

Larry's Tax Law

Disregarded Entities Under the Checkthe-Box Regulations Are Not Disregarded for All Tax Purposes

By Larry Brant on 6.16.22 | Posted in Federal Law, IRS, Legislation

More than 25 years ago, effective January 1, 1997, Treasury issued what have been called the "Check-the-Box" regulations (the "Regulations"). The Regulations ended decades of battles between taxpayers and the IRS over entity classification. Further, the Regulations simplified entity classification and brought much needed certainty to most entity classification decisions.

Under the Regulations, a business entity with more than one owner is either classified for federal tax purposes as a corporation or a partnership.² Likewise, a business entity with only one owner is either classified as a corporation or is disregarded for federal income tax purposes as being separate and apart from its owner.³

If a business entity is disregarded, its activities are generally treated for federal tax purposes as the activities of its owner. There are five notable exceptions to that rule.

(1) Employment Taxes.

The first exception relates to employment taxes.⁴ If the single-owner entity has employees, it will **not** be disregarded for employment tax purposes.⁵

Example. X is a domestic LLC that is solely owned by A, an individual. X is disregarded as an entity separate and apart from A. X employs 75 full time workers, all of whom are properly classified as employees and receive wages for federal tax purposes. All applicable provisions of the Code relating to the payment of wages by an employer apply to X. It is not disregarded for this purpose. Consequently, X is liable for income tax withholding, FICA taxes and FUTA taxes, and all employer reporting obligations relating thereto.⁶

In accordance with Treasury Regulation § 301.7701-2T, however, a disregarded entity is **not** the employer of the owner. Consequently, the single owner is subject to self-employment tax on the self-employment income with respect to the entity's activities. Likewise, if a partnership is the owner of a disregarded entity, the entity is **not** treated as a corporation for purposes of employing a partner of the partnership that owns the entity. Rather, the entity is disregarded as an entity separate and apart from the partnership; it is **not** the employer of any partner of the partnership that owns the entity. Consequently, any partner that works for the disregarded



entity is subject to the same self-employment tax rules as any partner of the partnership itself.

(2) Excise Taxes.

The second exception relates to certain excise taxes. Specifically, this exception broadly encompasses taxes imposed by certain Chapters of the Code (i.e., Chapter 31 (retail), Chapter 32 (manufacturers), except for Code §4181, Chapter 33 (facilities and services), Chapter 34 (foreign insurers), Chapter 35(wagering), Chapter 36 (harbor maintenance), except for Code § 4461, Chapter 38 (environmental), and 49 (indoor tanning), and any floor stock taxes related thereto). The exception also includes collection of taxes imposed by Chapters 33 and 49 of the Code, registration under Code §§ 4101, 4222 and 4412, claims for credit, refund and payment relating to these taxes or under Code §§ 6426 or 6427, assessment and collection of amounts imposed by Code § 4980H, and any reporting required by Code § 6056.⁷

If an entity is liable or responsible for any of these excise taxes or reporting responsibilities, it will **not** be disregarded with respect to such taxes and reporting obligations. In essence, for these limited purposes, it is treated as a corporation.⁸

Example. X is a domestic LLC that is solely owned by A, an individual. X is disregarded as an entity separate and apart from A. X mines coal from a mine located in the United States. A tax is imposed on the sale of the coal under Chapter 32 of the Code. X is responsible for reporting and paying this tax. It is not treated as separate and apart from A for this purpose. If X did not pay any of the tax imposed under Chapter 32 of the Code on its sale of coal, any notice of lien the Service files will be filed against X (rather than A) as if X was a corporation. In

(3) Certain Federal Tax Liabilities.

The third exception relates to federal taxes. A single-owner entity will **not** be disregarded as separate and apart from its owner in the case of:

- Federal tax liabilities of the entity that relate to any period for which the entity was not disregarded¹¹;
- Federal tax liabilities of any other entity for which the entity is liable; 12 and
- Refunds or credits of federal tax.¹³

Example. X is a domestic LLC that is disregarded for income tax purposes as separate and apart from its sole owner, A, an individual. X acquires 100% of the membership interests of Z from B and C, individuals. Immediately prior to the acquisition, Z was treated as a corporation for entity tax classification purposes. After thoroughly reviewing the tax implications, X properly and timely causes an entity classification election to be filed on behalf of Z, whereby Z will be treated as a disregarded entity from the date of acquisition. After the acquisition, the Services



assesses income taxes for a tax period when Z was owned by B and C, and was treated as a corporation taxed under Subchapter C of the Code. The Service's assessment is against Z; not X, its new owner. In the event Z fails to pay the assessment, the Service's collection efforts will be aimed at Z's assets rather than its sole owner, X, or X's sole owner, A. Z is **not** disregarded as an entity separate and apart from its owner for purposes of the prior period income tax liability. Hopefully, X has claims against B and C under the acquisition agreement for a breach of the tax representations and warranties.¹⁴

(4) Banks.

The fourth exception relates to banks. If the single-owner is a bank, as defined under Code § § 581 (domestic banks) or 585(a)(2)(B) (foreign banks) without regard to the second sentence, the special provisions of the Code applicable to banks will continue to apply to the single-owner as if the entity were a separate entity.¹⁵

(5) Gifts.

A possible fifth exception relates to estate and gift taxes. In a case brought before the United States Tax Court, ¹⁶ a taxpayer transferred cash and publicly traded securities to a newly formed LLC under state law. The taxpayer owned 100 percent of the membership interests in the LLC. Thereafter, the taxpayer transferred minority interests in the LLC to trusts for the benefit of her son and granddaughter. Additionally, she sold membership interests in the LLC on a promissory note to the trusts. In the end, she transferred a total of 50% of the membership interests of the LLC to the trusts. In valuing the membership interests for federal gift tax purposes, the taxpayer applied discounts for lack of marketability and minority ownership. The Service shouted foul! It asserted that the LLC, at the time of the transfers, was disregarded for federal tax purposes as an entity separate and apart from the taxpayer. Therefore, the property being transferred was simply gifts of cash and publicly traded securities from the taxpayer to the donees, for which no discounts are appropriate.

Although subject to strong dissenting opinions, U.S. Tax Court Judge Thomas B. Wells concluded, for purposes of federal gift tax, the transfers by the taxpayer to trusts for the benefit of her son and granddaughter should be properly valued as transfers of membership interests in the LLC; the LLC, although disregarded for federal income tax purposes, should **not be** disregarded for federal gift tax purposes. Presumably, this ruling would extend to the transfer of membership interests in a single member LLC that is disregarded for income tax purposes upon the death of the member.

While the Regulations clearly brought an end to the entity classifications battles that raged in the 1970s through the late 1990s, and created simplicity and certainty for taxpayers and their advisers in many respects, the Regulations have created many nuances that must be carefully considered. One of these nuances requiring careful analysis is whether an entity treated as



disregarded under the Regulations is truly disregarded for all income tax purposes.

I will be presenting a detailed White Paper on the Regulations at the NYU Tax Conferences in July in NYC and again at the 81st NYU Institute on Federal Taxation this fall in NYC and San Diego. I hope you can attend one of these conferences.

- 1. T. Reg. § 301.7701.
- 2. T. Reg. § 301.7701-2(a).
- 3. Id.
- 4. T. Reg. § 301.7701-2(a).
- 5. T. Reg. § 301.7701-2(c)(2)(iv).
- 6. T. Reg. § 301.7701-2(c)(2)(iv)(D).
- 7. T. Reg. § 301.7701-2(c)(2)(v).
- 8. T. Reg. § 301.7701-2(c)(2)(v)(B).
- 9. T. Reg. § 301.7701-2(c)(2)(v)(C)(i) and (ii).
- 10. T. Reg. § 301.7701-2(c)(2)(v)(C)(iv).
- 11. T. Reg. § 301.7701-2(c)(2)(iii)(A)(1).
- 12. T. Reg. § 301.7701-2(c)(2)(iii)(A)(2).
- 13. T. Reg. § 301.7701-2(c)(2)(iii)(A)(3).
- 14. T. Reg. § 301.7701-2(c)(2)(iii)(B), Examples 1 and 2.
- 15. T. Reg. §§ 301.7701-2(c)(2)(ii).
- 16. Suzanne J. Pierre v. Commissioner, 133 TC 24 (2009).

Tags: Check-the-Box regulations, disregarded entities, employment taxes, entity classification, estate & gift tax, excise tax, federal tax liabilities, U.S. Tax Court