

**JOHN CUNNINGHAM'S LLC NEWSLETTER  
FOR TAX AND FINANCIAL PROFESSIONALS**

**THE CHECK-THE-BOX REGULATIONS  
IN A NUTSHELL – PART I**

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If you are a CPA or an EA and you want to help business start-up clients, the single most important federal tax authority you have to understand next to the Internal Revenue Code itself is the famous set of U.S. Treasury Department regulations known as the Check-the-Box Regulations. These regulations became effective on January 1, 1997. You have to know how to apply the Check-the-Box Regulations in two quite different types of situations:

- CLIENTS HAVE ALREADY CHOSEN BUSINESS ENTITY. In the first situation, your clients have already decided on the type of state-law business entity they want to use in their new business. In this situation, your job is to tell your clients which types of federal income tax regimens (*i.e.*, sole proprietorship taxation or taxation under Subchapters C, K or S) will be available to them if they use that entity in their new business. I'll refer to the rules you should apply in this situation as the "standard" Check-the-Box rules.

EXAMPLE. Your client Mary Doe has already formed a single-member LLC to conduct her new business. She asks your help as to tax and financial matters in setting up her business. You must apply the "standard" Check-the-Box Rules to tell her which federal income tax regimens are available for her single-member LLC.

- CLIENTS HAVE NOT YET CHOSEN BUSINESS ENTITY. In the second situation, your clients haven't yet chosen a state-law business entity. In this situation, you must first decide which federal income tax regimen will be best for your clients. You must then tell the clients which types of state-law business entities can qualify for that regimen. I'll refer to the rules you should apply in this situation as the "reverse" Check-the-Box rules.

EXAMPLE. Your client Tom Roe asks for your help in starting a new business. He hasn't yet formed or chosen any state-law business entity for his new business. You have to tell him which federal income tax regimen will be best for his business and then you have to tell him which New Hampshire state-law business entities qualify for that regimen.

In this issue of this Newsletter, I'll state and illustrate the "standard" Check-the-Box Rules. In the next issue, I'll do the same for the "reverse" rules.

## THE SIX "STANDARD" CHECK-THE-BOX RULES

- 1) (1) CLIENTS HAVE CHOSEN STATE-LAW BUSINESS CORPORATION. If your clients have chosen to use a state-law business corporation, their default federal income tax regimen is Subchapter C, but if they meet the Subchapter S eligibility and election rules, they can, of course, elect Subchapter S, using IRS Form 2553.

EXAMPLE: Your client Tom Jones has already formed a state-law business corporation for his new business. He can get Subchapter C or Subchapter S taxation, but he can't get sole proprietorship taxation.

- (2) CLIENT IS INDIVIDUAL AND HAS CHOSEN STATE-LAW SOLE PROPRIETORSHIP. If your client has chosen to use a state-law sole proprietorship, the only federal income tax regimen available to your client is sole proprietorship federal income taxation.

EXAMPLE: Same facts as above, but Tom wants to conduct his new business as a state-law sole proprietorship. He can only get sole proprietorship taxation; he can't get Subchapter C or Subchapter S.

- (3) CLIENT IS INDIVIDUAL AND HAS CHOSEN SINGLE-MEMBER LLC. If your client is an individual and has chosen to use a single-member LLC, the client's default federal income tax regimen is sole proprietorship taxation. However, the client can elect Subchapter C under IRS Form 8832, and, if he or she meets the Subchapter S requirements, the client can elect into Subchapter S (using, of course, Form 2553).

EXAMPLE: Same facts as above, but Tom wants to conduct his business as a single-member LLC. He can get sole proprietorship taxation or taxation under Subchapters C or S.

- (4) CLIENT IS ENTITY AND HAS CHOSEN DIVISION. If your client is an entity that has chosen to conduct one or more units of its business as divisions (*i.e.*, as unincorporated administrative units), these divisions will be disregarded by the IRS and their tax items will be treated as those of its owner.

EXAMPLE: Your client XYZ, Inc. is starting a new line of business and wants to conduct it through a division. XYZ can only get pass-through taxation. It can't get Subchapter C (but probably wouldn't want it anyway).

- (5) CLIENT IS ENTITY AND HAS CHOSEN SINGLE-MEMBER LLC. If your client is an entity and has chosen to conduct one more units of its business as single-member LLCs, the default federal income taxation of these single-member LLCs will be that of "disregarded entities," and the tax items of these single-member LLCs will be deemed to be those of their owner. However, if the entity

so chooses, it can elect to have its single-member LLCs taxable under Subchapter C. (This choice will, of course, be made very rarely.)

EXAMPLE: Same facts as above, but XYZ, Inc. has formed a single-member LLC to conduct its new line of business. The new single-member LLC can get either divisional tax treatment or taxation under Subchapter C.

(6) CLIENTS HAVE CHOSEN LLC OR OTHER “MULTI-OWNER UNINCORPORATED BUSINESS ENTITY”. If your clients have chosen to use an LLC or other “multi-owner unincorporated entity” then the default federal income tax regimen of your clients’ entity will be that of a partnership taxable under Subchapter K. Under New Hampshire law, there are four kinds of unincorporated multi-owner business entities – namely, (i) LLCs, (ii) general partnerships that are not limited liability partnerships, (iii) LLPs, and (iv) limited partnerships). If your clients have chosen to use any of these types of entities in their business, they can elect to have the entity taxable under Subchapter C and, if they meet Subchapter S requirements, under Subchapter S.

EXAMPLE: Your clients Tom Jones and his wife Mary have formed a two-member LLC to conduct a new business of which they will be equal owners. The default taxation of their LLC will be partnership taxation under Subchapter K. However, Tom and Mary can elect to have their LLC taxed under either Subchapter C or Subchapter S.

Next month: The eight “Reverse” Check-the-Box Rules.

I’ve discussed all of the above rules and their practical impact in considerable detail in Chapter 9 of a handbook I’ve just finished writing for New Hampshire CPAs on LLC formations and conversion practice. If you’d like a copy of this chapter, just give me a call or send me an e-mail.

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