

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

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

THE EIGHT “REVERSE CHECK-THE-BOX RULES” THAT TAX
PROFESSIONALS SHOULD KNOW HOW TO APPLY
WHEN THEIR BUSINESS CLIENTS HAVE NOT YET DECIDED
ON THE TYPE OF STATE-LAW BUSINESS ENTITY
THEY WILL USE IN THEIR BUSINESS

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The single most important task that you as a CPA, EA and other tax professional must perform for your business start-up clients is normally that of helping them to choose the best federal income tax regimen for their business. This regimen – which, depending on the facts, will be either sole proprietorship taxation or taxation under Subchapters C, K or S - will of course determine the federal income tax liability of the clients' business and of the clients themselves as business owners. It will also determine the clients' liability for Social Security Taxes. Finally, in most states (including, to a degree, New Hampshire), it will determine the state income tax liabilities of their businesses and of themselves as business owners.

However, once you have resolved this issue for your client, you must then decide how the famous Check-the-Box Regulations will apply to your clients. These regulations can apply in two quite different situations.

- Situation # 1 – Your Client Has Already Chosen State-law Business Entity. The first situation is when your clients have already formed a particular type of state-law business entity for their business (*e.g.*, a state-law business corporation or an LLC) or at least have made a final decision as to the type of entity they want. This situation requires the application of the six “standard” Check-the-Box rules. These rules are set forth in Issue No. 3 of this Newsletter (entitled “The Check-the-Box Regulations in a Nutshell”), dated October 2, 2003.

EXAMPLE. Your client Mary Jones has formed a new state-law business corporation to conduct her business. Applying Rule 1 of the above “standard” Check-the-Box Rules, you advise Mary that the only federal income tax regimens available to her business as a state-law business corporation are Subchapters C and S. Under these rules, Mary *cannot* simultaneously conduct her business as a state-law business corporation and exploit the unique tax advantages of sole proprietorship federal income taxation.

- Situation # 2 – Client Has Not Yet Chosen State-law Business Entity. The second situation is when you have advised your clients which type of federal income tax regimen will be best for their business, but your clients have not yet decided on the type of state-law business entity they want to use in conducting that business.

In this situation, you need to be familiar with the eight “reverse” Check-the-Box Rules. These rules will tell you which types of state-law business entities can qualify for the federal income tax regimen that your clients need.

EXAMPLE. Your client Mary Jones is forming a new business. You advise her that the best federal income tax regimen for her from a combined federal income tax, Social Security Tax and state tax viewpoint is sole proprietorship taxation. Now you must decide which of the available state-law entities can provide her with that regimen under the Reverse Check-the-Box Rules.

The Seven Available Types of State-law Business Entities. Under New Hampshire law and the law of most other states, there are seven main types of state-law business entities from which clients can choose in selecting the entity that will best suit their business – namely:

- (1) State-law sole proprietorships;
- (2) Divisions (*i.e.*, administrative units of entities);
- (3) Traditional general partnerships (*i.e.*, state-law general partnerships that have not elected to be limited liability partnerships (“LLPs”) under state-law law and thus have not provided their partners with at least a partial liability shield);
- (4) LLPs;
- (5) Limited partnerships;
- (6) Corporations; and
- (7) LLCs.

Obviously, the only entities among the above seven types of entities that can be used by *single*-owner businesses are sole proprietorships, single-shareholder corporations and single-member LLCs; while the entities that can be used by *multi*-owner businesses are traditional general partnerships, LLPs, limited partnerships, multi-shareholder corporations and multi-member LLCs.

The Reverse Check-the-Box Rules. As indicated above, there are eight Reverse Check-the-Box Rules. This may seem like a lot of rules to learn, but fortunately, each of the eight rules is simple to understand and apply.

The eight Reverse Check-the-Box Rules, as applicable in specific hypothetical situations, are as follows:

(1) CLIENT IS INDIVIDUAL AND WANTS SOLE PROPRIETORSHIP FEDERAL INCOME TAXATION. Your client – whom we’ll call Mary Jones - is an individual and needs *sole proprietorship federal income taxation*. Under Reverse Check-the-Box Rule 1, Mary’s state-law business entity *cannot* be a state-law business corporation, but it *can* be either:

- a) A state-law sole proprietorship; or
- b) A single-member LLC.

If, like many individuals who own single-owner businesses, Mary needs a liability shield, she must reject the use of a state-law sole proprietorship for her business and must use a single-member LLC. There is no other option. (She will need a liability shield if, for example, she has even a single employee. You never know what your employees will do to create liability for you.)

(2) CLIENT IS INDIVIDUAL AND NEEDS SUBCHAPTER C. Mary, an individual, needs *Subchapter C taxation*. Under Reverse Check-the-Box Rule 2, Mary’s state-law business entity *cannot* be a state-law sole proprietorship, but it *can* be either:

- a) A state-law business corporation; or
- b) A single-member LLC that uses a Form 8832 to make a Subchapter C election.

(3) CLIENT IS INDIVIDUAL AND NEEDS SUBCHAPTER S. Mary, an individual, wants *Subchapter S taxation*. Under Reverse Check-the-Box Rule 3, Mary’s state-law business entity *cannot* be a state-law sole proprietorship, but it *can* be either

- a) A state-law business corporation that makes an S election; or
- b) A single-member LLC that elects into Subchapter C under Form 8832 and then into Subchapter S under Form 2553.

(4) CLIENT IS ENTITY AND NEEDS DIVISIONAL FEDERAL INCOME TAXATION. XYZ, Inc., an entity, needs each of its wholly owned business units to be taxable as *divisions*. Under Reverse Check-the-Box Rule 4, these business units *cannot* be state-law business corporations, but *can* be either:

- a) Divisions; or
- b) Single-member LLCs that accept the default federal income tax classification of “disregarded entities.”

(5) CLIENT IS ENTITY AND NEEDS ITS SUBSIDIARY BUSINESS UNITS TO BE TAXABLE UNDER SUBCHAPTER C. XYZ, Inc., an entity, needs its wholly owned business units to be taxable under *Subchapter C*. Under Reverse Check-the-Box Rule 5, these units *cannot* be divisions, but they *can* be either:

- a) State-law business corporations; or
- b) Single-member LLCs that elect to be Subchapter C corporations by using Form 8832.

(6) CLIENTS ARE TWO OR MORE INDIVIDUALS OR ENTITIES AND NEED PARTNERSHIP TAXATION. Jones and Smith are two or more individuals or entities that need their jointly owned entity to be taxable as a *partnership under*

Subchapter K. Under Reverse Check-the-Box Rule 6, their state-law business entity *cannot* be multi-shareholder corporations, but it *can* be any type of multi-owner unincorporated business entity – *i.e.*, it can be either:

- a) Traditional general partnerships;
- b) LLPs;
- c) Limited partnerships; or
- d) Multi-member LLCs.

(7) CLIENTS ARE TWO OR MORE INDIVIDUALS OR ENTITIES AND NEED SUBCHAPTER C TAXATION. Jones and Smith are two or more individuals or entities that want their jointly owned entity to be taxable as a Subchapter C corporation. Under Reverse Check-the-Box Rule 7, this entity can be either:

- a) A multi-shareholder state-law business corporation that accepts the default federal income tax regimen of Subchapter C; or
- b) Any of the above types of unincorporated business entities as long as this entity elects Subchapter C by using Form 8832.

(8) CLIENTS ARE TWO OR MORE QUALIFIED SUBCHAPTER S SHAREHOLDERS AND NEED SUBCHAPTER S TAXATION. Two or more individuals or other persons (*e.g.*, individuals who are U.S. citizens, resident aliens or Qualified Subchapter S Trusts) need their entity to be taxable as a *Subchapter S corporation*. Under Reverse Check-the-Box Rule 8, this entity can be either:

- a) A state-law business corporation that makes a Subchapter S election; or
- b) Any of the above types of unincorporated business entities as long as it elects Subchapter C by using Form 8832 and then elects Subchapter S by using Form 2553.

As I mentioned above, the fact that to advise your clients as to the type of state-law entity they will need in order to obtain the federal income tax regimen they need may sound daunting. However, I can assure you that when you actually begin applying these eight rules to actual client situations, you'll find the task an easy one.

If, however, despite the above assurance, you find it difficult to get a firm grip on the six Standard Check-the-Box Rules I discussed in last month's issue of this Newsletter and the eight Reverse Check-the-Box Rules I've discussed in this one, help is on the way: In next month's issue, I'll provide a clear and practical summary of all 16 of these rules in two simple charts.