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Dealing With Entity Classification Issues

by Neil E. Harl*

The move by the Department of the Treasury in late 1996, effective January 1, 1997, to allow the choice of entity to be governed by a check-the-box system was greeted enthusiastically by most tax practitioners, many of whom had labored for years under the long-standing procedure that an unincorporated association would not be taxed as a corporation unless it had more corporate than non-corporate characteristics. Under the check-the-box system, a taxpayer could treat domestic unincorporated as partnerships or as associations (which includes corporations) on an elective basis. If no election is made, the default status is as a partnership (if the entity has two or more members) or as a disregarded entity separate from its owner if it has a single owner.

For entities that choose to not be classified under the default rules, and entities that wish to change their classification, Form 8832 is to be submitted with the election to be effective as of the date specified in the election or, if no date is specified, the date filed.

Basic choices in classification

Under the regulations, and the check-the-box system rests upon regulations, not a statutory foundation, a business entity that is not specifically classified as a corporation can elect four possible changes in classification by election. Those choices are –

• A partnership (including a limited liability company (LLC) or limited liability partnership (LLP) can elect to be an association (taxed as a corporation). The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association and immediately thereafter liquidates by distributing stock of the association to the partners of the partnership originating the transfer.

• An association can elect to be a partnership. When that occurs, the association is deemed to have distributed its assets to its shareholders who then contribute the assets to the partnership. In effect, the association is liquidated with the assets conveyed to the partnership.

• An association can elect to be an entity that is disregarded but separate from its owner. Under that scenario, the association distributes its assets and liabilities to the single owner of the association in liquidation of the association.

• Finally, a disregarded entity can elect to be an association. The owner of the disregarded entity contributes all of the entity’s assets and liabilities to the association in exchange for stock of the association.

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What are the consequences?

The regulations do not provide great detail on the tax consequences of a change in classification. However, the regulations do state that the tax treatment of a change in classification for federal tax purposes is determined under the Internal Revenue Code “...and general principles of tax law.”13

Required liquidation and dissolution of corporations. That seems to suggest that any change in classification from an association to any other type of entity necessarily involves liquidation and dissolution of the corporate entity under the guise of an association. That, of course, means two levels of income tax liability for Subchapter C corporations (one involving ordinary income at the corporate level and one at the shareholder level which may be taxed as long-term capital gains)14 and, in most instances, for a corporation under Subchapter S, a single tax event measured by the difference between the fair market value of the distribution from the S corporation and the income tax basis of the stock given up, usually at long-term capital gain rules.15 Thus, under current law, corporate liquidation is often painful, tax-wise, especially with C corporations holding appreciated property such as farmland.

What about indebtedness in excess of basis? The check-the-box options that involve a shift from partnership to partnership or partnership to association could face the issue of indebtedness in excess of basis.16 For all classification changes in the presence of indebtedness in excess of basis there is a possibility that the regulations under I.R.C. § 1001 could provide a defense to income tax liability for that indebtedness in excess of income tax basis.17 Those regulations state that a disposition of property resulting in debt relief results in gain to be reported to the extent of the excess of the debt relief over the adjusted income tax basis of the property.18 The regulations go on to state that if the disposition of property that secures a recourse liability discharges the transferor from liability (and if another person agrees to pay the liability), whether or not the transferor is, in fact, released from liability, the conditions are met for income tax to be assessed on the reportable amount.19 Thus, if the obligors continue to be liable on the indebtedness and no one else becomes liable, either by express agreement or otherwise, the regulations effectively shield the amount of indebtedness over basis from income tax.

For a non-recourse liability, a disposition is considered in all instances to be a discharge of the transferor of the liability.20 Income tax liability on the potential gain from the excess of indebtedness over basis is clearly triggered.

The check-the-box options that involve a shift from partnership to partnership could have another defensive argument to make on the issue of indebtedness in excess of basis.21 Under the regulations governing that possibility, “contributions” and “distributions” of property between a partner and a partnership are not considered sales or other dispositions of the property involved.22 That would suggest that there is no taxable gain on indebtedness in excess of basis if there is no “...sales or other dispositions...” of the property. Therefore, if a shift is contemplated from a partnership to another type of partnership, such that the transfer involves a “contribution” to the new partnership entity, the regulations may provide a way in which it can be accomplished without triggering gain on the excess of indebtedness over basis. Interestingly, those regulations under I.R.C. § 1001 provide only limited relief in reclassifications under the check-the-box regulations.

Need for revision of governing agreement. Another planning problem is that the governing agreement for the entity was, perhaps, appropriate for the way the entity was operating before a reclassification but would be inappropriate for the entity after the reclassification has occurred. Substantial amendments may be required to provide appropriate operating guidance after reclassification.

ENDNOTES

4 Treas. Reg. § 301.7702(a).
5 Treas. Reg. § 301.7701-3(b).
6 Treas. Reg. § 301.7701-3(c)(1)(iii).
7 See Littriello v. United States, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,385 (W.D. Ky. 2005), aff’d, 484 F.3d 372 (6th Cir. 2007), cert. denied, (S. Ct. 2/19/2008).
8 Treas. Reg. § 301.7701-3(g)(i)(i).
9 Id.
10 Treas. Reg. § 301.7701-3(g)(i)(ii).
11 Treas. Reg. § 301.7701-3(g)(i)(iii).
12 See Treas. Reg. § 301.7701-3(g)(i)(iv).
13 Treas. Reg. § 301.7701-3(g)(2)(i).
18 Id.
20 Id.
22 Id.