicable business tax regime.

*a. Entity Theory*

Under the entity theory, a corporation is treated as a distinct taxpayer in its own right, separate and apart from its owners, and thus should be subject to tax.<sup>301</sup> While the entity theory does not necessarily have to result in double taxation,<sup>302</sup> the concept of the firm as a distinct taxpayer contributed, at least in part, to the development of a tax scheme that imposes two layers of tax.<sup>303</sup> Scholars differ as to the extent to which they believe that the entity theory explains the existence of the corporate double tax,<sup>304</sup> but even crediting the entity theory fails to explain why the double tax should apply only to incorporated and not unincorporated entities. While the entity theory may have prevailed with respect to corporations and not partnerships based on Congress's historical concept of the differences between the types of firms,<sup>305</sup> such differences are largely eliminated today; entities like limited partnerships and LLCs can have historically "corporate" characteristics like limited liability, free transferability of interests, continuity of life, and centralized management, and partners might not be actively involved in the partnership's business or be responsible for the partnership's debts. Similarly, a populist version of the entity theory focuses on the idea that "the public views corporations as distinct entities, not merely as vehicles for transferring profits to shareholders."<sup>306</sup> However, again, this explanation easily could be extended to include unincorporated

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301. See generally Steven A. Bank, *Entity Theory as a Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 465-504 (2001) (explaining the entity theory of corporate taxation).

302. See A.L.I., *TAXATION OF PRIVATE BUSINESS ENTERPRISES*, *supra* note 160, at 68 (explaining that taxation at the entity level without double taxation requires a strategy of corporate integration).

303. See *id.* at 36-40; William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 54 (1972) (understanding the corporation as a distinct person was "a significant element in the public's support of the law imposing the [corporate] tax"). Cf. Bank, *supra* note 301.

304. See, e.g., Bank, *supra* note 301.

305. See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 57-62 (1990).

306. Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 331 (1995).

entities as well, given that, as evidenced by the public outcry regarding the taxation of carried interests, the public may not draw a meaningful tax distinction based on organizational form.<sup>307</sup> Thus, even if the entity theory (or a populist version thereof) explains the development of the double tax, it has trouble explaining why the double tax should apply mandatorily only to incorporated entities, while most other business entities have the freedom to choose whether or not to be subject to the double tax.

### *b. Benefits Theory*

Benefits justifications for the corporate tax generally "posit that certain entity organizational structures allow participating taxpayers to achieve benefits that could not be achieved (either at all or at comparable costs) absent the utilization of the structure."<sup>308</sup> There are a variety of benefits conferred by the use of an incorporated entity, including limited liability, liquidity through the public markets, and access to particular types of capital. Hence, the corporate tax could be viewed as a "fee" for those benefits and for the incremental returns derivable from conducting economic activity in those entities.<sup>309</sup>

Incorporated entities generally protect their owners from personal liability for the entities' debts. However, the benefit of limited liability does not explain the current system that denies

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307. See, e.g., Jenny Anderson & Andrew Ross Sorkin, *Tax Gap Puts Private Equity Firms on the Hot Seat*, N.Y. TIMES, June 16, 2007, at C1; Paul Krugman, *An Unjustified Privilege*, N.Y. TIMES, July 13, 2007, at A19; see generally JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATED TO THE TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS, No. JCX-41-07 (2007); JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART I, No. JCX-62-07 (2007); JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II, No. JCX-63-07 (2007). Part of the issue spurring on the perceived unfairness in the treatment of holders of carried interests in a fund is that the same level of tax is not paid on the fund's earnings and the carried interest holder's earnings as is paid by a corporation and its owner-managers on the corporation's earnings. But see Steven A. Bank, *A Capital Lock-in Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 890-91, 897, 943 (2006) (suggesting that the public may distinguish between corporations and partnerships).

308. Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It*, 56 TAX L. REV. 329, 338 (2003).

309. Alvin C. Warren, *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1600 (1974) ("A separate tax on corporate income is sometimes considered appropriate because of the privileges and benefits granted corporations by the state, . . . such as limited liability for investors . . ."); see also Schlunk, *supra* note 308, at 338 (discussing "whether the corporate income tax is a plausible fee for a benefit" provided by the government).

incorporated entities the choice of entity classification, given that other entities, such as LLCs, whose owners are also protected from the entity's liabilities, can elect their tax classification. Moreover, the Service considered and explicitly rejected using limited liability as the key factor distinguishing entities that should be taxed as corporations from entities that should be taxed as partnerships,<sup>310</sup> and the Treasury now freely admits that "[a]s a general matter, it is not possible to relate the differences in the tax consequences that attend doing business in different legal entity forms to any substantive non-tax attributes of those legal forms."<sup>311</sup> The American Law Institute ("ALI") reached a similar conclusion that taxation of business entities should not turn on the existence or absence of limited liability.<sup>312</sup> In arriving at this conclusion, the ALI explained that "the income tax is not a tax on 'benefits conferred,'" any additional tax on such a benefit conferred "would not, in any event, measure properly the value of the benefit obtained," "limited liability is an efficient characteristic for firms," and "[a] classification rule based on limited liability would also raise difficult implementation questions."<sup>313</sup> Moreover, query why the federal government should be entitled to extract a tax on the benefit of limited liability that is actually conferred by the state governments.

In addition, while most publicly traded entities are structured as incorporated entities (and setting aside arguments based on optimal tax theory for a moment),<sup>314</sup> the benefit of liquidity through public trading also does not explain the current system where incorporated entities are unable to elect their tax classification, given that many incorporated entities are not publicly traded (like Koch Industries, Inc. and Mars, Incorporated)<sup>315</sup> but are still denied the choice of

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310. 45 Fed. Reg. 75,709 (Nov. 17, 1980) (proposing regulations that provided that "an organization in which no member has personal liability for the debts of the organization be classified as an association taxable as a corporation"); I.R.S. Announcement 83-4, 1983-2 I.R.B. 31 (withdrawing the proposed regulations).

311. JOINT COMM. ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY, No. JCX-48-08, at 26 (2008) (noting an exception that "access to the public equity markets must generally be through a C corporation").

312. A.L.I., TAXATION OF PRIVATE BUSINESS ENTERPRISE, *supra* note 160, at 55-56.

313. *Id.* But see Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223 (2000) (arguing in favor of determining tax classification based on limited liability).

314. See *infra* Part IV.B.4.c.

315. The companies were two of the top ten largest private companies in the United States in 2007. FORBES, SPECIAL REPORT - AMERICA'S LARGEST PRIVATE COMPANIES (Shlomo

business tax regime, while some unincorporated entities (like The Blackstone Group L.P. and Fortress Investment Group LLC)<sup>316</sup> are publicly traded but are allowed to elect their tax classification.<sup>317</sup> Similarly, while incorporated entities historically have been most attractive to capital investments from tax-exempt and foreign investors,<sup>318</sup> it is also difficult to justify the denial of the entity classification election to incorporated entities on the basis of the benefit of access to capital, given that LLCs and other entities that can elect their tax classification can also access capital from these investors with minimal tax cost.<sup>319</sup>

Moreover, a policy that denies incorporated entities a choice of tax classification and mandatorily taxes them as corporations on either a "public trading" basis or an "access to capital" basis suffers from many of the same weakness as distinguishing these entities based on the benefit of limited liability. These approaches effectively impose corporate-level tax on incorporated entities in exchange for "benefits conferred," and even if the corporate tax is (and should be) a tax on benefits conferred (a position rejected by many scholars), the additional corporate-level tax is unlikely to accurately measure the value of these benefits, may discourage efficient transactions/investments, and could be difficult to implement. Accordingly, limited liability, liquidity through public trading, and access to capital—while all benefits common to many incorporated entities—do not and should not justify denying the entity classification election to incorporated entities.

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Reifman, ed. 2007), [http://www.forbes.com/2007/11/08/largest-private-companies-biz-privates07-cx\\_sr\\_1108private\\_land.html](http://www.forbes.com/2007/11/08/largest-private-companies-biz-privates07-cx_sr_1108private_land.html).

316. The Blackstone Group L.P., *supra* note 216, at 240–56; Fortress Investment Group LLC, *supra* note 216, at 216–29.

317. See also *infra* Part IV.B.5 (discussing further the relationship between "public trading" and entity classification).

318. See *supra* note 213 and accompanying text.

319. Tax-exempt investors and foreign investors can invest in pass-through vehicles via corporate "blocker" entities. Then, the investor owns only stock or debt of a corporation, which does not generate UBTI or ECI, and the corporation owns the direct ownership interest in the pass-through vehicle. The tax cost of this blocker structure is minimized to the extent that the corporate blocker is capitalized with a significant amount of debt (interest on which is deductible). See *supra* note 215 and accompanying text.

*c. Optimal Tax Theory*

One key normative argument in favor of the double tax on corporations is that it imposes a higher tax burden on a relatively inelastic feature of business and is thus an efficient way to raise revenue.<sup>320</sup> In order for optimal tax theory to support the mandatory imposition of the double tax on incorporated entities, the demand for incorporated entities must be relatively inelastic. However, particularly as LLCs gain greater acceptance, the demand for incorporation appears to be becoming more elastic; the data comparing the rate of formation of C corporations to the rate of formation of entities taxed as flow-throughs documents a shift away from incorporated entities, likely spurred on by a difference in the tax regimes.<sup>321</sup> Thus, the benefit of incorporation itself (as opposed to incorporation as a proxy for public trading or access to capital) may not be sufficiently in demand such that a higher tax burden could be imposed with minimal distortion.

Nevertheless, optimal tax theory may present a reasonable case for imposing higher tax burdens on entities that are publicly traded because public trading is a relatively inelastic feature of business.<sup>322</sup> Even so, imposing a higher tax on publicly traded entities will still affect the price that investors are willing to pay for equity investments.<sup>323</sup> Moreover, as it becomes easier to raise significant amounts of capital through private markets,<sup>324</sup> the argument for mandatorily subjecting publicly traded corporations to the double corporate tax weakens. Additionally, even if optimal tax theory supports the imposition of a higher tax on publicly traded entities, the imposition of the higher tax on all incorporated entities is overinclusive given that many incorporated entities are not publicly

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320. See, e.g., Terrence R. Chorvat, *Apologia for the Double Taxation of Corporate Income*, 38 WAKE FOREST L. REV. 239, 255–56, n.34 (2003) (discussing optimal tax theory as a defense for the corporate tax and citing F.P. Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47, 58–59 (1927)).

321. JOINT COMM. ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY, No. JCX-48-08, at 3–4, 6–9 (2008); see also Merrill, *supra* note 223 (discussing the ratio of business earned by C corporations to business earned by pass-throughs).

322. See Yin, *supra* note 87, at 132–33.

323. See Chorvat, *supra* note 320, at 255–56.

324. See Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231 (2008).

traded.<sup>325</sup> The existence of private incorporated entities that do not restructure into entities taxable as pass-throughs may lead some to suggest that there is some other benefit of being incorporated, beyond public trading, upon which higher tax can be imposed efficiently. However, many of these private incorporated entities were formed before the CTB regulations and are locked into Subchapter C because they are ineligible for Subchapter S, because of the huge built-in gain that they would have to recognize were they to liquidate and then reform as an LLC or because of the significant transaction costs of such a restructuring.<sup>326</sup> Query whether optimal tax theory does or should mandate the imposition of a higher tax burden on entities because of their desire to avoid those extra tax and non-tax costs of restructuring. Thus, optimal tax theory has trouble explaining why a higher tax burden should mandatorily be imposed on all incorporated entities.

#### *d. Capital Lock-In/Agency Theory*

Another suggested explanation for the corporate income tax is the "capital lock-in theory." Under this explanation, given the delegation of substantial control over assets to the board of directors and given shareholders' limited rights to corporate assets, corporations are more successful than unincorporated entities at protecting business capital for use in future growth and at preventing "hold-up" by individual owners demanding a return of their investment.<sup>327</sup> The corporate income tax actually protects this ability of managers to accumulate wealth inside the corporation (which is considered under the capital lock-in theory to confer long-term benefits to the business and its owners), while still imposing some tax.<sup>328</sup>

A more cynical variation on this theory is that the persistence of the corporate tax derives from the agency relationship between corporate managers and shareholders.

In its strongest articulation, double taxation becomes an ally of corporate management because it helps persuade shareholders to allow managers to retain earnings and

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325. See *supra* note 315 and accompanying text.

326. See I.R.C. § 336 (2007).

327. See Bank, *supra* note 307 at 892, 914 n.149, 945.

328. *Id.*



invest them free of substantial monitoring. Stated more moderately, fighting double taxation is of considerably lower value to managers than trying to secure research and investment credits.<sup>329</sup>

This argument may help explain why incorporated entities *are* subject to the double corporate tax and not afforded a choice of entity classifications, but unless there is good reason to allow business managers to exploit their agency relationship with shareholders more than their agency relationship with equity holders in unincorporated businesses, this argument does not explain why incorporated entities *should* be subject to the double corporate tax without any choice as to tax classification.

Moreover, even under the more benign version of this explanation for the corporate tax, incorporated entities could still be given a choice of entity classification. Then, managers and owners could decide whether capital lock-in is indeed sufficiently valuable to the enterprise such that it is in the owners' and managers' interests to protect it with the imposition of the corporate tax.

#### *e. Political Theories*

Another explanation for the persistence of the double tax is that "the corporate tax [is] simply another tax on capital[, and v]oters, in this view, favor the corporate tax because they believe that the tax falls on owners of capital; they do not themselves own significant amounts of capital; and they feel that those who do should be taxed."<sup>330</sup> Accepting this theory should mandate the imposition of

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329. Bank, *supra* note 301, at 535 (citing Arlen & Weiss, *supra* note 306, at 336, 348-49). This explanation is based on the agency relationship between owners and managers regarding distribution of corporate profits. Another agency explanation for the corporate tax focuses on the agency relationship between owners and managers regarding the disposition of corporate assets. Professors Kanda and Levmore argue that the corporate tax actually reduces agency costs that arise in the context of dispositions of corporate assets because the corporate tax unifies the goal of the managers and the owners (in that they all face the same corporate tax) whereas a pass-through tax regime could lead to a situation where a manager-owner makes a decision to defer or accelerate the disposition of business assets in light of differing tax goals of the owners (who face different levels of tax as a result of the disposition depending on their individual circumstances). Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 227-34 (1991). Thus, the corporate tax reduces the risk that the manager-owner would make the disposition decision in a self-interested way. *Id.* at 232-33. Even under this variation on the agency theory explanation for the corporate tax, incorporated entities could still be given a choice of entity classification. If this reduction of agency costs is sufficiently valuable to the owners, they could cause the entity to elect to be taxed under Subchapter C.

330. Arlen & Weiss, *supra* note 306, at 331-32 (citations omitted).

the same tax not only on incorporated entities but on all owners of business capital regardless of the form of business. The CTB regulations do not do so.

A similar argument offered to explain the double tax is that "[t]he corporate tax is a politically expedient way of raising revenue because the public does not understand that it ultimately bears the burden of the tax."<sup>331</sup> Again, this theory fails to explain why this "hidden tax" should be mandatorily imposed on incorporated entities while unincorporated entities can elect whether or not to subject themselves to this tax.

### *f. Regulatory Theory*

Some "praise [the corporate tax's] ability to serve as a tool to regulate the corporation"<sup>332</sup> in that changes to the corporate tax can be used as a tool to reform corporate behavior. There is considerable doubt, however, as to whether the corporate tax can or should effectively regulate corporations and thus whether the corporate tax is justified based on its ability to regulate business.<sup>333</sup> Even accepting the regulatory theory as an explanation for the corporate tax, query why incorporated entities should be mandatorily subject to such regulation while most other business entities are subjected to regulation by the corporate tax only at their option.

### *g. Progressivity*

Another argument for the corporate double tax is that it increases the progressivity of the tax system<sup>334</sup> in that the corporate tax is effectively a tax on wealthy individuals because corporate stock is likely to be owned more by wealthy individuals than by middle or lower income individuals. However, if increasing the tax burden on the wealthy is the goal of the corporate tax, then the CTB

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331. *Id.* at 332.

332. Bank, *supra* note 307, at 899; *see also* Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1212–50 (2004) (explaining the evolution of the corporate tax as an effort to "regulate and place limits on the power of corporate management" and arguing the corporate tax is defensible "as a means to control the excessive accumulation of power in the hands of corporate management").

333. Bank, *supra* note 307, at 901.

334. *See* Chorvat, *supra* note 320, at 258; *see also* Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1066–69 (1989) (explaining an argument justifying the imposition of a double tax where the first level of tax is not assessed at the "appropriate" rate).

election's limitations are completely illogical. In an era of widespread availability of 401(k)s to taxpayers of various income strata and private equity funds in which only the wealthiest of taxpayers can invest,<sup>335</sup> progressivity is undermined by mandatorily imposing the double corporate tax on many of the former investments and allowing the latter to electively avoid this additional "progressivity-enhancing" tax.

##### 5. No Choice of Business Tax Regime for Publicly Traded Partnerships

Certain entities are mandatorily treated as corporations under Code sections or Treasury regulations other than the CTB regulations.<sup>336</sup> For example, Code section 7704 provides that, if interests in a partnership are traded on an established securities market or are readily tradable on a secondary market ("publicly traded"), the partnership will be taxed as a corporation unless 90 percent or more of the partnership's income is passive-type income.<sup>337</sup> Thus, with limited exceptions, any partnership that is publicly traded will be taxed as a corporation and will be denied its choice of business tax regime.

Hence, in order to defend the parameters of the CTB election, this denial of entity classification choice to publicly traded partnerships ("PTPs") must be explained; PTPs must be sufficiently different from other business entities so as to mandate corporate taxation.<sup>338</sup> The publicly traded partnership rules were enacted in an effort to protect the corporate tax base from erosion by certain arrangements (considered to be tax shelters), often structured as limited partnerships with hundreds or thousands of limited partners holding publicly traded interests.<sup>339</sup> Congress viewed these entities

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335. See 17 C.F.R. §§ 230.501(a), 230.505-506 (2008) (providing exemptions from registration under the Securities Act of 1933 for certain offerings to "accredited investors," which, for natural persons, generally includes high income and high net worth individuals).

336. Treas. Reg. § 301.7701-2(b)(7) (as amended in 2008). For example, this includes taxable mortgage pools. I.R.C. § 7701(i) (2008).

337. I.R.C. §§ 7704(a), (c) (2008).

338. Rather than revisiting the theories explaining the corporate tax as in Part IV.B.4 (which would yield an unsatisfactory explanation, as in Part IV.B.4), this analysis of the denial of entity classification choice to publicly traded partnerships focuses on features and issues specific to PTPs.

339. See H.R. REP. NO. 100-391(II) (1987); JOINT COMM. ON TAXATION, TAX TREATMENT OF MASTER LIMITED PARTNERSHIPS, No. JCS-18-87 (1987).

as sufficiently resembling corporations<sup>340</sup> and as conducting "activities that would otherwise be conducted in the corporate form . . . subject to two levels of tax,"<sup>341</sup> thus meriting application of the double corporate tax.

However, query the continued relevance today of this explanation for imposing the double corporate tax on these entities. While these PTPs do earn income from active businesses, the existence of an active business cannot be the distinguishing factor in determining whether an entity is mandatorily subject to corporate taxation or whether the entity is afforded a choice of classifications; active businesses are regularly conducted in LLCs, limited partnerships and general partnerships, all of which have discretion to choose their tax classification under the CTB regulations.<sup>342</sup>

The crux of the issue seems to be the existence of "public trading,"<sup>343</sup> and a theory behind the publicly traded partnership rules may be that the double corporate tax is a fee for access to the public financial markets.<sup>344</sup> However, this attempted explanation fails for a number of reasons. First, as discussed above, the corporate income tax is not generally viewed as the cost of benefits conferred, and even if it were, measuring the value of that benefit conferred would be extremely difficult.<sup>345</sup> Second, the public trading explanation for the mandatory imposition of corporate tax is both underinclusive and overinclusive given that many entities are mandatorily subject to the corporate tax even though their interests are not publicly traded (e.g., privately held corporations) and given that a number of entities have

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340. See H.R. REP. NO. 100-391(II) (1987).

341. *Id.*

342. U.S. DEP'T OF THE TREASURY, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS, BACKGROUND PAPER 12-15 (2007), available at <http://www.treasury.gov/press/releases/reports/07230%20r.pdf> (noting that unincorporated businesses represent a significant portion of active business activity in the United States). Moreover, there are many similarities among the types of businesses that are conducted in incorporated entities and unincorporated entities; there is significant overlap among the industries in which corporations and partnerships are engaged. See JOINT COMM. ON TAXATION, *supra* note 121, at 17-18.

343. Cf. A.L.I., TAXATION OF PRIVATE BUSINESS ENTERPRISE, *supra* note 160 (differentiating between private and public businesses, and only discussing the taxation of private business).

344. See Yin, *supra* note 87, at 132; see also Rudnick, *supra* note 334, at 1082-93, 1098, 1172-86 (arguing that the imposition of an additional layer of tax on public companies is appropriate based on benefits theory, ability-to-pay theory, and optimal tax theory grounds).

345. See Yin, *supra* note 87, at 132; see also Maine, *supra* note 313.

a choice of entity classification despite the fact that their interests are publicly traded (e.g., The Blackstone Group L.P. and Fortress Investment Group LLC).<sup>346</sup> Third, query why businesses that access capital from a wide array of investors through the public markets should be put at a competitive disadvantage in comparison to businesses that are able to access enough capital from larger private investors with fewer liquidity concerns.<sup>347</sup> Fourth, while optimal tax theory may suggest that revenue can be raised efficiently by imposing a higher tax burden on entities that have relatively inelastic features like public trading, the imposition of a higher tax still affects the price that investors are willing to pay for publicly traded stock, and the demand for access to capital through the public markets becomes more elastic as more companies are able to raise capital in the private markets.<sup>348</sup>

Alternatively, as was suggested by the Treasury Department when the publicly traded partnership rules were originally proposed,<sup>349</sup> it may not be public trading *per se* that explains why publicly traded entities are mandatorily taxed as corporations, but rather the fact that the existence of public trading is indicative of other corporate characteristics like limited liability,<sup>350</sup> free transferability of interests, centralized management, and continuity of life.<sup>351</sup> Thus, mandatory taxation as a corporation would be merited either because these publicly traded entities resemble

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346. See, e.g., *supra* note 316. There have been some proposals to eliminate the availability of the qualifying income exception to corporate taxation for publicly traded partnerships where the partnership receives income from specified investment advice or asset management activities. See, e.g., S. 1624, 110th Cong. (2007). This would limit the ability of partnerships to have their interests publicly traded while avoiding taxation as a corporation. *Id.*

347. See generally A.L.I., TAXATION OF PRIVATE BUSINESS ENTERPRISE, *supra* note 160, at 59.

348. See *supra* Part IV.B.4.c.

349. *Issues Relating to Pass-Through Entities: Hearings Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 99th Cong. 7, 31 (1986) (Statement of J. Roger Metz, Assistant Secretary for Tax Policy, Dep't of the Treasury) (explaining that the proposal of § 7704 "is not based on the view that publicly traded limited partnerships are different in kind from all other partnerships, but on the view that public trading in the interests of a limited partnership is indicative of the existence of the other, more relevant, classification factors").

350. Some scholars argue that it is limited liability that actually makes public trading possible. See Maine, *supra* note 313, at 251. Accordingly, levying an additional tax charge on publicly traded entities is tantamount to levying the additional charge on the benefit of limited liability. Nevertheless, limited liability is valuable for non-public companies too, so query why those companies should escape the extra tax levy if the concept is that the corporate tax imposes an additional charge on the benefit of limited liability. See *id.* at 253–54.

351. See A.L.I., TAXATION OF PRIVATE BUSINESS ENTERPRISE, *supra* note 160, at 58.

corporations or as a tax charge on the provision of the benefit conferred by one or more of these characteristics. However, the adoption of the CTB regulations explicitly rejected the use of these corporate resemblance factors in determining how a business entity should be taxed, so implicitly reincorporating these resemblance factors through the publicly traded partnership rules seems contrary to the stated rationale behind the CTB regulations.<sup>352</sup> Further, viewing the mandatory imposition of the corporate tax as a levy on these benefits runs counter to the notion that the income tax is generally not a tax in exchange for benefits conferred, and moreover, many other business entities possess these beneficial characteristics but are afforded a choice of entity classification.<sup>353</sup>

One other explanation for treating publicly traded entities differently from privately held entities is the concern that the recordkeeping burden and the administration of a pass-through taxation regime would be unwieldy and inefficient for entities that are publicly traded. The Treasury explains that generally conditioning access to the public capital markets on the use of an entity taxed as a corporation "may be of practical administrative importance, since the IRS need not depend on accurate filing by potentially thousands of partners whose interests may be constantly changing through public trading (and some of whom may be tax-exempt or foreign), nor must the IRS separately deal with each of these partners to collect any taxes due."<sup>354</sup> While some entities that are taxed as partnerships do have interests that are publicly traded,<sup>355</sup> administrability is a compelling concern. Nevertheless, this concern could be mitigated if such publicly traded entities took advantage of the simplified flow-through regime and reporting requirements for electing large partnerships,<sup>356</sup> which would reduce the recordkeeping

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352. Moreover, public trading really reflects free transferability of *economic* interests, but the Kintner regulations looked to free transferability of *governance* interests, so the public trading explanation is an imperfect fit, even with the pre-CTB analysis. *See id.*

353. *See supra* Part IV.B.4.b.

354. JOINT COMM. ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY, No. JCX-48-08, at 43 (2008). The administrability concern may be particularly compelling in specific situations, for example, where there are complex Code section 704(c) issues involving contributed property.

355. *See* The Blackstone Group L.P., *supra* note 216; Fortress Investment Group LLC, *supra* note 216. Given the relatively recent IPOs of Fortress Investments, LLC, and The Blackstone Group, L.P., it may be too early to determine the extent of the problems of tax administration caused by these types of entities. *See supra* note 316.

356. I.R.C. §§ 771-777 (1998). However, given the differences between the regular

and administration burdens. Further, partnership recordkeeping and administration is complicated for a number of reasons, and partnerships that have publicly traded interests are not necessarily more complicated (and thus more deserving of mandatory taxation as corporations) than other partnerships with complex special allocations, multiple classes of interests, significant amounts of contributed property, and frequent transfers of partnership interests and/or assets. Even with these complications, such partnerships are allowed to choose their entity classification. Moreover, even if administrability is an overriding concern meriting taxation at the entity level, query why these entities should be subject to *extra* taxation; taxation at the entity level need not necessarily imply double taxation as long as there is a way to integrate the corporate-level and shareholder-level taxes.

As with incorporated entities, the Treasury was powerless to allow elective entity classification for publicly traded partnerships.<sup>357</sup> Given that the CTB regulations were constrained by the existing statutory provisions, any regulations regarding entity classification could not undo either the double tax regime in general or corporate tax treatment for publicly traded partnerships. However, while the statutory limitations explain how it came to be that the current entity classification rules mandatorily tax publicly traded partnerships as corporations, the foregoing arguments attempting to explain why publicly traded partnerships are mandatorily classified as corporations struggle to explain why such entities *should* be treated differently than other business entities. Further, as with incorporated entities, this limitation on the availability of the CTB election is not neutral; although public trading is a relatively inelastic feature of business,<sup>358</sup> denying publicly traded partnerships the ability to choose their entity classification could distort their decisions as to how and from whom to obtain capital.

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partnership regime and the regime for electing large partnerships (“ELPs”), there may be a strategic component to a partnership’s decision whether or not to elect to be treated as an ELP. See generally ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION ¶ 9.01[19] (2008) (explaining several ways in which the tax rules for ELPs differ from the tax rules applicable to partnerships in general, many of which may impact a partnership’s decision whether or not to elect treatment as an ELP).

357. See *supra* notes 295–296 and accompanying text.

358. See Yin, *supra* note 87, at 132–33.

## 6. Evaluation of the CTB Election in Light of Its Limitations

While some limitations on the availability of the CTB election advance the goals of the explicitly elective classification system for the taxation of business entities, it is hard, in some situations, to draw a substantive, theoretically coherent distinction between where the CTB election is allowed and where it is not. Moreover, treating incorporated entities differently than unincorporated entities for tax purposes and, to a lesser extent, treating publicly traded entities differently than privately held entities for tax purposes creates the same kind of distortion of economic choices (between using different entities) that the CTB election purported to eliminate.<sup>359</sup> The lack of coherence in the boundaries of the CTB election undermines the provision of choice to those entities for which choice is allowed. Incorporated entities and publicly traded entities are "virtually indistinguishable" from other business entities, at least based on factors that have meaningful tax policy import, and hence, all business entities should be classified in the same manner. Ideally, the regimes for taxing businesses would be unified, and absent that, either all such business entities should be afforded a choice of tax classification among the multiple regimes or all such business entities should be denied the choice.

Unfortunately, progress on these issues may be hindered by the existence of the CTB regulations themselves. By claiming that it had sufficient authority to promulgate an elective entity classification system and promulgating the CTB regulations in response to the substantial flaws of the Kintner regulations, the Treasury lost the opportunity to encourage Congress to step in. Had the Treasury concluded that it lacked the authority to implement the CTB regime (as many commentators have suggested),<sup>360</sup> Congress may have reconsidered the multi-regime system for taxing business or, at the very least, entertained a more consistent approach to determining which business entities are subject to which business tax regimes.<sup>361</sup> Instead, the Treasury was forced to accept the flawed multi-regime system for taxing business and was limited to designing an entity classification system bound by the statutory limitations of the

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359. See *supra* notes 92, 115, 165, 166, 358 and accompanying text.

360. See *supra* note 108.

361. Admittedly, this is rather optimistic.



definition of “corporation” in Code section 7701(a)(3) and the publicly traded partnership rules of Code section 7704. Thus, the incoherence of the limitations on the elective entity classification system became unavoidable when the Treasury assumed the responsibility of fixing the entity classification regime in the mid-1990s. Now, even if the Treasury concludes that the entity classification system is hopelessly flawed without Congressional action,<sup>362</sup> Congress may be reluctant to accept an invitation to fix the entity classification system and multi-regime business tax system because the problems with these systems may be less compelling (at least to taxpayers) than they were in the 1990s when there was an explosion of LLCs and when there were higher tax rates applicable to dividends and capital gains.

## V. CONCLUSION

The CTB regulations represent an improvement over the Kintner regulations, at least for domestic entities. However, the last twelve years have shown that the CTB regulations are far from a panacea for all that ailed the entity classification process, even for domestic entities. Some complexity remains. Other complications were created by the new regime. Transaction costs have not been reduced as much as they could be. The benefits of flexibility in structuring business operations and transactions, while increasing the neutrality of the tax system, may be too much of a good thing, possibly causing inefficiency (deadweight loss arising from tax planning, particularly with foreign entities), harming the fisc, and failing to address inequities (e.g., that benefits are still available more for the taxpayers who can afford the most sophisticated advice). Further, a careful look at the dimensions of the CTB election reveals discrepancies between the goals of the CTB election and the election’s scope, which undermine the existence of the election itself.

These infirmities inherent in the CTB regulations put additional pressure on the fundamental question that lurks behind this entire analysis: why are there multiple regimes for taxing businesses? There has been a tremendous amount of writing on this issue, most of which condemns the multi-regime system and argues for some sort of corporate integration.<sup>363</sup> This Article does not attempt to

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362. This Article lends support to this view.

363. See, e.g., A.L.I., TAXATION OF PRIVATE BUSINESS ENTERPRISE, *supra* note 160; A.L.I.,

rehash that debate, nor does this Article advocate for any particular model for taxing business (Subchapter C, K, or S or any particular approach to corporate integration). However, the foregoing analysis demonstrates that many of the remaining policy weaknesses facing the entity classification system stem largely from the existence of the multi-regime system. The CTB regulations themselves may exacerbate this problem because, although policymakers starting anew are unlikely to choose our multi-regime system for taxing business entities with its various eligibility rules and limited-availability elections, the promulgation of the CTB regulations bridged part of the gap between the multiple different business tax regimes, possibly reducing the impetus for Congress to take the next step in the journey that created our current rules governing the taxation of businesses.

So now, even if the scope of the election is modified and the elective rules are made mandatory, little progress would be made because it is the continued existence of multiple regimes for taxing businesses that perpetuates much of the complexity, administrability, cost, efficiency, and equity problems discussed herein. As long as partnerships are taxed as conduits, corporations are subject to an entity-level tax, and conduit and entity taxation continue to produce significantly different tax results, any taxpayer forming or operating a business must analyze the different regimes and determine which regime provides better tax consequences. The need for this analysis complicates business planning, forces taxpayers to incur otherwise unnecessary transaction costs, results in a possibly inefficient allocation of resources, disadvantages taxpayers with less knowledge, sophistication and/or wealth, and means that the income tax still wields influence over taxpayers' business decisions regarding choice of entity. Further, it is the absence of a strong normative argument in favor of each of the federal income tax's multiple regimes for taxing businesses that makes it so difficult to

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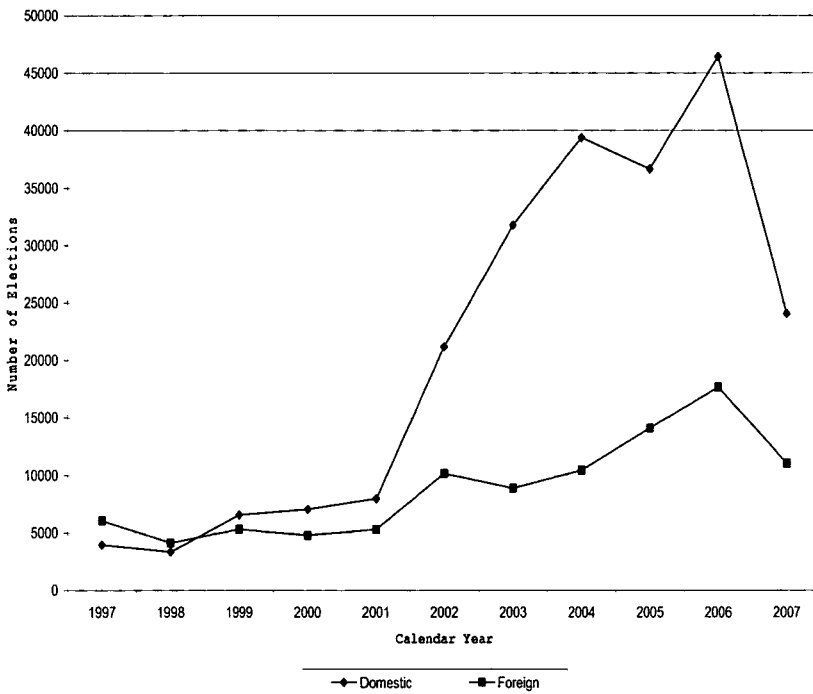
INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAX, *supra* note 248; U.S. DEP'T OF THE TREASURY, *supra* note 248; PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM ch. 5, at 94-100 (2005); Hamill, *The LLC*, *supra* note 54, at n.19 (collecting citations of articles debating the integration issue); Klein & Zolt, *supra* note 97; Kleinbard, *supra* note 261; Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229 (1998); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249 (1999); Yin, *supra* note 87.

justify the denial of entity classification choice to incorporated entities and publicly traded partnerships. Without affirmative, principled theories defending each regime (and particularly the corporate double tax) and the differences between the regimes, it becomes almost futile to argue why certain entities should be mandatorily subject to one regime or another while other entities are allowed to select their applicable regime. Thus, checking in on the check-the-box regulations suggests not only that improvements could still be made to the entity classification system, but it also underscores a fundamental problem with the continued existence of multiple business tax regimes among which taxpayers can choose, thus adding to the arguments in favor of reforming the manner in which businesses are taxed.

APPENDIX A  
 ENTITY CLASSIFICATION ELECTIONS<sup>364</sup>  
 CALENDAR YEARS 1997-2007

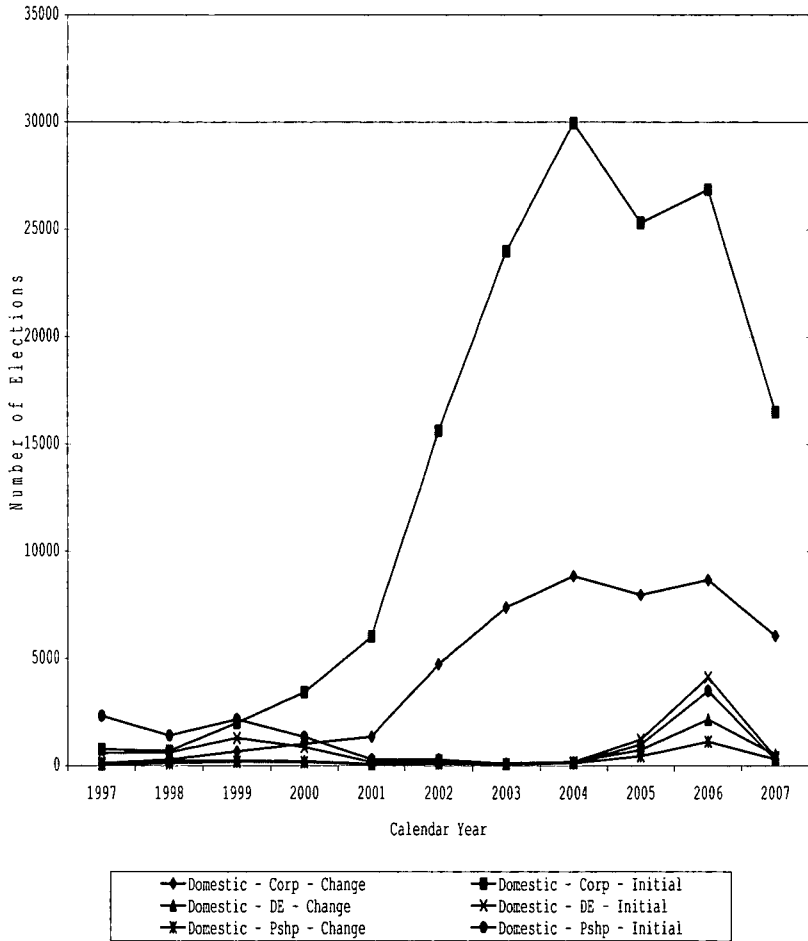
**Figure 1: Entity Classification Elections**

Total Number of Elections per Calendar Year for Domestic and Foreign Entities



364. I.R.S. Statistics of Income Division (June 2008) (unpublished data on file with author). With respect to all information reflected in Figures 1, 2, and 3 in this Appendix A, note that 2007 data is preliminary, that the counts include Form 8832s processed by Statistics of Income through June 2008, that the counts only include filings with valid and complete information, and that calendar year counts are based on the election date reported by the taxpayer and any corrections made by the Internal Revenue Service at the time of filing relative to the filing requirements.

**Figure 2: Domestic Entity Classification Elections**  
 Number of Elections by Domestic Entities per Calendar Year, by Tax Classification Elected (Corporate, Disregarded Entity, or Partnership), and by Timing of Election (Change in Status or Initial Election)



**Figure 3: Foreign Entity Classification Elections**  
 Number of Elections by Foreign Entities per Calendar Year, by Tax Classification Elected (Corporate, Disregarded Entity, or Partnership), and by Timing of Election (Change in Status or Initial Election)

