

DISREGARDED ENTITIES

Disregarded Entities: To Be Or Not To Be?

Exceptions to the general rule that a disregarded entity is treated as a “tax nothing” for tax purposes have burgeoned over the last several years.

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As practitioners regularly use disregarded entities (DREs) in estate, corporate, and tax planning, it is very important that they consider during the course of planning the growing number of instances in which DREs are considered to exist, in whole or in part, for tax purposes.

Various provisions of the Code and regulations confer “disregarded” status on an entity. This article briefly describes the four most common forms of DREs and their origins and outlines some of the more significant—but often overlooked—exceptions and modifications to the general rule that DREs are treated as “tax nothings.” Because the forms of DREs originate in different statutory and regulatory provisions, some of the exceptions and modifications are specific to only certain forms of DREs, others apply to all forms of DREs, and some are unique to grantor trusts. Practitioners should be attentive to this growing class of exceptions and modifications when tax planning for their clients.

Types of Disregarded Entities

The discussion below gives a general overview of four of the more frequently used types of DREs and their legislative creation, but there are also other miscellaneous DREs that arise primarily through the combined use of one DRE. For example, a partnership between a taxpayer and a DRE that is wholly-owned by the taxpayer does not constitute a partnership for federal tax purposes; rather, the partnership is a DRE, absent an election (under the check-the-box regulations discussed below) to be treated as a corporation.¹

Grantor Trust Rules.

The oldest form of a disregarded entity is the grantor trust. While the development of the grantor trust rules began in the early 1900s, Congress did not issue statutory guidance until 1954. That statutory guidance developed into what is commonly known today as the grantor trust rules, which are found in Subpart E of Subchapter J of the Code.²

In short, the primary result of the grantor trust rules is to tax the grantor of a trust on the trust's income if the grantor retains dominion and control over the trust (or a portion of it).³ In doing so, the grantor trust rules treat the grantor of a trust as the “owner” of the trust (or relevant portion thereof) for income tax purposes.⁴ As a result, in calculating his or her taxable income, the grantor includes the applicable portion of the trust's income, deductions, and credits.⁵

Unlike the check-the-box rules, there are conflicting views regarding the treatment of a grantor trust as a DRE. While the plain language of the Code's grantor trust rules appears to imply that a wholly grantor trust (i.e., a trust that is deemed to be entirely owned by a single individual or entity) will be disregarded for federal income tax purposes and the IRS has treated grantor trusts as DREs, at least one court has not interpreted the rules in that manner.⁶ Given the varying views on the topic, each practitioner needs to determine whether his or her particular grantor trust may be treated as a DRE. This article assumes that the grantor trust rules treat applicable grantor trusts as DREs, and will survey the exceptions and modifications that apply given such assumption.

Check-the-Box Rules.

Prior to 1997, the federal tax classification of an unincorporated business entity was determined under what were known as the "*Kintner* Regulations," which analyzed four characteristics of the entity to determine whether it more closely resembled a corporation or a partnership.⁷ In 1997, the Treasury Department showed sympathy for practitioners when it simplified the classification of unincorporated business entities by promulgating Regs. 301.7701-1, -2, and -3, now universally known as the "check-the-box" regulations.⁸

A business entity that is not automatically classified as a corporation (a "per se corporation") pursuant to the check-the-box regulations (an "eligible entity") may generally elect its classification for federal tax purposes.⁹ The default classification for a domestic eligible entity is:

- (1) A partnership if the entity has two or more members.
- (2) "Disregarded as an entity separate from its owner" if it has a single owner.¹⁰

The default classification for a foreign eligible entity is:

- (1) A partnership if it has two or more members and at least one member does not have limited liability.
- (2) A corporation if all members have limited liability.
- (3) A DRE if it has a single owner that does not have limited liability.¹¹

A member of a foreign eligible entity has limited liability if the member has no personal liability for the debts or claims against the entity by reason of being a member.¹²

Although a single-member eligible entity, such as a domestic limited liability company (LLC) with a single owner (SMLLC), is automatically treated as "disregarded as an entity separate from its owner," it may elect on Form 8832 to be taxed as a corporation.¹³ If an SMLLC does not elect to be treated as a corporation, the check-the-box regulations treat its activities "in the same manner as a sole proprietorship, branch, or division of the owner."¹⁴ Thus, except where an exception or modification exists, a non-electing SMLLC is generally ignored for federal tax purposes.

Qualified Subchapter S Subsidiary Rules.

A very common form of DRE is the qualified Subchapter S corporation (QSub). Any domestic corporation that is eligible to be a Subchapter S corporation and that is wholly owned by a Subchapter S corporation will be treated as a QSub if its parent corporation so elects.¹⁵ The QSub election is made on Form 8869. When the QSub election is made, the subsidiary is generally deemed to have liquidated into the S corporation parent.¹⁶

In general, a QSub is not treated as a separate corporation for federal tax purposes.¹⁷ All of the QSub's assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and items of income, deduction, and credit of the Subchapter S corporation parent.¹⁸ As discussed below, however, there are certain regulatory exceptions to the general rule that a QSub is not treated as a separate corporation for federal tax purposes.

Qualified REIT Subsidiary Rules.

A qualified real estate investment trust subsidiary (QRS) is a relatively specialized form of disregarded entity. A real estate investment trust (REIT) is an electing domestic corporation (or trust or other association taxable as a corporation) that meets various organizational requirements, derives most of its income from passive real property sources, distributes most of its income to its owners, and holds mainly real estate.¹⁹ REITs generally receive conduit income tax treatment for income distributed to their owners.²⁰

A QRS is a corporation (or trust or other association taxable as a corporation) which is wholly owned by a REIT and does not elect with its owner to be treated as a taxable REIT subsidiary.²¹ A QRS is not treated as a separate corporation, and, like a QSub, its assets, liabilities, and items of income, deductions, and credit are treated as those of the REIT owner.²² Thus, the corporate status of a QRS is generally ignored for federal tax purposes. As with QSubs, however, there are certain regulatory exceptions to the general rule that a QRS is disregarded for federal tax purposes.

General Exceptions and Modifications

The number of exceptions and modifications to the general rule that DREs are treated as "tax nothings" has quietly increased over the last decade. A survey of some of the more prevalent exceptions and modifications to the general rule follows.

Employment and Excise Taxes.

Shortly after the check-the-box regulations and the QSub rules were issued in the late 1990s, the IRS issued Notice 99-6.²³ This Notice announced the IRS's intention to issue guidance on the proper method for DREs to report employment taxes. It also sought public comment on the issue. Notice 99-6 set forth two methods for reporting and paying employment tax for DREs until the IRS issued its guidance. The temporary guidance said that the IRS would accept reporting and payment of employment taxes with respect to SMLLC or QSub employees if either of the following occurred:

- (1) The owner calculated, reported, and paid all employment tax obligations with respect to the DRE's employees under its own name and taxpayer identification number.
- (2) The DRE separately calculated, reported, and paid all employment tax obligations with respect to its employees under the owner's own name and taxpayer identification number.²⁴

Despite allowing a DRE to separately calculate, report, and pay employment tax obligations with respect to its employees, Notice 99-6 said that the owner would, nonetheless, retain ultimate responsibility for the employment tax obligations incurred with respect to the DRE's employees.

After almost six years, the IRS issued proposed regulations governing the treatment of DREs for employment tax and related reporting purposes.²⁵ In August 2007, the IRS finalized the proposed regulations with a few minor modifications.²⁶ Reg. 301.7701-2(c)(2)(iv) treats eligible

single-owner DREs (e.g., SMLLCs) as corporations for employment tax purposes.²⁷ Thus, the entity now must use its own taxpayer identification number when it files and pays employment taxes.²⁸ An individual owner of a DRE, however, is subject to self-employment tax and is not treated as an employee of the disregarded entity for employment tax purposes.²⁹ This special employment tax provision is applicable with respect to wages paid on or after 1/1/09.³⁰ The IRS also recently updated its *Employer Tax Guide* to reflect the final regulations.³¹

In addition, the IRS issued a similar provision with respect to certain excise tax reporting, registration, and payment obligations.³² That provision treats an eligible single-owner DRE as a separate entity for certain excise tax purposes.³³ This special excise tax rule applies to liabilities imposed and actions first required or permitted in periods beginning on or after 1/1/08.³⁴

The IRS also issued a final regulation under Section 1361 that mirrors the employment and excise tax regulation provisions promulgated under Section 7701.³⁵ Like the check-the-box regulations' rules, the QSub regulation treats a QSub as a corporation for employment and excise tax purposes only.³⁶ The regulation relating to employment taxes applies with respect to wages paid on or after 1/1/09, but the excise tax provision applies to liabilities imposed and actions first required or permitted in periods beginning on or after 1/1/08.³⁷ The IRS probably did not need to issue separate provisions under Section 1361 because Regs. 301.7701-2(c)(2)(iv) and (v) appear to cover QSubs as well as SMLLCs. The IRS did not issue special provisions with respect to REITs, but Regs. 301.7701-2(c)(2)(iv) and (v) should also cover REITs. There is no authority explicitly extending these rules to grantor trusts.

Tax Liability Considerations

A DRE, including an SMLLC, a QSub, and a QRS, is treated as a separate entity for purposes of:

- (1) Federal tax liabilities of the entity for any tax period for which the entity was not disregarded,
- (2) Federal tax liabilities of any other entity for which the entity is liable.
- (3) Federal tax refunds or credits.³⁸

The regulations setting forth these exceptions apply after 3/31/04.³⁹ The following examples illustrate these exceptions to the general rule that DREs are treated as tax nothings.

If a domestic corporation merges (pursuant to a state law merger) into a domestic SMLLC owned by an individual, the SMLLC is the successor to the corporation, for state law purposes, and is liable for all of the corporation's debts. If the IRS sought to extend the statute of limitations on assessment with respect to a liability of the corporation for a tax year prior to the tax year in which the merger occurred, the SMLLC is liable for the corporation's taxes that remain unpaid, and, therefore, is the proper party to sign the consent to extend the period of limitations.⁴⁰ The result would be the same if the SMLLC was a QSub or a QRS.⁴¹

Using this example, assume that for a tax year ending before the merger occurred the IRS determines that the corporation miscalculated and underreported its income tax liability. Because the SMLLC is the successor to the corporation and is liable for the underpayment of the corporation's taxes, the IRS may assess the deficiency directly against the SMLLC.⁴² In the event that the SMLLC fails to pay the liability after notice and demand, the IRS can file a federal tax lien against all of the SMLLC's property and its rights to property.⁴³

With respect to QSubs and QRSs, their owners are not liable for deficiencies relating to a tax year that precedes the year in which the QSub or QRS election is made, because the tax liability is for a tax year for which the QSub or QRS was not disregarded.⁴⁴ As a result, the IRS may

assess the liability only against the QSub or QRS and, in the event of a failure to pay the liability after notice and demand, may file a federal tax lien only against the QSub's or QRS's property and rights to property.⁴⁵

Another instance in which a DRE is recognized for federal tax purposes arises when the IRS is seeking to collect a tax liability from the sole member of a SMLLC. In CCA 199930013, the IRS Chief Counsel advised that the IRS could not levy on an LLC's assets, because under state law the sole member of the LLC did not own the property of the LLC. The Chief Counsel stated that the mere fact that an LLC is disregarded as an entity separate from its sole member (the taxpayer in that case) for federal tax purposes does not entitle the IRS to disregard the LLC for collection purposes.⁴⁶ The Chief Counsel added that state law determines a taxpayer's property interests for purposes of tax collection,⁴⁷ but the IRS could levy on the taxpayer's distributive interest in the LLC and sell that interest or file suit to foreclose the federal tax lien against the ownership interest.⁴⁸ In addition, depending on the facts of the case, the IRS might collect from an LLC's assets on the basis that it is the alter ego of its single-member or pursuant to a nominee or transferee liability theory.⁴⁹

TEFRA Rules.

Another exception to the general rule arises in the context of the Code's audit rules for partnerships, which were enacted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA radically changed the way in which the IRS audits partnerships for errors in reporting partnership income.⁵⁰ TEFRA's basis is found in Section 6221, which provides that "the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level."

Section 6231(a)(1)(B) excludes "small partnerships" from the TEFRA rules by excluding from the definition of a "partnership" any partnership with ten or fewer partners, each of whom is a U.S. individual, a C corporation, or an estate of a deceased partner. The small partnership exception does not apply, however, to a partnership for a tax year if any partner in the partnership during that tax year is a "pass-thru partner."⁵¹ A pass-thru partner means a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership.⁵²

The issue that arises in this context is whether a DRE that is a partner of a partnership is disregarded when determining whether the small partnership exception to TEFRA applies. The IRS has looked at this issue on at least two different occasions and, in both cases, treated an SMLLC as a separate entity. That is, the IRS determined that the SMLLC—not its individual sole member—was the partner in applying the small partnership exception to the TEFRA audit rules.⁵³ Because the SMLLC was treated as the partner and was a "pass-thru partner," as defined in Section 6231(a)(9), the small partnership exception did not apply in either case.

In CCA 200250012, IRS Chief Counsel reasoned that the statutory language indicated that Congress intended that the small partnership exception to TEFRA would not apply whenever, as a factual matter, ownership in the partnership is held through another person, regardless of the legal classification of that person. Rev. Rul. 2004-88 reached the same result, but the IRS reasoned there that state law dictated the holding. The IRS based its holding on the fact that the sole member of the SMLLC partner was not a partner of the partnership under state law; rather, the IRS found that the sole member held his partnership interest in the partnership indirectly through the SMLLC (i.e., was an indirect partner via the "pass-thru partner").

Sharing of Partnership Liabilities under Code Section 752.

Another relatively recent variance from the treatment of DREs as “tax nothings” can be found in the Section 752 regulations, which deal with the allocation of partner-level tax basis arising from partnership-level debt. Under these complex rules, partnership debt is generally allocated to the partner or partners, if any, that bear the ultimate “economic risk of loss” for the debt. For example, where a partnership debt is guaranteed by a partner, that partner generally would be allocated the debt’s entire associated tax basis. In determining which partner bears the economic risk of loss, the rules provide a general assumption that a partner is financially able to perform under any guarantee agreement irrespective of the partner’s actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.⁵⁴ As a result, tax planners were able to insert virtually valueless DREs as guarantors of partnership debt to secure the associated debt basis for use by the ultimate owners of the entities.

Final regulations published on 10/11/06 significantly modified this approach for all partners holding partnership interests through a DRE.⁵⁵ Under Reg. 1.752-2(k)(1), where a partner holds his partnership interest through a DRE, the DRE’s obligations are taken into account when determining the partner’s economic risk of loss for the partnership-level liability only to the extent of the net value of the DRE as of the date on which the partnership determines the partner’s share of partnership liabilities.⁵⁶ In the event that one or more DREs have payment obligations with respect to one or more liabilities of a partnership, the partnership must allocate the net value of each DRE among the liabilities in a reasonable and consistent manner, taking into account the relative priorities of those liabilities.⁵⁷

This special treatment of DREs in this context has been criticized by some commentators in that it uniquely singles out DREs when, in fact, any pass-through entity that limits the liability of its owners can be used to accomplish similar results without a similar net value limitation.⁵⁸ Nonetheless, the special treatment exists and represents another danger in simply ignoring a DRE as nonexistent during the course of tax planning.

State Tax Treatment of DREs.

Despite the fact that almost every state generally respects the federal classification of an SMLLC as a DRE for income tax purposes, several states impose an entity-level tax or fee on LLCs, including SMLLCs.⁵⁹ The types of taxes or fees imposed, and the SMLLCs subject to the tax, vary widely from state-to-state. Practitioners should inquire into a state’s entity-level tax on SMLLCs, and possibly other DREs, before proceeding with planning opportunities in that state.

Unlike the general conformity with federal law classification for income tax purposes, most states treat LLCs, including SMLLCs, as separate legal entities with respect to registration fees, sales and use taxes, employment taxes, and property taxes. As a result, LLCs are generally subject to liability for these taxes and fees. Additionally, most states require an SMLLC to file its own separate sales and use tax return, notwithstanding the fact that for state income tax purposes the SMLLC is disregarded.⁶⁰ On the other hand, many states allow an SMLLC and its owner to elect to file a consolidated sales and use tax return, if certain conditions are met.⁶¹ Consequently, practitioners should analyze a DRE’s tax and filing obligations state by state, so that they can fully apprise their clients of all potential taxes and fees a particular state may impose.

Grantor Trust Considerations

As mentioned briefly above, opinions differ as to whether a wholly grantor trust is considered a disregarded entity. In *Rothstein*,⁶² the Second Circuit Court of Appeals implicitly held that a wholly grantor trust was not disregarded for all income tax purposes, because the grantor received a cost basis for assets purchased from the trust. In Rev. Rul. 85-13, 1985-1 CB 184,

however, the IRS reached the opposite result on facts similar to those in *Rothstein*. That is, the IRS held that the acquisition of the trust's property by the grantor in exchange for a note could not be a sale because the grantor was both the maker and owner of the note. As a result, the grantor did not receive a new cost basis in the stock purchased from the trust.

The IRS has explicitly stated that it will not follow the Second Circuit's decision in *Rothstein*. Indeed, many estate planners rely heavily on Rev. Rul. 85-13's conclusions for a variety of estate planning techniques involving sales to grantor trusts. Consequently, the lasting impact of the *Rothstein* decision may prove negligible.

Even if disregarded for federal income tax purposes, states may not disregard a wholly grantor trust for certain purposes. For example, Pennsylvania varies from federal law regarding grantor trusts and imposes state income tax on grantor trusts according to the same personal income tax rules that apply to irrevocable trusts, unless the grantor trust is a revocable trust.⁶³ For some non-income tax purposes (e.g., sales tax), a wholly grantor trust that is disregarded for federal income tax purposes may be respected as the owner of the trust's corpus by some states. In New York, for instance, a sale between a grantor and his grantor trust could be subject to sales tax, because for sales tax purposes New York generally respects the separate existence of distinct legal entities, even though the distinction may be disregarded for federal and state income tax purposes.⁶⁴

Foreign Tax Planning Considerations

Practitioners should be aware that foreign countries may not treat U.S. grantor trusts as disregarded entities. As noted below, a wholly grantor trust is treated as a separate entity for Canadian tax purposes. Various planning opportunities may arise as a result of such divergent treatment.

Conduit Financing.

Treasury has proposed respecting DREs in an attempt to combat perceived tax avoidance achieved through the use of multiple-party financing transactions.⁶⁵ In general, a financing arrangement is a series of transactions in which one person advances money or other property or grants rights to use property and another person receives money or other property or rights to use property, the advance and receipt are effected through one or more other persons, and financing transactions link all of the entities.⁶⁶ Examples of a financing transaction include debt and any lease or license.⁶⁷

Since 1995, regulations have allowed the IRS to ignore intermediate entities participating in a financing arrangement where the intermediate entities are acting as conduit entities and to recharacterize the financing arrangement as a transaction directly between the remaining parties for purposes of imposing tax under Sections 871 and 881 and withholding obligations under Sections 1441 and 1442.⁶⁸

In December 2008, the IRS issued proposed regulations under Section 881.⁶⁹ Under Prop. Reg. 1.881-3(a)(2)(i)(C), any transaction entered into by a DRE will be taken into account for purposes of determining whether a conduit financing arrangement exists. The proposed regulation accomplishes this by stating that, for purposes of the regulations under Section 881, the term "person" includes a business entity that is disregarded as an entity separate from its single member owner under the check-the-box regulations.⁷⁰

Currently, this change to the regulation remains only proposed. The proposed regulation states that it is not effective until the date it is adopted as a final regulation.⁷¹ It is interesting to note,

however, that the Preamble to the proposed regulation states that the proposed regulations “clarify that a disregarded entity is a person for purposes of Regulation 1.881-3,” implying that the IRS does not need the proposed regulation’s change to effect this result.⁷² Consequently, practitioners practicing in this area should employ caution both before and after the proposed regulation becomes final.

Dual Consolidated Losses.

The dual consolidated loss (DCL) rules are generally intended to prevent companies with tax residency in two different jurisdictions from using the same losses to obtain tax benefits in both jurisdictions. The provisions in Section 1503(d), and the consolidated return regulations that disallow the use of a DCL, generally treat a DRE as a separate entity.⁷³ An example of a DRE to which the DCL rules may apply is the so-called “hybrid entity,” which is an entity that is disregarded for U.S. tax purposes but is subject to an entity-level income tax by a foreign country.⁷⁴ The purpose of the DCL provisions, as applied to a domestic corporation that owns a hybrid entity, is to prevent a single net operating loss (NOL) generated by a DRE from being used in both the U.S. and in a foreign jurisdiction.⁷⁵

The DCL rules apply only to a dual resident corporation (DRC). A DRC is a domestic corporation or a separate unit of the domestic corporation (e.g., a hybrid entity that is a DRE for U.S. tax purposes) that is subject to U.S. tax on its worldwide income and a foreign jurisdiction’s tax on its worldwide income or with respect to its separate unit’s worldwide income.⁷⁶ Without the general disallowance of the DCL to the DRC, use of the DCL could occur in both the U.S. and the foreign jurisdiction because the DRC could offset its own income with the NOL generated by the DRE for U.S. tax purposes, and that NOL might also be used for foreign tax purposes against income that may not be subject to U.S. tax.⁷⁷

In general, the DCL rules forbid a DRC from reducing the taxable income of any other member of its affiliated group by the amount of the DRE’s DCL unless, as provided in the regulations, the loss does not offset the income of any foreign corporation.⁷⁸ For purposes of determining the DCL, the DRE is treated as a separate entity and its income, deductions, gain, and loss are computed on a “stand alone” basis from the DRC that owns the DRE.⁷⁹ In that respect, the DRE is not treated as a disregarded entity.

Treatment by Foreign Countries

Practitioners should also be aware of the treatment of DREs by foreign countries. Canada, for example, generally does not disregard U.S. SMLLCs; rather, it treats them as corporations. Also, a grantor trust that is disregarded in the U.S. is respected as a trust in Canada. Some income tax treaties between the U.S. and foreign countries specifically address the treatment of disregarded entities (also called “fiscally transparent” entities by some treaties).

In addition to some countries treating DREs differently than the U.S., the Code contains some provisions that create special rules for certain DREs (or “fiscally transparent” entities). Section 894 generally operates to deny certain treaty benefits to a “hybrid entity” (i.e., an entity treated as fiscally transparent for U.S. income tax purposes but recognized as a separate entity for purposes of the tax law of the foreign country). Under that section, income derived by a foreign person through a fiscally transparent entity is denied the benefit of a reduced rate of withholding tax that an income tax treaty may provide if certain conditions are met. For instance, if a U.S. company makes an interest payment to an LLC that is wholly owned by a Canadian company, the payment is generally subject to the full 30% withholding rate imposed by Code section 1442(a) and is not entitled to the benefits of a reduced rate of withholding that the U.S./Canada income tax treaty would otherwise permit.

Practitioners should be cognizant of the treatment of DREs by other countries.⁸⁰ Not only can the different treatment by a foreign country present traps for the unwary, but they can also produce significant planning opportunities for U.S. individuals and businesses.

Obama Proposal.

The Obama administration recently released its 2010 budget proposals, which included a proposal that would make a regulatory change to the check-the-box regulations requiring some foreign subsidiaries to be treated as separate corporations for U.S. federal tax purposes.⁸¹ The proposal is designed to prohibit the shifting of income from one foreign subsidiary to another in a tax-haven country.⁸²

Under the proposal, a foreign eligible entity with a single owner that is organized or created in a country other than that of its single owner would be treated as a corporation for all federal tax purposes.⁸³ Existing eligible entities would undergo a deemed conversion into a corporation under the proposal, resulting in the entities incurring the usual tax consequences related to a conversion (e.g., triggering of dual-consolidated losses). Except in cases of U.S. tax avoidance, the proposal generally would not apply to a first-tier foreign eligible entity wholly owned by a U.S. person.⁸⁴

If adopted, the proposal would not take effect until 2011.⁸⁵ Given the Obama Administration's heightened scrutiny of offshore tax havens and international tax abuses, this proposal is one to monitor closely.

Conclusion

There are now several instances in which DREs are not really disregarded for tax purposes. In addition, various proposals would increase the number of exceptions/modifications to the general rule that a DRE is a "tax nothing." It is important for practitioners to keep this assortment of disclaimers in mind in advising clients with respect to tax planning using DREs. The erosion of the check-the-box regulations and other DRE provisions continues to be a trap for the unwary.

1

Rev. Rul. 2004-77, 2004-2 CB 119 (holding that where a domestic corporation and its wholly owned LLC were the only two partners in a limited partnership, the limited partnership could not be classified as a partnership for federal tax purposes, and therefore, would be disregarded for federal tax purposes, absent an election to be treated as a corporation).

2

See Sections 671 through 679.

3

See generally Section 671.

4

Section 671.

5

Id.

6

See Rothstein, 54 AFTR 2d 84-5072, 735 F2d 704, 84-1 USTC ¶9505 (CA-2, 1984) (discussed below). But see Rev. Rul. 85-13, 1985-1 CB 184.

[7](#)

The Kintner Regulations, promulgated in 1960, were derived from the case of Kintner, 46 AFTR 995, 216 F2d 418, 54-2 USTC ¶9626 (CA-9, 1954).

[8](#)

TD 8697, 12/17/96.

[9](#)

Reg. 301.7701-3(a). A business entity is any entity that is not a trust. See Reg. 301.7701-2(a).

[10](#)

Reg. 301-7701-3(b)(1).

[11](#)

Reg. 301-7701-3(b)(2)(i).

[12](#)

Reg. 301-7701-3(b)(2)(ii).

[13](#)

Reg. 301.7701-3(a).

[14](#)

Reg. 301-7701-2(a).

[15](#)

Section 1361(b)(3)(B). Certain types of corporations are not eligible to make a QSub election (e.g., insurance companies subject to tax under Subchapter L of the Code). See Section 1361(b)(2).

[16](#)

Reg. 1.1361-4(a)(2).

[17](#)

Reg. 1.1361-4(a)(1)(i).

[18](#)

Reg. 1.1361-4(a)(1)(ii).

[19](#)

Sections 856(a) and (c), and 857(a)(1).

[20](#)

See Section 857(c)(2); see also S. Rep't. No. 106-201, 106th Cong., 1st Sess. 55 (1999).

[21](#)

Sections 856(i)(2) and (l)(1).

[22](#)

Section 856(i)(1).

[23](#)

1999-1 CB 321. The Notice did not specifically mention grantor trusts or QRSs, but its stated purpose was to address issues related to entities “disregarded as entities separate from their owners for federal tax purposes.” While it was clearly intended to respond to the then recently enacted check-the-box regulations and QSub rules, the Notice should also have applied to grantor trusts and QRSs—but it would be unusual for a grantor trust or QRS to have employees.

[24](#)

Id.

[25](#)

REG-114371-05, 10/18/05.

[26](#)

TD 9356, 8/15/07. The issuance of the final regulations made Notice 99-6 obsolete as of 1/1/09.

[27](#)

Reg. 301.7701-2(a) references these special employment and excise tax rules.

[28](#)

Reg. 301.7701-2(c)(2)(iv)(C), Example ii.

[29](#)

Reg. 301.7701-2(c)(2)(iv)(A).

[30](#)

Reg. 301.7701-2(e)(5).

[31](#)

IRS Publication 15, *Employer's Tax Guide* (3/09).

[32](#)

Reg. 301.7701-2(c)(2)(v).

[33](#)

See Reg. 301.7701-2(c)(2)(v) for a list of relevant excise taxes and associated exceptions.

[34](#)

Reg. 301.7701-2(e)(6).

[35](#)

Regs. 1.1361-4(a)(7) and (8).

[36](#)

Id.

[37](#)

Regs. 1.1361-4(a)(7)(ii) and (8)(ii).

[38](#)

Regs. 301.7701-2(c)(2)(iii)(A), 1.1361-4(a)(6), and 1.856-9. Grantor trusts are not covered by these provisions.

[39](#)

Regs. 301.7701-2(e)(2), 1.1361-4(a)(6)(iii), and 1.856-9(c).

[40](#)

See Reg. 301.7701-2(c)(2)(iii)(B), Example 1.

[41](#)

See Regs. 1.1361-4(a)(6)(ii), Example 3, and 1.856-9(b), Example 3.

[42](#)

See Reg. 301.7701-2(c)(2)(iii)(B), Example 2.

[43](#)

Id.

[44](#)

See Regs. 1.1361-4(a)(6)(ii), Example 2, and 1.856-9(b), Example 2.

[45](#)

See *id.*

[46](#)

CCA 199930013.

[47](#)

Id.

[48](#)

See also CCA 200235023.

[49](#)

Id.

[50](#)

TEFRA (codified as Sections 6221 through 6234).

[51](#)

Reg. 301.6231(a)(1)-1(a)(2).

[52](#)

Section 6231(a)(9).

[53](#)

CCA 200250012; Rev. Rul. 2004-88, 2004-2 CB 165.

[54](#)

Reg. 1.752-2(b)(6).

[55](#)

TD 9289, 10/11/06. These disregarded entity rules apply to liabilities incurred or assumed by a partnership on or after 10/11/06, other than liabilities incurred or assumed pursuant to a binding written contract in effect prior to that date. See Reg. 1.752-2(l).

[56](#)

These rules do not apply to an obligation of a DRE to the extent that its owner is otherwise required to make a payment with regard to the obligation of the DRE. See Reg. 1.752-2(l). In addition, the specific DREs cited in the applicable Regulations do not expressly include grantor trusts.

57

Reg. 1.752-2(k)(3).

58

See, e.g., McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* (WG&L, 2009), ¶ 8.02[8].

59

Fenwick, McLoughlin, Salmon, Smith, Tilley, and Wood, *State Taxation of Pass-Through Entities and Their Owners* (WG&L, 2009), Appendix, Tables 8 and 9. Alabama, California, New Jersey, New York, Pennsylvania, Tennessee, and Texas are a few of the states that impose various entity-level taxes or fees on LLCs.

60

Fenwick, McLoughlin, Salmon, Smith, Tilley, and Wood, *State Taxation of Pass-Through Entities and Their Owners* (WG&L, 2009), ¶18.03.

61

Id.

62

54 AFTR 2d 84-5072, 735 F2d 704, 84-1 USTC ¶9505 (CA-2, 1984).

63

Pennsylvania Personal Income Tax Guide (03/06).

64

See e.g., Cleveland Browns Transportation LLC, TSB-A-06(8)S, 03/06/06 (sales of transportation services to an operating entity by its wholly owned and income tax disregarded LLC were recognized for sales tax purposes).

65

REG-113462-08, 12/22/08.

66

Reg. 1.881-3(a)(2)(i)(A).

67

Reg. 1.881-3(a)(2)(ii)(A).

68

Reg. 1.881-3(a)(1).

69

Supra note 65.

70

Prop. Reg. 1.881-3(a)(2)(i)(C). The proposed regulation does not expressly apply to any DREs not within the ambit of the check-the-box regulations.

71

Id.

72

Supra note 65.

[73](#)

See Reg. 1.1503(d).

[74](#)

Reg. 1.1503(d)-1(b)(3).

[75](#)

TD 9315, 3/16/07.

[76](#)

Reg. 1.1503(d)-1(b)(2).

[77](#)

TD 9315, 3/16/07.

[78](#)

Id.; Section 1503(d)(1). The DCL rules also specifically speak about situations involving “transparent entities,” which are uniquely defined for purposes of the DCL rules.

[79](#)

See generally Reg. 1.1503(d)-5.

[80](#)

There are also other narrow areas where the IRS has indicated it will treat a DRE as separate from its sole owner, such as the foreign exchange rules under Section 987 in the case of certain DREs that are qualified business units and have a different functional currency than their U.S. parent.

[81](#)

See Dept. of Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (May 2009).

[82](#)

President Obama announced the proposal during his 5/4/09 news conference regarding combating tax havens.

[83](#)

See *supra* footnote 77.

[84](#)

Id.

[85](#)

Id.