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Disregarded Entities

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This Portfolio revises and supersedes 704-2nd T.M., *Disregarded Entities.* Portfolio 704-2nd T.M. should be discarded.

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Disregarded Entities

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Disregarded Entities*, No. 704-3rd discusses the treatment of entities that are recognized as having a legal status separate from their owners for certain purposes but are disregarded for federal income tax purposes. More specifically, the three types of disregarded entities — elective classification (i.e., "check-the-box"), qualified S corporation subsidiaries, and qualified real estate investment trust subsidiaries — are examined with a focus on their qualification, formation, conversion, operation, and termination, as well as the effect of their tax treatment on taxpayers. The Portfolio also covers various transactions in which a disregarded entity can be involved (including corporate reorganizations, partnership transactions, and like-kind exchanges) and describes the tax consequences of the use of such entities in each instance. Finally, the Portfolio discusses the use of disregarded entities in cross-border transactions.

This Portfolio may be cited as Napoli, and Pisem, 704-3rd T.M., *Disregarded Entities*.

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TABLE OF CONTENTS

ISBN 978-1-63359-467-8

ISBN 978-1-63359-467-8

ISBN 978-1-63359-467-8

DETAILED ANALYSIS

I. Introduction and Entity Classification

A. Scope of Portfolio

A "disregarded entity" (referred to in this Portfolio as a DRE) is an entity that exists for legal purposes but is disregarded for all federal income tax purposes. How can an entire Portfolio be devoted to the tax implications of DREs when such entities are, by definition, disregarded for all federal income tax purposes? The answer is that such entities are not disregarded for non-tax purposes and so can affect the rights and obligations of taxpayers owning and dealing with them. Moreover, it long has been the case that tax consequences are dependent on the rights and obligations of taxpayers as those rights and obligations are defined by non-tax rules and regulations. Accordingly, creation, use, or liquidation of an entity disregarded for tax purposes has an indirect (and "indirect" should not suggest insignificant) effect on taxpayers whose non-tax relationships are affected by the entity.

This Portfolio provides a detailed analysis of entity classification as it relates to DREs, the taxation of DREs, transactions involving DREs, treatment of DRE liabilities, the application of certain Code sections to DREs, changes in ownership and/or classification of DREs, the use of DREs in reorganizations and other types of corporate transactions, the use of DREs in cross-border transactions, and state and local taxation of DREs. In addition, this Portfolio provides a discussion of two specialized types of DRE, a qualified subchapter S subsidiary (QSub) and a qualified real estate investment trust (REIT) subsidiary (QRS).

B. Entity Classification

1. General Application of the Check-the-Box Regulations

The question of whether an "organization" arises to the level of an "entity" is not necessarily answered in the same way for federal tax purposes as it is for state law purposes.[1] Similarly, an entity may be classified in one way for federal tax purposes and in a different way for state law purposes.[2]

For federal tax purposes, under the check-the-box regulations, certain organizations must be classified as corporations, and others must be classified as trusts. However, any "eligible entity" may elect to be classified either as a corporation or as a partnership (if it has more than one member) or a DRE (if it has only one owner). For domestic eligible entities, noncorporate classification is generally the default option.[3]

An eligible entity is a "business entity" that is "not classified as a corporation under sections 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8)."[4] Those paragraphs classify as a corporation:

- a business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;[5]
- a joint stock association;[6]
- an insurance company;[7]
- a bank;[8]
- a governmental subdivision;[9]
- a business entity taxable as a corporation under a provision other than §7701(a)(3);[10] and
- an enumerated foreign entity.[11]

A "business entity" is "any entity recognized for federal tax purposes … that is not properly classified as a trust under Section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code."[12]

2. Default Classifications

The check-the-box rules provide default classifications for eligible entities that do not elect another federal tax classification. Those default classifications are:

- a partnership, if the entity is domestic[13] and has two or more members;

[1] Reg. §301.7701-1(a)(1) ("Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.").

[2] *See, e.g.*, *Morrissey v. Commissioner*, 296 U.S. 344, 358 (1935) ("While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive."); *Commissioner v. Tower*, 327 U.S. 280, 287 (1946) ("[T]he Tax Court in making a final authoritative finding on the question whether this was a real partnership is not governed by how Michigan law might treat the same circumstances for purposes of state law.").

[3] Reg. §301.7701-3(a), Reg. §301.7701-3(b). For a detailed discussion of the check-the-box rules, see 700 T.M., *Choice of Entity: Business and Tax Considerations*, at III.C.

[4] Reg. §301.7701-3(a).

[5] Reg. §301.7701-2(b)(1).

[6] Reg. §301.7701-2(b)(3).

[7] Reg. §301.7701-2(b)(4).

[8] Reg. §301.7701-2(b)(5).

[9] Reg. §301.7701-2(b)(6).

[10] Reg. §301.7701-2(b)(7). For example, taxable mortgage pools and many publicly traded partnerships are taxable as corporations under such provisions. *See* §7701(i) and §7704.

[11] Reg. §301.7701-2(b)(8). The preamble to the proposed check-the-box regulations clarifies that the enumerated entities are foreign analogues to U.S. state law corporations. 61 Fed. Reg. 21,989 at 21,991 (May 13, 1996).

[12] Reg. §301.7701-2(a).

[13] Reg. §301.7701-3(b)(1)(i). A business entity is domestic if it is created or organized as any type of entity in the United States, or under the law of the United States or of any State; otherwise, it is foreign. Thus, entities that are created or organized both in the United States and in a foreign jurisdiction are domestic. Reg. §301.7701-5(a).

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• disregarded as an entity separate from its owner, if it is domestic and has a single owner;[14]

• a partnership, if it is foreign, has two or more members, and at least one member does not have limited liability;[15]

• a corporation, if it is foreign and all members have limited liability;[16] and

• disregarded as an entity separate from its owner, if it is foreign and has a single owner that does not have limited liability.[17]

3. Entities Properly Classified as Disregarded Entities (DREs)

Based on the discussion above, under the check-the-box rules, in order for a domestic entity to be considered a DRE for federal tax purposes, it must be:

• an "eligible entity"

• with a single owner

• that either (1) failed to elect to be a corporation or (2) revoked a former election to be classified as a corporation.

a. Is the Entity an "Eligible Entity?"

An eligible entity is (i) a "business entity" that (ii) is "not classified as a corporation under sections 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8)."[18] A "business entity" is "any entity recognized for federal tax purposes … that is not properly classified as a trust under Section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code."[19] Thus, to be a business entity, an organization must be (i) an "entity recognized for federal tax purposes," (ii) that is not classified as a trust, and (iii) is not subject to "special treatment."

Whether a particular arrangement rises to the level of an "entity recognized for federal tax purposes" is not always clear. The existence of an entity for federal tax purposes is distinct from its existence under local law.[20] Courts have considered whether relationships between lenders and borrowers,[21] lessors and lessees,[22] employers and employees,[23] and co-owners of property[24] should be characterized as giving rise to entities for federal tax purposes.[25] The regulations state that "[a] joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom."[26] Advisors thus must often evaluate whether an arrangement gives rise to an "entity recognized for federal tax purposes" before proceeding to a check-the-box analysis. For additional discussion of arrangements that do or do not give rise to entities for federal tax purposes, see 700 T.M., *Choice of Entity: Business and Tax Considerations*, at III.C.

Whether an entity is a "trust" may also be unclear. An organization that lacks associates and an objective to carry on business for profit may be classified as a trust under the rules contained in Reg. §301.7701-4.[27] However, the fact that an organization technically is organized in trust form (e.g., under state trust law) does not change the character of the organization if it is classified more appropriately as a business entity.[28] Under Reg. §301.7701-4(b), an organization formed as a trust that is not an arrangement to protect or conserve property for beneficiaries and that carries on a business for profit may be classified as an association or a partnership.[29] An entity organized as a trust could be subject to the check-the-box regulations and be classified as a partnership or association for federal tax purposes.

The definition of a "business entity" excludes those "subject to special treatment under the Internal Revenue Code."[30] According to the preamble to the final check-the-box regulations, Qualified Settlement Funds and Real Estate Mortgage Investment Conduits (REMICs) are examples of entities subject to "special treatment."[31] Other examples of entities subject to "special treatment," but which are disregarded for federal income tax purposes, are Qualified Subchapter S Subsidiaries (QSubs)[32] and Qualified REIT Subsidiaries.[33]

b. Does the Entity Have a Single Owner?

A DRE must have a "single owner."[34] However, neither the check-the-box regulations nor the preamble to the regulations defines an "owner" for this purpose. Practitioners may look to general debt-equity considerations and other relevant facts and circumstances.[35] Guidance from the IRS is discussed below.

(1) Upon Formation

Multiple owners of a DRE will be ignored if they are themselves DREs.

[14] Reg. §301.7701-3(b)(1)(ii).

[15] Reg. §301.7701-3(b)(2)(i)(A).

[16] Reg. §301.7701-3(b)(2)(i)(B).

[17] Reg. §301.7701-3(b)(2)(i)(C).

[18] Reg. §301.7701-3(a).

[19] Reg. §301.7701-2(a).

[20] Reg. §301.7701-1(a)(1) ("Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.").

[21] *Hartman v. Commissioner*, T.C. Memo 1958-206; *Arthur Venneri Co. v. United States*, 340 F.2d 337 (Ct. Cl. 1965).

[22] *Haley v. Commissioner*, 203 F.2d 815 (5th Cir. 1953); *Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993).

[23] *Luna v. Commissioner*, 42 T.C. 1067 (1964).

[24] Rev. Rul. 75-374; Rev. Proc. 2002-22.

[25] In other cases, courts have *not* considered whether agency or agency-like relationships between individuals and/or regarded entities have given rise to new entities for federal tax purposes, but rather have considered whether to attribute income received by a purported agent to its principal. *See, e.g.*, *Commissioner v. Bollinger*, 485 U.S. 340 (1988); *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949), *Moline Props. v. Commissioner*, 319 U.S. 436 (1943). *See also* Rev. Rul. 92-105 (interest in an Illinois land trust constitutes qualifying real property for purposes of §1031; trust arrangement is not a partnership).

[26] Reg. §301.7701-1(a)(2).

[27] Reg. §301.7701-1(b).

[28] Reg. §301.7701-4(b).

[29] *See, e.g.*, *Rost v. United States*, 44 F.4th 294 (5th Cir. 2022) (analyzing whether an entity is a trust); PLR 200219017 (purported trust is not a trust because its primary purpose is not protecting and preserving trust property).

[30] Reg. §301.7701-2(a).

[31] Preamble to T.D. 8697, 61 Fed. Reg. 66,585 (Dec. 17, 1996); §860A; Reg. §1.468B-1 through §1.468B-5.

[32] §1361(b)(3)(B), discussed in XI.A., below.

[33] §856(i), discussed in XII.B., below.

[34] Reg. §301.7701-3(a).

[35] *See* 702 T.M., *Capitalizing a Business Entity: Debt vs. Equity*.

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Example: If T owns two DREs, X and Y, and if X and Y then form a partnership under applicable local law, this partnership will be treated as having a single owner for tax purposes, because T will be treated as owning all interests in the partnership.[36]

Before the elective classification regulations were promulgated, the IRS would issue a Private Letter Ruling on certain partnership classification issues only if a purported partner whose status as such was needed to support the ruling held at least a 1% interest in each material item of the partnership's income, gain, loss, deduction, and credit.[37] No such threshold exists in the current regulations.

However, the IRS has ignored the purported existence of multiple owners under limited circumstances.[38] For example, in CCA 200501001, the Office of Chief Counsel analyzed a situation in which an LLC requested a taxpayer identification number (TIN) and indicated that it was a partnership with an individual as general partner. The individual represented that his father had become a member of the LLC at approximately the time at which the TIN was requested. After the IRS assessed employment taxes and filed a notice of federal tax lien in the name of the LLC, the LLC's authorized representative asserted that the LLC was actually a single-member entity because the father was "not a member, rather … only an investor."[39] Further, apparently, the son had reported all of the income from the LLC on Schedule C of his Form 1040 over several years.

The Office of Chief Counsel was asked, "If Son reported the income and expenses from the business in his Schedules C, and represents that he is the only member, should this be enough to consider the LLC a single-member LLC and treat it as such back to Year 1?" Chief Counsel replied, "Credible evidence that one member of an LLC reported all of the income and expenses from the LLC's business for each year of its existence and represents that he or she is now and has always been the sole owner of LLC would be sufficient to consider LLC a single-member entity unless or until there is credible evidence to the contrary." Elsewhere in the CCA, Chief Counsel said that "[o]wnership generally involves an analysis of who has the benefits and burdens and control of the entity… Thus, the determination as to whether there is more than one owner of an LLC is dependent on the facts and circumstances of each case."[40]

Similarly, a trust and a corporation owned by that trust were members in an LLC, but all profits and losses of the LLC were allocated to the trust. The corporation had only limited powers over the operation of the LLC, and the corporation's participation in the venture was intended to achieve bankruptcy-remote status for the LLC. On these facts, the IRS ruled that the LLC should be treated as owned exclusively by the trust, because the venture did not constitute an agreement to operate a business and share profits and losses between the trust and the corporation.[41] In another Private Letter Ruling, an LLC interest held by a corporation's wholly owned subsidiary was ignored when the interest held by the subsidiary included no economic rights in the venture.[42]

(2) Ownership by Spouses

Arrangements between spouses may give rise to partnerships for federal tax purposes.[43] In 2007, Congress simplified reporting for certain spouses that would otherwise file a partnership return by enacting §761(f), which provides that certain "qualified joint ventures" conducted by spouses who file a joint return will not be classified as partnerships for federal tax purposes.[44] A "qualified joint venture" is a joint venture involving the conduct of a trade or business if (i) the only members of the joint venture are spouses, (ii) both spouses materially participate (within the meaning of §469(h), disregarding §469(h)(5)) in the trade or business, and (iii) both spouses elect to apply §761(f).[45] If these requirements are satisfied, the joint venture is not classified as a partnership for federal income tax purposes.[46] Further, the tax items of the joint venture are divided between the spouses "in accordance with their interests in the venture" and each spouse must take into account that spouse's respective share of the joint venture's tax items as if the tax items were attributable to a trade or business conducted by each spouse as a sole proprietor.[47]

Rev. Proc. 2002-69 permits an entity owned solely by spouses as community property to be disregarded for federal tax purposes, as long as the entity is not otherwise classified as a corporation under Reg. §301.7701-2. The spouses may also treat the entity as a partnership.[48] If the spouses change their reporting position, the IRS will treat the change as a conversion of the entity (presumably from a DRE to a partnership or vice-versa).[49]

Rev. Proc. 2002-69 raises some difficult questions. Suppose Spouse 1 forms an LLC in a community property state, and Spouse 1 and Spouse 2 adopt the position respected under Rev. Proc. 2002-69 that the entity is classified as a partnership. If Spouse 1 and Spouse 2 then move to a non-community property state, does that work an automatic conversion of the entity into a DRE because Spouse 1 becomes the only owner? The answer may depend on how the interest is treated under state law. For example, in New York, a non-community property state, property which was acquired as community property under the laws of another jurisdiction sometimes continues to be treated as community property.[50]

[36] Rev. Rul. 2004-77.

[37] Rev. Proc. 89-12.

[38] For further discussion of this issue, see 700 T.M., *Choice of Entity: Business and Tax Considerations*, III.C.4.b.(2)–(3).

[39] It is not obvious what the authorized representative meant, since it is common for investors in an LLC to also be members of the LLC.

[40] For the proposition that ownership involves analyzing who has the benefits, burdens, and control of an entity, Chief Counsel cited *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237–1238 (1981).

[41] PLR 199911033.

[42] PLR 199914006; *see also* PLR 200201024.

[43] *Commissioner v. Tower*, 327 U.S. 280 (1946) ("There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other, purposes.").

[44] Pub. L. No. 110-28, §8215.

[45] §761(f)(2).

[46] §761(f)(1)(A).

[47] §761(f)(1)(B), §761(f)(1)(C).

[48] Rev. Proc. 2002-69.

[49] See VI., below, and Rev. Rul. 99-5 and Rev. Rul. 99-6 for the potential treatment of these conversions.

[50] N.Y. Est. Powers & Trusts Law §6-6.1, 6-6.3 (McKinney 2023).

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A second issue raised by Rev. Proc. 2002-69 is the consistency requirement imposed on classification of the entity as a partnership. The revenue procedure provides that the entity will be classified as a partnership if spouses treat the entity as a partnership and they "file the appropriate partnership returns." What if they treat the entity as a partnership, but fail to file the partnership returns; for example, what if they fail to file a Form 1065 on behalf of the entity? Does this failure cause the entity to be classified as a DRE, even if the spouses treat the entity as a partnership on separate returns? Similarly, what if one spouse treats the entity as a DRE, but the other spouse treats the entity as a partnership? Unfortunately, Rev. Proc. 2002-69 provides no default rule for inconsistent treatment and offers no analysis from which one could extend its reach.

However, the Chief Counsel's Office advised in CCA 200852001 that, based on Rev. Proc. 2002-69, an entity owned by spouses as community property was a DRE rather than a partnership because the couple had never treated the entity as a partnership or filed partnership returns for the entity after its corporate dissolution. The entity, in fact, had filed a Form 1120-S during audit after its administrative dissolution, but the Chief Counsel found no evidence that it had ever attempted to file an S corporation election or a check-the-box election to be classified as an association. Thus, according to the Chief Counsel, the entity could be classified only as a partnership or a DRE, and, though ordinarily it would be a partnership (as it had two owners), the IRS should accept the taxpayers' position, in accordance with Rev. Proc. 2002-69, that the entity was a DRE owned by the spouses as sole proprietors of a business.[51]

(3) Reduction in Number of Owners to One

Domestic eligible entities with a single owner are disregarded by default.[52] Thus, if an entity has two or more owners, but the number of owners is later reduced to one, the entity thereupon becomes disregarded. This situation is discussed in detail in VI., below.

4. Changes to Elective Classification

An elective classification change is a transaction without an actual form in the commercial world.[53] The regulations specify a form that will be applied to each type of elective conversion, thus rejecting commentators' recommendations that taxpayers be allowed to choose which form to apply to an elective classification change.[54]

The regulations treat an elective change in classification as triggering one or more deemed transactions, which differ depending upon the reclassification that is taking place.[55] The tax treatment of a change in classification is determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine.[56] This rule is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the regulations.[57]

a. Sixty-Month Limitation on Subsequent Election

Under the elective classification regulations, an "eligible entity" is permitted to change its tax classification by filing Form 8832.[58] However, once a change is elected, a subsequent elective change generally cannot be made within 60 months.[59] For purposes of this 60-month limitation, an election by a newly formed eligible entity that is effective on the date of formation (whether determined under the applicable default rule or by means of an effective election) is not considered an elective change in tax classification.[60] Thus, an entity is permitted to elect to change its tax status any time after formation, but such an election will trigger the 60-month limitation. However, the IRS may allow an entity to change its classification within 60 months of its previous election if more than 50% of the ownership interests in the entity at the time of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.[61] If an entity having multiple owners wishes to change its tax status, each owner must sign the election form, or the form must be signed by an officer, manager, or member of the electing entity who is authorized to make the election.[62] The election can be effective prospectively or retroactively to a date not more than 75 days earlier or 12 months after the date on which the election is filed.[63]

b. Timing of the Classification Change

A change of classification election is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur as the result of the change in classification are treated as occurring as of immediately before the close of the day before the election becomes effective.[64] If an elective classification change is effective at the same time as an automatic classification change resulting from a change in the number of owners, the deemed transactions resulting from the elective change pre-empt the transactions that would result from the automatic classification change.[65]

A special rule applies when a change of classification occurs incident to a purchase and §338 election. In such circumstances, a corporation's classification election cannot be effective before the day after the acquisition date of the target corporation. In addition, the transactions that are deemed to occur as

[51] *See 6611, Ltd., v. Commissioner*, T.C. Memo 2013-49, for an example of the Tax Court's similarly applying Rev. Proc. 2002-69.

[52] Reg. §301.7701-3(b)(1)(ii).

[53] Preamble to T.D. 8844, 64 Fed. Reg. 66,580 (Nov. 29, 1999).

[54] 64 Fed. Reg. 66,580, 66,581.

[55] Reg. §301.7701-3(g)(1).

[56] Reg. §301.7701-3(g)(2). See VII.B., below, for further discussion of this issue.

[57] *See* Preamble to REG-105162-97, 62 Fed. Reg. 55,768, 55,769 (Oct. 28, 1997).

[58] Reg. §301.7701-3(c)(1)(i).

[59] Reg. §301.7701-3(c)(1)(iv).

[60] Reg. §301.7701-3(c)(1)(iv).

[61] Reg. §301.7701-3(c)(1)(iv); PLR 201331001 (foreign DRE permitted classification change by election less than 60 months after a prior change where 50% ownership change to persons that did not own any interests in the entity on the filing date or effective date of the prior classification change).

[62] Reg. §301.7701-3(c)(2)(i).

[63] Reg. §301.7701-3(c)(1)(iii).

[64] Reg. §301.7701-3(g)(3).

[65] Reg. §301.7701-3(f)(2). *See* PLR 200109019 (corporation that converted into LLC under state law and filed election to be classified as association effective on date of conversion would not be classified as entity other than corporation).

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a result of the classification election will be treated as occurring immediately after the §338 transactions.[66]

c. Revoking a Former Election

Under some circumstances an entity may convert from one form of tax classification to another and then desire to return to its original classification. If the reconversion can be completed in the same taxable year as the initial conversion, it may sometimes be treated as a rescission of the initial reclassification and thereby allow the two reclassification transactions to be ignored entirely.

The Internal Revenue Manual discusses when the IRS will accept a request to withdraw a classification election.[67] For the request to be accepted, the IRS must receive the request by the due date of the "initial tax return."[68] According to the Manual, the IRS will tell untimely taxpayers that they cannot change their classification for that tax year, but may request a timely return to their default classification for the following year.[69]

In PLR 200613027, a state limited liability company taxable as a partnership changed its tax classification to that of a C corporation by filing a certificate of conversion and certificate of incorporation with the state. The change occurred in anticipation of an initial public offering. However, a dramatic change in market conditions forced a cancellation of the IPO, and the entity proposed to rescind its tax classification change before the end of the taxable year that included the original conversion. Based on a representation that the rescission was intended to restore the legal and financial arrangements of the entity and its owners to their relative positions immediately prior to the deemed incorporation, the IRS agreed that the rescission would not constitute a taxable corporate liquidation. In so ruling, the IRS cited Rev. Rul. 80-58, which allowed no gain to be recognized on the sale of property when the property was reconveyed to the seller in the taxable year of the sale.

Similarly, in PLR 200952036, a limited partnership (classified as a partnership for federal income tax purposes) changed its tax classification by filing a certificate of conversion with the state to become a corporation. It then sought to rescind the incorporation and convert to a limited liability company in the same year because of unmet investment goals. The IRS ruled that the conversion would not result in a taxable corporate liquidation because the proposed rescission was intended to restore — and no material changes had in the interim occurred to — the pre-existing legal and financial arrangements between the equity holders and the taxpayer from the time that the entity converted into a corporation. Therefore, the IRS also ruled that the converted LLC and its owners would be treated, respectively, as a partnership and partners for federal income tax purposes at all times during the tax year in question.

The IRS currently will not issue rulings or determination letters on whether a completed transaction can be rescinded for federal income tax purposes.[70]

5. Grantor Trusts

As described above, under the check-the-box rules, (i) only "eligible entities" may elect to be disregarded for federal income tax purposes,[71] (ii) "eligible entities" must be "business entities,"[72] and (iii) organizations classified as trusts under Reg. §301.7701-4 are not business entities.[73] Therefore, the check-the-box rules do not allow organizations classified as trusts under Reg. §301.7701-4 to elect to be disregarded for federal income tax purposes.

Nevertheless, certain trusts are treated similarly to DREs. Sections 671 to 679 of the Code, known as the "grantor trust rules," treat grantors (and sometimes others) who have retained certain powers over, or interests in, trusts as "owners" of portions of those trusts.[74] Section 671 provides that if such a person is an "owner" under the grantor trust rules, "there shall then be included in computing the taxable income and credits of [that person] those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust." Section 671 *does not* say that the grantor of a grantor trust is treated as the owner of that portion of the trust for all federal income tax purposes, although it also does not foreclose that result.[75] Nevertheless, taxpayers and the IRS have at times asserted that grantors should be treated as the owner of grantor trust assets, analogously to how a DRE is treated as a sole proprietorship, branch, or division of the owner.[76]

Certain sections of the Code and Regulations specify the treatment of grantor trusts. For example:

- For attributing stock ownership for certain purposes under applicable provisions of subchapter C and certain other rules, the Code attributes stock owned by a grantor trust to the person considered to be the owner of the respective portion of that trust.[77]
- For purposes of the Foreign Account Tax Compliance Act (FATCA), withholding agents must withhold 30% of certain payments to foreign financial institutions that do not agree to report information about account holders who are the deemed owners of any portion of grantor trusts.[78]
- For qualification as an S corporation, the corporation may normally only have individuals as shareholders, except that grantor trusts may be shareholders if their deemed owners are individuals who are U.S. citizens or residents.[79]
- For purposes of applying the bankruptcy or insolvency exceptions in §108, the exclusions apply only if the owner of the grantor trust is under the jurisdiction of the court in

[66] Reg. §301.7701-3(g)(3)(ii).

[67] IRM 3.13.2.27.10 (last updated Apr. 13, 2023).

[68] IRM 3.13.2.27.10(2). It is not clear whether extensions are taken into account.

[69] IRM 3.13.2.27.10(4). The Manual does not seem to contemplate withdrawing one affirmative classification to return to a previously affirmed classification, but rather only returning to a default classification.

[70] Rev. Proc. 2025-3, §3.02(8). This has been the IRS position since 2012.

[71] Reg. §301.7701-3(a).

[72] Reg. §301.7701-3(a).

[73] Reg. §301.7701-2(a).

[74] The grantor trust rules may also treat certain non-grantor persons as "owners" for these purposes. §678.

[75] Prop. Reg. §1.671-2(f) would do exactly this, but has not been finalized since it was proposed in 1996. 61 Fed. Reg. 50,786 (Sept. 27, 1996).

[76] *See* Rev. Rul. 85-13.

[77] §318(a)(2)(B)(ii), §318(a)(3)(B)(ii), §1563(e)(3)(B).

[78] §1471(c)(1)(A), §1473(2)(A)(iii)(I).

[79] §1361(b)(1)(B), §1361(c)(2).

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a Title 11 case, as the Title 11 debtor, or only to the extent that the owner of the grantor trust is insolvent.[80]

• An item of income, deduction, or credit included in computing the taxable income and credits of the grantor or another person under §671 is treated as if it had been received or paid directly by the grantor or other person.[81]

This Portfolio does not cover the taxation of grantor trusts. Moreover, this Portfolio's references to DREs are references to eligible entities classified as DREs for federal income tax purposes. For a detailed discussion of the taxation of grantor trusts, see 819 T.M., *Grantor Trusts (Sections 671–679)* (Estates, Gifts and Trusts Series).

[80] Reg. §1.108-9(a)(2), §1.108-9(a)(3).
[81] Reg. §1.671-2(c).

ISBN 978-1-63359-467-8

II. General Taxation of DREs

A. General Rule — Entity Is Disregarded

With limited exceptions (discussed in II.C., below), IRS documents use language almost identical to the language in §856 and §1361 (related to qualified REIT subsidiaries and qualified subchapter S subsidiaries) to describe the characteristics of all DREs.[82] Accordingly, all DREs are treated similarly; all assets, liabilities, and tax attributes are passed through to the regarded owner of the entity.

A DRE does not file its own tax return; instead, all items of income, gain, deduction or loss attributable to the DRE are included on the tax return of the owner, which, in the case of an individual, might be Form 1040 or 1040SR, Schedule C, *Profit or Loss from Business (Sole Proprietorship)*.[83] A DRE owned by an individual taxpayer is essentially treated as a sole proprietorship for federal income tax purposes.

> *Example:* Individual taxpayer T owns a DRE that operates a business. The business generates $20,000 of income. The business is considered a sole proprietorship for federal tax purposes. In other words, the existence of the DRE is ignored, and T must report the $20,000 of income on Form 1040.

For a DRE with a corporate owner, all tax attributes would be reflected on the corporation's Form 1120, as if the entity were a division of the corporation.[84] A partnership that owns a DRE would reflect the entity's operations on the partnership's Form 1065.

B. Self-Employment Tax

A taxpayer-owner of a DRE is not considered an employee of the DRE. Thus, a DRE's taxpayer-owner is subject to self-employment tax on self-employment income with respect to the entity's activities.[85] The taxpayer-owner is also subject to backup withholding under §3406.[86]

> *Example:* Individual taxpayer T owns a DRE that operates a business. The business generates $20,000 of net income. T must report the $20,000 of income on Form 1040, and that income is subject to self-employment taxes.

C. Circumstances Under Which DRE Is Treated as Regarded Entity

1. Employment Taxes

Generally, entities that are disregarded for income tax purposes are not disregarded for employment tax purposes; instead, for such taxes, they are treated as corporations and must obtain an EIN.[87] The DRE must comply with tax withholding requirements, pay Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes, and file all forms with the IRS and Social Security Administration under its own name and EIN.[88] However, they remain disregarded for purposes of backup withholding and self-employment taxes.[89]

> *Example:*[90] Individual taxpayer T owns a DRE. The DRE has employees and pays wages. The DRE is classified as an entity separate from T (as a corporation) for purposes of employment taxes. Thus, the DRE is subject to the provisions in subtitle C and, therefore, is liable for income tax withholding, FICA taxes, and FUTA taxes. The DRE must file under its name and EIN all the applicable Forms (e.g., Form 941, "Employer's Quarterly Employment Tax Return," Form 940, "Employer's Annual Federal Unemployment Tax Return") and must file with the Social Security Administration. The DRE must also furnish to its employees Form W-2, "Wage and Tax Statement" and make timely employment tax deposits. Note, however, that T is subject to tax under §1401 on T's net earnings from self-employment with respect to the DRE's activities and is not considered an employee of the DRE. T is able to deduct trade or business expenses paid or incurred with respect to activities carried on through the DRE, including the employer's share of employment taxes, and A is subject to backup withholding and self-employment taxes.

Under previous versions of the regulations, taxpayers tried to use the DRE's separate treatment for employment tax purposes to allow a partner to be treated as an employee of the partnership,[91] notwithstanding the IRS's view that, for federal income tax purposes, an individual cannot be treated as an employee of a partnership in which the individual is a partner.[92] This perceived loophole was closed by the addition of Reg. §301.7701-2(c)(2)(iv)(C)(*2*), which clarifies that a DRE is not treated as a corporation for purposes of employing a partner of a partnership that owns the entity.[93] Rather, the entity is disre-

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[82] *See, e.g.*, FAA 20150301F ("Treas. Reg. 301.7701-2(b)(1) provides that a single member limited liability company ('LLC') that does not elect otherwise is disregarded as an entity separate from its owner. A disregarded LLC's 'activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.' Treas. Reg. 301.7701-2(a). Therefore, the assets and liabilities of a DRE are treated as the assets and liabilities of its owner."); Prop. Reg. REG-154159-09 ("The activities of an entity that is a DRE are treated in the same manner as a sole proprietorship, branch, or division of the owner (except for certain employment and excise tax rules). Accordingly, for federal income tax purposes, all assets, liabilities, and items of income, deduction, and credit of a DRE are treated as assets, liabilities, and such items (as the case may be) of the owner of the DRE.").

[83] Pub. 334, *Tax Guide for Small Businesses*; Pub. 3402, *Taxation of Limited Liability Companies*; Instructions for Schedule C. Alternatively, an individual taxpayer could report the activities of a DRE on Form 1040 or 1040SR, Schedule E, Supplemental Income or Loss, or Form 1040 or 1040SR, Schedule F, Profit or Loss from Farming.

[84] *Single Member Limited Liability Companies*, IRS (Aug. 19, 2022), https://www.irs.gov/businesses/small-businesses-self-employed/single-member-limited-liability-companies; Instructions for Form 1120.

[85] Reg. §301.7701-2(c)(2)(iv)(C)(*2*).

[86] Reg. §301.7701-2(c)(2)(iv)(C)(*1*).

[87] Reg. §301.7701-2(c)(2)(iv)(A), §301.7701-2(c)(2)(iv)(B).

[88] Reg. §301.7701-2(c)(2)(iv)(B).

[89] Reg. §301.7701-2(c)(2)(iv)(C)(*1*), §301.7701-2(c)(2)(iv)(C)(*2*).

[90] Reg. §301.7701-2(c)(2)(iv)(D).

[91] T.D. 9766, 81 Fed. Reg. 26,693 (May 4, 2016).

[92] *See* Rev. Rul. 70-411; Rev. Rul. 69-184 (restricting bona fide partners from being treated as employees for certain purposes).

[93] T.D. 9766, 81 Fed. Reg. 26,693 (May 4, 2016).

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garded as an entity separate from the partnership, and the partner of the partnership is subject to the same self-employment tax rules that would apply if the entity did not exist.[94]

Example: An LLC/DRE is wholly owned by an entity taxed as a partnership. Individuals A and B own the partnership. The LLC/DRE is not treated as a corporation for purposes of employing A or B. The LLC/DRE is disregarded as an entity separate from the partnership for employment purposes and is not the employer of A or B. Thus, net earnings from the LLC/DRE that flow through the partnership to A and B are subject to self-employment taxes.

Disregarded entities also remain disregarded for certain employment tax exceptions related to family members or members of the same religious faith, such that the owner of the DRE is treated as the employer for purposes of the exceptions.[95] For example, §3101 and §3111 of the Federal Insurance Contributions Act impose on every "individual" and "employer" a tax equal to 6.2% of the "wages" received by the individual or paid by the employer with respect to "employment."[96] Section 3121(b)(3) provides that "employment" does not include certain services performed between family members. Reg. §31.3121(b)(3)-1(d) provides that services performed in the employ of a corporation *do not* qualify for this family member exception, *except* that DREs that are normally treated as corporations for employment tax purposes remain disregarded for purposes of this exception, such that employers that are disregarded for federal income tax purposes may still qualify for this exception. For the family member exception, the single owner of the DRE is treated as the employer.[97] A similar analysis applies for the Federal Unemployment Tax Act.[98]

2. Excise Taxes

A disregarded entity is treated as separate from its owner for purposes of certain excise taxes and related collection, assessment, registration, payment, credit, and refund issues.[99] For these excise tax purposes, the disregarded entity is treated as a corporation separate from its owner.[100]

Example:[101] A disregarded LLC, LLCB, is wholly owned by B and is engaged in the activity of mining coal. Because LLCB is treated as separate from its owner, B, LLCB is considered the producer of the coal and is liable for an excise tax on the sale of the coal under §4121. LLCB must file a Form 720, *Quarterly Federal Excise Tax Return,* under its own name and TIN. If LLCB later used diesel fuel in a nontaxable way, it could claim a credit or payment pursuant to §6427. If LLCB did not pay tax on the sale of coal or otherwise became liable for a deficiency on its excise taxes, any notice of lien would be filed as if LLCB were a corporation.

3. Prior Tax Obligations

A DRE is respected as an entity separate from its owner for purposes of federal tax liabilities from any period for which the entity was regarded, federal tax liabilities of any other entity for which the entity is liable, and refunds and credits of federal tax.[102] The regulations provide two examples of the application of these provisions.

Example (1):[103] X is a domestic corporation that merges into Z, a disregarded LLC that is wholly owned by Y. Under state law, as a result of the merger, Z is liable for all of X Corp.'s liabilities. Accordingly, if the IRS seeks to extend the period of limitations for one of X Corp.'s tax years when it was in existence, Z LLC, not its regarded owner, Y, is the proper party to sign the consent because it is the successor of X Corp.

Example (2):[104] Assume the facts in *Example (1),* above. Assume, instead, that, as a result of an examination, the IRS determines that X Corp. miscalculated and underreported its income tax liability for a year that it was in existence. Because Z LLC is the successor to X Corp.'s liabilities, including unpaid tax liabilities, the IRS will seek to collect the deficiency from Z LLC. If needed, the IRS may use collection mechanisms like a general tax lien against Z LLC, not its regarded owner, Y.

4. Reporting Requirements of DREs Wholly Owned by a Foreign Person

A DRE is treated as a corporation separate from its owner for purposes of the reporting requirements in §6038A if the entity is a domestic entity and a foreign person has direct or indirect sole ownership of the entity.[105] This makes the entity a "reporting corporation" for purposes of §6038A, and the entity, therefore, is required to file Form 5472 for any year in which the entity engages in certain "reportable transactions"[106] and maintain records sufficient to establish the accuracy of the treatment of these transactions.[107] Reg. §1.6038A-2(b)(11) contains examples of the treatment of DREs for purposes of §6038A.

5. Partnership Audit Procedures

Section 1101 of the Bipartisan Budget Act of 2015 enacted a "centralized partnership audit regime" in which adjustments for any partnership-related item are generally determined, and

[94] Reg. §301.7701-2(c)(2)(iv)(C)(*2*).

[95] Reg. §301.7701-2(c)(2)(iv)(B), §31.3121(b)(3)-1(d), §31.3127-1(b), §31.3306(c)(5)-1(d).

[96] §3101(a), §3111(a).

[97] Reg. §31.3121(b)(3)-1(d) (last sentence).

[98] §3106 (imposing tax on every "employer"), §3306(c)(5) (exempting certain family relations from the definition of "employment"); Reg. §31.3306(c)(5)-1(d) (not extending family exception to services performed in employ of a corporation, *except* for a DRE that is treated as a corporation for employment tax purposes).

[99] Reg. §301.7701-2(c)(2)(v).

[100] Reg. §301.7701-2(c)(2)(v)(B).

[101] Reg. §301.7701-2(c)(2)(v)(C).

[102] Reg. §301.7701-2(c)(2)(iii).

[103] Reg. §301.7701-2(c)(2)(iii)(B) *Ex.* 1.

[104] Reg. §301.7701-2(c)(2)(iii)(B) *Ex.* 2.

[105] Reg. §301.7701-2(c)(2)(vi)(A).

[106] Reg. §1.6038A-2(a).

[107] Reg. §1.6038A-3.

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any tax assessed and collected, at the partnership level.[108] Certain "eligible partnerships" may elect out of this regime, leading to the determination, assessment, and collection of partnership-related tax items at the partner level. Eligible partnerships are partnerships with 100 or fewer partners and for which each statement the partnership was required to furnish under §6031(b) was furnished to an "eligible partner" for the entire taxable year.[109] A DRE is specifically listed in the regulations as a partner that is *not* an eligible partner,[110] meaning that if a partnership has any DREs as partners for any part of a taxable year, it is not eligible to elect out of the §6221 centralized audit regime for that year. However, under the centralized audit regime, DREs can serve as the partnership representative.[111] Therefore, an entity otherwise disregarded may be regarded by the IRS for purposes of partnership audit elections and procedures.

For a detailed discussion of the post-2017 partnership audit rules, see 629 T.M., *The Partnership Audit Rules Under the Bipartisan Budget Act*, and for a discussion of the pre-2018 partnership audit rules, see 624 T.M., *Audit Procedures for Pass-Through Entities.*

6. FBAR

A U.S. person with a financial interest in or signatory authority over foreign financial accounts worth an aggregate amount of $10,000 or more at any point during the calendar year must electronically file a FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).[112] FBAR is governed by Title 31 of the U.S. Code, not the Internal Revenue Code; therefore, the treatment of DREs for tax purposes under the Internal Revenue Code is irrelevant for purposes of FBAR.[113] An entity, including but not limited to, a corporation, partnership, trust, or LLC created, organized, or formed under the laws of the United States, any state, the District of Columbia, a territory or insular possession, or Indian tribe is considered a U.S. person for FBAR purposes.[114] Therefore, domestic DREs, such as LLCs, must file an FBAR report independent of their owners if they meet the requirements. Owners of these DREs might also have an FBAR reporting obligation with respect to the accounts reported by their DREs.

7. Conduit Financing Regulations

The conduit financing regulations allow Treasury to disregard the involvement of certain intermediate entities in multiparty financing transactions. These regulations address the concern that borrowers and lenders will attempt to use intermediate "conduit entities" to seek the benefits of income tax treaties or other tax benefits to which they would otherwise not be entitled.[115] Reg. §1.881-3(a)(1) allows the existence of the conduit entity to be disregarded and the financing transaction to be recharacterized as occurring directly between the borrower and the lender. However, to be recharacterized under the regulations, the financing arrangement must meet certain technical requirements. One requirement is that the financing arrangement be "effected through one or more other persons (intermediate entities)…"[116] For purposes of that section, the term "person" includes DREs.[117] Therefore, an entity that is otherwise disregarded for tax purposes may be regarded as a party for purposes of applying the conduit financing regulations.

8. Valuation of Gifts of Interests

In some cases, courts have given effect to the existence of a DRE in valuing gifts and charitable contributions of interests in DREs. The distinction between viewing the transaction as a gift of an interest in an entity (which ignores the entity's "disregardedness") and viewing it as a gift of an interest in an entity's assets is important, because valuation discounts may cause an interest in an entity to be worth less than a proportionate share of the entity's assets.

In *Pierre v. Commissioner*,[118] the taxpayer formed a single-member LLC that was disregarded for tax purposes and transferred $4.25 million in cash and marketable securities to the LLC. The taxpayer then gifted partial membership interests in the LLC to two trusts.[119] On the taxpayer's gift tax return, the gift was valued as a non-managing interest in an LLC, with a resulting discount as compared to the value of the underlying assets. The IRS argued that, since the entity was disregarded for tax purposes, the gift should be valued as a gift of the underlying assets. The court sided with the taxpayer, noting that the historical approach of the gift tax regime was to use state law to determine the nature of the property interest to be valued. Under state law in that case, the taxpayer owned no direct interest in the assets of the entity and was considered only to own, and thus to transfer, interests in the entity itself. Therefore, the LLC interests, not the underlying assets, were the property to be valued for gift tax purposes.

The Tax Court reached a similar conclusion in a different context in *RERI Holdings I, LLC v. Commissioner*.[120] In *RERI Holdings*, the taxpayer donated interests in a DRE to a charitable organization and claimed a §170 charitable deduction based on the undiscounted value of the assets held by the DRE. The court followed *Pierre* in determining that the interest in the entity was the proper asset to be valued, not the underlying assets.

D. TIN Issues Under §6109 and §7701 Regulations

1. Income Taxes

Every U.S. person and many non-U.S. persons filing a return under the Internal Revenue Code must include on the re-

[108] Pub. L. No. 114-74 (amending §6221 *et seq*).

[109] Reg. §301.6221(b)-1(b)(1).

[110] Reg. §301.6221(b)-1(b)(3)(ii)(D). Qualified subchapter S subsidiaries are also not eligible partners. Reg. §301.6221(b)-1(b)(3)(ii)(G).

[111] Reg. §301.6223-1(b)(1).

[112] 31 C.F.R. §1010.350; Pub. 5569, *Report of Foreign Bank and Financial Accounts (FBAR) Reference Guide*. See 6085 T.M., *Report of Foreign Bank and Financial Accounts (FBAR)*, for a detailed overview of the FBAR rules.

[113] Pub. 5569, at 1.

[114] 31 C.F.R. §1010.350.

[115] *See, e.g.*, Peter M. Daub, *The Conduit Regulations Revisited*, 146(9) Tax Notes 409, 410 (2015); 6460 T.M., *U.S. Income Taxation of Foreign Corporations*, at IV.H; 6855 T.M., *U.S. Income Tax Treaties — The Limitation Benefits Article*, at II.C.

[116] Reg. §1.881-3(a)(2)(i)(A).

[117] Reg. §1.881-3(a)(2)(i)(C).

[118] 133 T.C. 24 (2009).

[119] At the same time, the taxpayer sold the remaining interests in the LLC to the trusts for notes reflecting an appraisal of the interests at the discounted value.

[120] 143 T.C. 41 (2014).

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turn a so-called taxpayer identification number (TIN), as required by the forms and accompanying instructions.[121] This obligation exists not only for forms requiring the filer's TIN, such as Forms 1040, 1065, and 1120, but also for information forms requiring another's TIN, such as Forms 1099-INT, 1099-DIV, and 1099-MISC. Taxpayers who are the owners of DREs or who are transacting with such an owner will likely encounter issues relating to TINs of DREs. This section describes special rules relating to these issues.

Generally, a DRE does not have its own EIN and must "use" its owner's TIN for federal tax purposes.[122] However, this rule applies only "except as otherwise provided in regulations or other guidance."[123] For example, as described in II.C.1. and II.C.2., above, DREs with employees must obtain an employer identification number for employment and excise tax purposes.[124] If a DRE becomes separately regarded and does not already have its own EIN, it must acquire one and not use the TIN of the single owner.[125]

Reg. §301.6109-1(h)(2)(i) provides that an entity with an EIN "will *retain* that EIN if its federal tax classification changes under §301.7701-3."[126] The regulations thus appear to distinguish between a DRE's *using* a TIN, as in Reg. §301.6109-1(h)(2)(i), and its *retaining* an EIN for later use, as in Reg. §301.6109-1(h)(1).

The following example illustrates when a DRE "retains," but does not "use," a TIN.

> *Example 1:* A contributes cash to newly formed X LLC, which elects to be classified as a corporation for federal income tax purposes under Reg. §301.7701(c)(1)(i) and obtains an EIN. Sixty months and one day after the effective date of the election, X changes its election such that it is disregarded as separate from its owner for federal income tax purposes. *See* Reg. §301.7701-3(b)(3)(ii). Under Reg. §301.6109-1(h)(1), X *retains* its EIN. However, under Reg. §301.6109-1(h)(2)(i), X *uses* the TIN of its single owner for federal tax purposes. If, 60 months and one day later, X again elects to be classified as a corporation, then under Reg. §301.6109-1(h)(2)(ii), X would use its "old" EIN that it had retained.

Contrast this distinction between "retaining" and "using" a TIN with Rev. Rul. 2001-61, in which the IRS addressed which EIN an entity should use under the following facts:[127]

> *Example 2:* X, an eligible entity classified as a partnership, becomes a DRE for federal tax purposes when the entity's ownership is reduced to one member. (See, for example, Rev. Rul. 99-6.) X calculates, reports, and pays its employment tax obligations under its own name and EIN.[128]
>
> On these facts, the IRS concluded that X must (i) continue to use its EIN for employment tax purposes but (ii) use the TIN of its owner "[f]or all federal tax purposes other than employment obligations or except as otherwise provided in regulations or other guidance." This concept of using multiple EINs for different tax purposes is not immediately evident from the regulations. However, because a DRE "uses" its owner's TIN "except as otherwise provided in regulations or other guidance," the ruling is consistent with the regulations.[129]

2. *Form W-9*

Those obtaining the TIN of a U.S. person for an information return or for purposes of being relieved of an obligation to withhold, such as payors of interest and dividends to certain taxpayers, typically request it using Form W-9.[130] Payees who do not complete and return Form W-9 risk subjecting themselves to the backup withholding regime, under which payors withhold 24% of certain "reportable payments," including interest and dividends.[131] Additionally, under §1446, transferees

[121] §6109(a); Reg. §301.6109-1(b), §301.6109-1(c). Although the §6109 regulations use the term "taxpayer *identifying* number," it is common (even for the IRS) to say "taxpayer identification number." *See, e.g.,* Taxpayer Identification Numbers (TIN), https://www.irs.gov/individuals/international-taxpayers/taxpayer-identification-numbers-tin (last updated Oct. 3, 2022). Social security numbers, individual taxpayer identification numbers, and employer identification numbers are all examples of TINs. Reg. §301.6109-1(a)(1)(i).

[122] Reg. §301.6109-1(h)(2)(i).

[123] Reg. §301.6109-1(h)(2)(i).

[124] Reg. §301.7701-2(c)(2)(iv)(A), §301.7701-2(c)(2)(iv)(B) (employment taxes); §301.7701-2(c)(2)(v)(A), §301.7701-2(c)(2)(v)(B) (excise taxes); §301.7701-2(c)(2)(iv)(D) *Ex.* ii (must obtain EIN for employment tax purposes); §301.7701-2(c)(2)(v)(C) *Ex.* ii (must obtain EIN for excise tax purposes). *See also* Do You Need an EIN? at https://www.irs.gov/businesses/small-businesses-self-employed/do-you-need-an-ein (last updated Apr. 7, 2023).

[125] Reg. §301.6109-1(h)(2)(ii). *See also* Instructions to Form 8832, Page 6 (Rev. Dec. 2013). The regulations add that if a DRE has an EIN and later becomes separately regarded, then the newly regarded entity must use the EIN it obtained when it was disregarded, rather than the TIN of its single owner.

[126] Reg. §301.6109-1(h)(1) (emphasis added).

[127] The revenue ruling also addressed another example: "Y is a DRE for federal tax purposes. Y calculates, reports, and pays its employment tax obligations under its own name and EIN. Y becomes a partnership for federal tax purposes when the entity's ownership expands to include more than one member." On these facts, the IRS concluded that Y must continue to use its EIN for "all federal tax purposes as a partnership." This follows from Reg. §301.6109-1(h)(2)(ii).

[128] Before January 1, 2009—the effective date of the finalized employment tax DRE regulations, discussed below—Notice 99-6 allowed two methods to calculate, report, and pay employment taxes with respect to employees of DREs. The DRE's owner could calculate, report, and pay employment taxes under the owner's name and TIN as if the employees of the DRE were employed directly by the owner, or the DRE could separately calculate, report, and pay its employment tax obligations under its own name and TIN. Notice 99-6 was obsoleted by the finalized regulations. T.D. 9356, 72 Fed. Reg. 45,892 (Aug. 15, 2007). Now, as discussed below, the regulations generally require a DRE to calculate, report, and pay its employment tax obligations under its own name and TIN.

[129] Reg. §301.6109-1(h)(2)(i).

[130] §6042, §6049 (requiring information returns to be completed by payors of certain dividends and interest, respectively); Reg. §1.6042-2(a)(1), §1.6049-4(b)(1) (requiring information return to be completed on Form 1099); General Instructions for Certain Information Returns ("If the recipient is a U.S. person … the IRS suggests that you request the recipient complete Form W-9."). *See also* Form W-9 General Instructions ("An individual or entity … who is required to file an information return with the IRS … must obtain your correct taxpayer identification number … to report on an information return the amount paid to you, or other amount reportable on an information return.").

Certain recipients of payments *must* complete Form W-9. For example, those receiving interest payments and dividends subject to backup withholding must complete Form W-9 unless the payor provides a substantially similar form. Reg. §31.3406(d)-1(b)(3) (requiring a payee who receive dividends and interest subject to backup withholding to certify its TIN to the payor using the certificate provided in §31.3406(h)-3), §31.3406(h)-3(a) (generally providing that Form W-9 is the form on which the payee certifies its TIN).

[131] §3406(a), §3406(b)(1)(A), §3406(b)(2)(A)(i), §3406(b)(2)(A)(ii).

ISBN 978-1-63359-467-8

of a partnership interest in some cases must withhold 10% of the amount realized on the transfer unless the transferee relies on some certification that the transferor is not foreign, including a completed Form W-9.[132] A completed Form W-9 may also be used to certify that a taxpayer is not foreign for purposes of the Foreign Investment in Real Property Tax Act (FIRPTA).[133]

Form W-9's instructions direct taxpayers how to complete the form when DREs are involved. This guidance is summarized below.[134]

Lines 1 and 2 (name): The instructions provide that "[t]he name of the entity entered on line 1 should *never* be a DRE. The name on line 1 should be the name shown on the income tax return on which the income should be reported." If the payee is a DRE, the DRE's name should be entered on line 2. If the owner of the DRE is foreign, then the owner must complete Form W-8 instead of Form W-9, even if the foreign person has a U.S. TIN.

Line 3 (federal tax classification): The instructions for line 3 state that "a single-member LLC that is disregarded from the owner should check the appropriate box for the tax classification *of its owner*." The specific instructions elaborate that a single-member LLC owned by an individual and disregarded for federal tax purposes should check the box for "individual/sole proprietor." Further, an LLC that is a DRE but owned by an LLC that is *not* disregarded should select "Limited liability company" and provide the owner LLC's federal tax classification.[135]

Lines 5 and 6 (address): The instructions say to "enter *your* address" and "enter *your* city, state, and ZIP code." Although it is unclear whether these instructions apply to the DRE or its owner, in the context of the instructions, it is likely that the address requested is that of the person named on line 1.

Part I (TIN): the instructions provide that a disregarded single-member LLC enters the SSN or EIN of its owner, *not* its own EIN. Presumably DREs other than single-member LLCs do the same. The instructions also suggest that DREs with an individual owner may use a TIN other than an SSN, such as an Individual Taxpayer Identification Number (ITIN), if the owner does not have an SSN.

Part II (Certification): the instructions require that the person identified on line 1 (that is, the single owner) sign the form.

[132] §1446(f); Reg. §1.1446(f)-2(a), §1.1446(f)-2(b)(1), §1.1446(f)-2(b)(2).
[133] Reg. §1.1445-2(b)(2)(v).
[134] *See* Form W-9, General Instructions.
[135] Although the specific instructions refer only to disregarded LLCs owned by regarded LLCs, presumably this rule applies to all DREs owned by regarded LLCs.

ISBN 978-1-63359-467-8

III. Transactions Between a DRE and Its Owner

A. Transactions Generally Disregarded

As discussed in II.A., above, all tax items attributable to a DRE are included on the tax return of its owner. If a person is the sole owner of a DRE and that person sells an asset to the entity, the owner is essentially "selling" the asset to itself. Thus, there is no sale for federal income tax purposes, no amount of gain or loss realized, and no change in basis.[136] It does not matter whether a transaction is "upstream," "downstream," or between two DREs with a single owner, as illustrated by the examples below.

Example 1: Owner owns all of the membership interests of A, a limited liability company that is disregarded as separate from Owner for federal income tax purposes. Owner sells Blackacre to A. The sale does not give rise to any amount realized or change in basis. The result is the same if instead A sells Blackacre to Owner.

Example 2: Same facts as Example 1, except Owner also owns all of the membership interests of B, a limited liability company that is disregarded as separate from Owner for federal income tax purposes. A sells Blackacre to B. The sale does not give rise to any amount realized or change in basis. The result is the same if instead B sells Blackacre to A.

B. DREs as Partners

If a taxpayer holds a partnership interest through a DRE, the limited liability achieved by that structure may affect the partner's share of liabilities of the partnership, as discussed in further detail in IV.D., below.

If a DRE and its owner are the sole partners in a local law partnership, the resulting entity is itself a DRE for federal income tax purposes, since it is treated as having only a single owner.[137]

C. Loans Between a DRE and Its Owner

If a person is a sole owner of a DRE and lends money to, or borrows money from, that DRE, there is no loan for federal income tax purposes, because persons cannot lend money to themselves. Thus, the lender (whether it is the DRE or its sole owner) does not realize interest income, and the borrower does not incur interest expense. If the lender cancels the debt, there is no realization of cancellation-of-indebtedness income.

D. Payments for Performance of Services

Persons are not considered to receive compensation for services performed for themselves. Therefore, payments between a DRE and its sole owner for services do not create income or deductions.

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[136] *Compare* James Dobson, 1 B.T.A. 1082 (1925) (taxpayer bid on and won his own shares offered at auction; "this transaction, of course, did not constitute a sale . . . since one cannot sell things to himself, the sale was nugatory"); Rev. Rul. 55-77; *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (asserting that gain is realized when it is "severed from the capital").

[137] *See* Rev. Rul. 2004-77, discussed above in I., above. Note that the resulting entity could alternatively elect to be treated as an association.

ISBN 978-1-63359-467-8

IV. Treatment of DRE Liabilities

A. Characterizing DRE Debt as Recourse or Nonrecourse

1. Definition of Recourse and Nonrecourse Debt

Whether an obligation is recourse or nonrecourse matters for various purposes of the Code. An obligation is generally "recourse" if the borrower has personal liability for the debt; an obligation is nonrecourse if the lender can only recover against particular assets.[138] Generally, if a creditor's right of recovery is limited to a particular asset securing the liability, the liability is nonrecourse. If a creditor's right of recovery extends to all assets of a taxpayer, the liability is recourse.[139]

As discussed below, the characterization of a liability as recourse or nonrecourse is especially relevant when property is transferred to a creditor in satisfaction of a debt. If the debt is nonrecourse, this transaction is treated in its entirety as a taxable exchange, with the amount of the debt that is discharged included in the amount realized.[140] The taxpayer-owner does not realize COD income on the exchange.

2. DRE Debt Characterization

Liabilities of a DRE are generally treated as liabilities of the owner of the entity for federal tax purposes. However, the IRS has taken the position that even if DRE debt is recourse at the entity level, if the taxpayer-owner has not personally guaranteed the debt and has limited liability for the entity's debts under state law, the taxpayer-owner is not personally liable for the DRE debt and, therefore, that debt is characterized as nonrecourse indebtedness of the taxpayer-owner for purposes of the Code.[141]

Each of PLR 202050014 and PLR 201644018 involved a lower-tier disregarded LLC that transferred property to creditors in exchange for debt cancellation. In both rulings, the LLCs transferred cash and stock or stock rights in controlled entities to creditors in final satisfaction of their debt. The IRS ruled that, because the owners did not have personal liability for the LLC indebtedness under state limited liability provisions, the debt would be treated as nonrecourse. The transaction was therefore treated as a taxable exchange with the amount of the discharge going into the amount realized by the owner. In both PLRs, the debt cancellation was part of a larger tax-free reorganization of the corporate group under §368(a)(1)(G), so the owner ultimately did not realize gain or loss on the exchange.

B. Discharge of DRE Debt

1. Transfer of Asset to Creditor — Amount Realized Under Reg. §1.1001-2

Under the §1001 regulations, if debt is discharged in consideration of the sale or other disposition of property, the tax treatment of the transaction depends on whether the debt is recourse or nonrecourse. The amount of any debt that is discharged in such a transaction is generally included in the amount realized.[142] However, in the case of a recourse liability, if the amount of the debt discharged exceeds the fair market value of the asset, the excess is income under §61(a)(12) from the discharge of indebtedness (commonly called "cancellation of debt" or "COD" income) and not included in the amount realized.[143] There are several exclusions available under §108 for COD income, including an insolvency exclusion which generally allows a debtor to exclude COD income if the debtor is insolvent.[144]

If the debt is nonrecourse, the entire amount discharged is included in the amount realized, even if the amount of the discharged debt exceeds the fair market value of the property.[145] No part of the transaction represents COD income taxable under §61(a)(12), and the exclusions under §108 do not apply to the transaction.

> *Example (1):* An insolvent multi-member LLC owns property with a fair market value of $1 million, an adjusted basis of $800,000 subject to recourse debt of $1.2 million. The LLC transfers the property to the lender in full satisfaction of the debt. Because the debt is recourse, the LLC has an amount realized on the transfer of the property equal to $1 million (the fair market value of the property), thus recognizing $200,000 of gain on the transfer ($1 million fair market value minus $800,000 basis). The difference between the amount of discharged debt ($1.2 million) and the fair market value of the property ($1 million) is COD income. However, the LLC is likely able to exclude the $200,000 of COD from income because it was insolvent.

> *Example (2):* An insolvent multi-member LLC owns property with a fair market value of $1 million, an adjusted basis of $500,000 subject to nonrecourse debt of $1.2 million. The LLC transfers the property to the lender in full satisfaction of the debt. Because the debt is nonrecourse, the LLC has an amount realized on the transfer of the property equal to $1.2 million (the full amount of the discharged debt, despite the fact that this amount exceeds the fair market value of the property) and, thus, recognizes $400,000 of gain on the transfer ($1.2 million amount realized minus $800,000 basis).

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[138] Reg. §1.1001-2(c). *E.g., Commissioner v. Tufts*, 461 U.S. 300, 302 (1983); *Raphan v. United States*, 759 F.2d 879, 885 (Fed. Cir. 1985); *Great Plains Gasification Assocs. v. Commissioner*, T.C. Memo 2006-276; Reg. §1.1001-2(c) (examples associating recourse debt with personal liability); Reg. §1.752-1(a) (recourse liability is one for which a partner or related person "bears the economic risk of loss. . ."); Reg. §1.465-27(b)(5) (treating DRE financing as qualified nonrecourse financing by reference to §1.465-27(b)(4) based on the personal liability of members).

[139] *See, e.g.*, CCA 201525010.

[140] *Frazier v. Commissioner*, 111 T.C. 243, 245 (1998); *Gehl v. Commissioner*, 102 T.C. 784, 785 (1994).

[141] *See, e.g.*, PLR 202050014, PLR 201644018; CCA 201525010; FAA 20150301F (Issue 1).

[142] Reg. §1.1001-2(a); *see also Tufts*, 461 U.S. 300.

[143] Reg. §1.1001-2(b), §1.1001-2(c) *Ex.* 8.

[144] *See* §108(a)(1)(B).

[145] §7701(g); *Commissioner v. Tufts*, 461 U.S. 300, 302; *Frazier v. Commissioner*, 111 T.C. 243, 245 (1998); *Great Plains Gasification*, T.C. Memo 2006-276; Reg. §1.1001-2(c) *Ex.* 7.

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As discussed above, if the taxpayer-owner of a DRE has limited liability for the debts of the entity, the lack of personal liability could make the debt nonrecourse to the taxpayer-owner regardless of the characterization of the debt at the entity level.[146] If the debt of the entity is discharged, it should be treated as the discharge of nonrecourse indebtedness for the taxpayer-owner.

Example (3): Taxpayer A is the sole owner of X LLC, an insolvent DRE for federal income tax purposes. X LLC owns Blackacre, which has a fair market value and basis of $80. X LLC owes $100 to creditor B. The debt is secured by a mortgage on Blackacre, and B has recourse to all of X LLC's assets. Thus, the debt is recourse at the entity level. X LLC transfers Blackacre to B in satisfaction of its debt and then dissolves as an entity under state law. If X LLC were a regarded taxpayer, then X LLC would recognize $20 of COD income on the exchange ($100 of debt discharged minus $80 fair market value of property) because the debt would be recourse. However, because X LLC is a DRE, the treatment of the transaction is determined with reference to A. The debt is nonrecourse to A because of state limited liability provisions which limit A's personal liability to the amount of capital contributed to X LLC.[147] Therefore, the transaction is treated as if Blackacre were sold to B for $100 (the amount realized). A recognizes $20 of gain, equal to the difference between the $100 amount realized and the $80 of basis in Blackacre.

2. Transfer of Interest in DRE to Creditor

The treatment of the relief from debt owed by a DRE is even clearer if interests in the DRE are transferred to creditors, instead of the entity's assets. As discussed in VI., below, a transfer of the interests in a DRE is characterized as a transfer of the entity's assets.[148]

Example: Taxpayer A is the sole owner of X LLC, an insolvent DRE for federal income tax purposes. X LLC owns Blackacre, which has a fair market value and basis of $80. X LLC owes $100 to creditor B and owns no other assets. The debt is secured by a mortgage on Blackacre, and B has recourse to all of X LLC's assets. A transfers all of the interests in X LLC to B, effectively in satisfaction of X LLC's debt. Because the interests in X LLC are disregarded for federal tax purposes, the exchange is not considered a sale of entity interests, but is, instead, treated as a sale of the assets of the DRE. The debt is nonrecourse to A because of state limited liability provisions which limit A's personal liability to the amount of capital contributed to X LLC. Therefore, A is treated as transferring Blackacre to B in satisfaction of a nonrecourse debt. The amount realized is $100, A's basis is $80, and A recognizes $20 of gain on the exchange.

3. Mezzanine Financing Transaction

The characterization of the debt discharge transaction would change if a taxpayer-owner of a DRE and a lender engaged in a mezzanine financing transaction in which the lender lent money to the taxpayer-owner on a recourse basis secured by the taxpayer-owner's interest in the DRE. In that case, the debt would be recourse to the taxpayer-owner.

Example: A borrows $100 from B on a recourse basis secured by A's interest in X LLC, a DRE. X LLC owns Blackacre, which has a fair market value and basis of $80. A transfers the interest in X LLC to B in full satisfaction of the debt. This transaction is treated as a transfer of Blackacre to B, but A would recognize $20 of COD income on the discharge of the recourse liability. A's amount realized would therefore be $80, resulting in no gain or loss on the exchange of Blackacre, but $20 of ordinary income from the COD inclusion.

C. Significant Modification of Debt — Reg. §1.1001-3

If the terms of a debt instrument are modified, the modification may result in a taxable exchange of the old debt instrument for the modified debt instrument under *Cottage Savings Association v. Commissioner*[149] and the §1001 regulations.[150] A change in the obligor and a change in the recourse nature of the debt instrument are considered modifications,[151] but only a "significant modification" results in a taxable exchange.[152] A change in the classification of an eligible entity under the check-the-box regulations may result in there being a new obligor of the entity's liabilities for tax purposes; likewise, a change in the status of the entity may change whether the entity's debt is considered recourse or nonrecourse for purposes of the Code. However, the legal status of the entity under local law likely remains the same despite the tax classification change, leaving the rights of the entity's creditors unchanged. In this situation, the question is whether the formal modification resulting from the change in classification should be considered a "significant modification" for purposes of Reg. §1.1001-3.

The general rule for determining whether a significant modification has occurred is whether "the legal rights or obligations that are altered and the degree to which they are altered are economically significant."[153] Under this definition, a tax classification change that does not affect an entity's status under local law presumably should not result in a significant modification. However, some modifications are considered significant modifications *per se*, including most changes in the oblig-

[146] *See, e.g.*, CCA 201525010; FAA 20150301F (Issue 1).

[147] *See, e.g.*, *Great Plains Gasification*, T.C. Memo 2006-276 (partnership debt that was discharged in foreclosure sale was "in substance nonrecourse where lender's recovery was effectively limited to encumbered assets by the terms of the loan and partnership agreement).

[148] *See* Rev. Rul. 99-5; PLR 201421001 (applying Rev. Rul. 99-5 to a distribution by a trust of interests in a DRE to the trust's beneficiaries).

[149] 499 U.S. 554 (1991).

[150] Reg. §1.1001-3.

[151] Reg. §1.1001-3(c)(2)(i).

[152] Reg. §1.1001-3(b).

[153] Reg. §1.1001-3(e)(1).

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or of a recourse instrument,[154] recourse debt's becoming nonrecourse debt, and nonrecourse debt's becoming recourse debt.[155]

There are some important exceptions to these *per se* rules. In the case of a change in obligor, the modification is not considered significant if the new obligor acquires "substantially all of the assets of the original obligor" (assuming the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration).[156] If a recourse debt instrument becomes a nonrecourse debt instrument, there is no significant modification if the instrument continues to be secured only by the original collateral, and the modification does not result in a change in payment expectations.[157]

When a regarded entity becomes a DRE, the resulting changes in the nature of any outstanding debt at the entity level may fall under the exceptions to the *per se* rules. For example, if an LLC that is classified as an association for federal tax purposes elects to be classified as a DRE, the owner of the association would be deemed to receive all of the assets and liabilities of the association in a complete liquidation.[158] For tax purposes, the obligor on any outstanding debt would change from the association to the owner. However, the "new" obligor would be considered to have acquired substantially all of the assets of the association in the liquidation, thereby qualifying for the exception to the *per se* rule.

If the debt were recourse to the LLC, the change from association to DRE could cause the liability to be recharacterized as nonrecourse for federal tax purposes because the regarded owner would not have personal liability for the DRE's debt. However, both before and after the classification change, the creditors of the entity would only have access to the assets of the LLC itself. Therefore, any deemed change from recourse to nonrecourse as a result of an eligible entity becoming disregarded should not result in any change in the original collateral or the payment expectations of the creditors. Thus, the exception to the *per se* rule in Reg. §1.1001-3(e)(5)(ii)(B)(*2*) should apply.

The application of the *per se* rules is different if a DRE becomes regarded. Under local law, the result is the same: the legal rights and obligations of the creditors remain unchanged. However, for tax purposes, the changes no longer seem to qualify for the exceptions to the *per se* rules.

For example, if a disregarded LLC elects to be classified as an association for tax purposes, the owner of the LLC is deemed to contribute all the assets and liabilities of the entity to a newly formed corporation.[159] For federal tax purposes, the obligor of the debt could be considered to change from the owner of the formerly disregarded entity to the newly regarded association, even though there has been no change in obligor under local law.[160] If the owner of the LLC owns assets outside the entity, then the association may not have acquired substantially all of the assets of the original obligor, so the exception to the *per se* rule may not apply. If the debt was recourse to the LLC, then before the election, it could have been considered nonrecourse to the owner of the LLC for tax purposes. After the election, the debt would be recourse to a regarded association. There is no exception to the *per se* significant modification rule for debt that changes from nonrecourse to recourse. Therefore, while the creditors are in the same economic position that they were before the election, a significant modification of the entity's debt obligations would seem to result under the §1001 regulations.

The same result — a significant modification for tax purposes with no underlying modification in substantive legal rights — could follow from a change in status that results automatically from a change in the number of owners.[161] If an ownership interest in a DRE is sold to a new member such that the entity becomes a partnership under the §7701 regulations,[162] the rights of the creditors may be unchanged, but, for tax purposes, the new obligor is the partnership.

The IRS has considered whether a change in entity status under the check-the-box regulations constitutes a significant modification for purposes of §1001 in various PLRs.[163] Each addresses a situation in which a regarded entity becomes a DRE, and they therefore do not resolve the more problematic issue of changes from disregarded to regarded. However, part of the basis for the ruling in each PLR is that federal tax law looks to state law to determine legal entitlements.[164] The PLRs note that, under state law, the legal relationship of the creditors to the entity would be unchanged by the new tax classification. Accordingly, the first PLR to address the issue ruled that there was no modification at all as a result of the classification change.[165] The other PLRs consistently ruled that there had been no *significant modification* as a result of the change but did not go as far as to say that there had been no modification at all. Indeed, the later PLRs expressly hold that a modification did occur as a result of the substitution of a new obligor, but that the modification was not significant because it qualified for one of the exceptions to the *per se* rule.[166] The same conclusion was reached in a Chief Counsel Advice Memorandum that considered whether an election that changed the classification of a corporation to a partnership would be considered a significant modification.[167]

Despite the variations in reasoning, all the PLRs seem to indicate that the consequences of the transaction for purposes of Reg. §1.1001-3 should be determined with reference to the legal rights and obligations of the parties under local law and

[154] Reg. §1.1001-3(e)(4)(i)(A).

[155] Reg. §1.1001-3(e)(5)(ii)(A).

[156] Reg. §1.1001-3(e)(4)(i)(C).

[157] Reg. §1.1001-3(e)(5)(ii)(B)(2).

[158] Reg. §301.7701-3(g)(1)(iii).

[159] Reg. §301.7701-3(g)(1)(iv).

[160] Various PLRs, discussed below, consider the situation in which a regarded entity becomes a DRE, but none considers the issue of a DRE becoming regarded. Moreover, while the PLRs rely on local law to justify a finding that there has been no significant modification of the debt, only one found that there had been no modification at all as a result of the modification, with the others declining to go that far. *Compare* PLR 200315001 *with* PLR 201010015; PLR 200709013.

[161] *See* discussion in VI.A., below.

[162] Reg. §301.7701-3(f)(2); Rev. Rul. 99-5.

[163] PLR 201010015, PLR 200709013, PLR 200630002, PLR 200315001.

[164] *E.g.*, PLR 201010015 (citing *Aquilino v. United States*, 363 U.S. 509, 513 (1930); *Morgan v. Commissioner*, 309 U.S. 78, 82 (1940)).

[165] PLR 200315001 ("In these circumstances, the restructuring will not effect an alteration that results in either a change of obligor or a change in the recourse nature of the Debt for purposes of Section 1.1001-3(c)(2)(i).").

[166] PLR 201010015, PLR 200709013. *See also* AM 2011-003 ("A corporation's change in entity classification to a partnership under §301.7701-3 results in a substitution of a new obligor under §1.1001-3.").

[167] AM 2011-003.

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without regard to the characterization under federal tax law. The same reasoning applies to classification changes that result in a disregarded corporation becoming regarded, but the formal exceptions to the *per se* rules would likely not apply. The situation has not been considered by IRS guidance, however, so the treatment remains somewhat uncertain.[168]

D. Application of §752

A partner's basis in a partnership interest is determined in part by the partner's share of the partnership's liabilities.[169] Under the §752 regulations, a partner's share of a liability depends on the recourse or nonrecourse nature of the debt.[170] A liability is considered recourse for these purposes to the extent that a partner or person related to a partner bears the economic risk of loss for the liability.[171] On the other hand, a liability is considered nonrecourse to the extent that no partner or related person bears the economic risk of loss.[172]

A partner bears the economic risk of loss for a liability to the extent that a partner would be obligated to make a payment to any person if the partnership constructively liquidated and the liability became due and payable.[173] The economic risk of loss determination looks to the partner's obligations under local law,[174] so, if a partner is a limited partner or otherwise has limited liability, then that partner generally does not have an obligation to pay any amount upon a constructive liquidation.[175] However, if a person has an obligation, it is generally assumed that the person will satisfy that obligation regardless of ability to pay, subject to certain exceptions.[176]

Disregarded entities cause difficulties in applying the assumption that obligations will be satisfied. The liabilities of a DRE are considered the liabilities of its owner for purposes of the tax law. However, if a partner owns a partnership interest through a DRE, the limited liability provisions under local law may protect the partner from the economic risk of loss. An assumption that the partner would satisfy the obligations of the entity therefore may not be consistent with the reality of the situation.[177] A recourse liability of the entity is considered a liability of the owner, but the owner's liability is effectively nonrecourse, and the owner does not bear the economic risk of loss.[178]

Previous versions of the §752 regulations applied a "net value" rule that took the obligations of a DRE into account only to the extent of the value of the entity's assets that could be subject to creditors' claims under local law.[179] The obligations of the DRE were nonrecourse to the partner-owner to the extent that the owner had no obligation to pay the liabilities of the entity, and the entity's liabilities exceeded the value of its assets.[180] The net value rules were reserved by temporary regulations issued in 2016;[181] final regulations issued in 2019 formally rejected the net value rule and introduced a new facts and circumstances test to determine whether there is a commercially reasonable expectation of payment.[182] One justification for the change of the net value rule was that it took into account only the current value of an entity's assets and not its potential future earnings; a lender might consider both factors.[183]

Under the current regulations, an obligation of a partner to make a payment is not recognized if there is not a "commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable."[184] While the section applies to the obligations of a *partner*, the determination of whether there is a commercially reasonable expectation of payment applies to the *payment obligor*. This separates the inquiry in the case of a DRE: the owner of the DRE is considered to be the partner for tax purposes in all circumstances, but the payment obligor may be the DRE itself.

Examples in Reg. §1.752-2(k)(2) apply the test to obligations of DREs, though the test is not necessarily confined to that context. In Reg. §1.752-2(k)(2), Example 1, taxpayer A forms a wholly owned LLC in 2020. In the same year, A contributes $100,000 to the LLC. A has no liability for the debts of the LLC, and the LLC has no rights of contribution from A. The LLC contributes the $100,000 to a limited partnership, and taxpayers B and C contribute $100,000 each. Under the partnership agreement, only the LLC is required to restore a deficit in its capital account. On January 1, 2021, the partnership borrows $300,000 from a bank and uses the proceeds of the loan and the $300,000 cash on hand to purchase a non-depreciable property worth $600,000. In 2021, the partnership makes only interest payments on its debt and has a net taxable loss for the year. The partners' shares of the $300,000 in debt are determined at the end of the taxable year. LLC's only asset at that time is the limited partnership interest.

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[168] For further discussion of the issue, see 181 T.M., *Time Value of Money — Holders of Debt Instruments*, VIII.B, 182 T.M., *Time Value of Money — Issuers of Debt Instruments*, XIII.B.2.d.(1)(b), and 6585 T.M., *Collateralized Loan Obligations*, II.D.

[169] §752. For a detailed discussion of the allocation of partnership liabilities, see 714 T.M., *Partnerships — Allocation of Liabilities; Basis Rules.*

[170] Reg. §1.752-2, §1.752-3.

[171] Reg. §1.752-1(a)(1).

[172] Reg. §1.752-1(a)(2).

[173] Reg. §1.752-2(b)(1).

[174] Reg. §1.752-2(b)(3)(i)(C).

[175] Reg. §1.752-2(f) *Ex.* 4 (involving limited partnership interest); *compare* Reg. §1.752-2(f) *Ex.* 1 (different result involving general partnership interest).

[176] Reg. §1.752-2(b)(6).

[177] Preamble to REG-128767-04, 69 Fed. Reg. 49,832 (Aug. 12, 2004) ("Because a disregarded entity and its owner are treated as a single entity, the presumption of deemed satisfaction of obligations undertaken by the owner arguably should include payment obligations undertaken by the disregarded entity. However, because of statutory limitations on liability, the owner of a disregarded entity may have no obligation to satisfy payment obligations undertaken by the disregarded entity.").

[178] T.D. 9289, 71 Fed. Reg. 59,669 (Oct. 11, 2006) ("The IRS and the Treasury Department believe that applying the presumption of deemed satisfaction to a disregarded entity that shields the federal tax partner from liability for the entity's obligations would, in many cases, cause partnership liabilities that are economically indistinguishable from nonrecourse liabilities to be classified as recourse for purposes of §752. Applying the presumption of deemed satisfaction to disregarded entities would distort the allocation of partnership liabilities in those cases. Accordingly, these comments are not adopted in the final regulations.")

[179] T.D. 9289; Former Reg. §1.752-2(k).

[180] T.D. 9289; Former Reg. §1.752-2(k).

[181] T.D. 9788, 81 Fed. Reg. 69,282 (Nov. 17, 2016).

[182] T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019) (Reg. §1.752-2(k)). The 2019 final regulations also expanded the anti-abuse rule in Reg. §1.752-2(j), which can cause an obligation to be disregarded if the principal purpose is to eliminate the economic risk of loss or create the appearance that a partner or related person is bearing the economic risk of loss.

[183] T.D. 9877 ("Furthermore, net value as provided in §1.752-2(k) may not accurately take into account future earnings of a business entity, which normally factor into lending decisions.").

[184] Reg. §1.752-2(k)(1).

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Because the LLC is the only partner with a deficit restoration obligation, the LLC would be responsible for the full $300,000 amount of the debt in the case of a constructive liquidation. However, A is the partner for federal tax purposes, because the LLC is a DRE. If the deemed satisfaction of obligation rule applied, then A would be considered to meet the obligation of the LLC, even though, under local law, A has no liability for the obligations of the LLC. Reg. §1.752-2(k) addresses this issue by applying the reasonable expectation of payment test to the LLC as the payment obligor. The LLC has no assets besides the limited partnership interest, which would have no value if the partnership were constructively to liquidate.[185] The LLC therefore has no assets with which to satisfy the $300,000 which would become due and payable in a constructive liquidation, meaning that it is not commercially reasonable to expect the LLC to fulfill its deficit restoration obligation. The obligation is therefore not recognized, so A is not subject to the economic risk of loss for the debt. The debt is characterized as nonrecourse under Reg. §1.752-1(a)(2) and allocated among A, B, and C according to the rules in Reg. §1.752-3.

In Reg. §1.752-2(k)(2), Example 2, the facts are the same, except that, in addition to the limited partnership interest, the LLC owns real property worth $475,000 encumbered by a $200,000 liability and expects $20,000 of net rental income per year from the property. Under these facts, there is a commercially reasonable expectation that the LLC could use the value of the real estate and the expected rental income to satisfy the $300,000 deficit restoration obligation in the case of a constructive liquidation, so the obligation is recognized for purposes of determining economic risk of loss to A. The result is that the full $300,000 liability is considered recourse under Reg. §1.752-1(a)(1) and allocated to A under §1.752-2.

Example 2 is interesting because the LLC would not be able to satisfy the full $300,000 at the time of an immediate constructive liquidation. The net value of the LLC's non-partnership assets in the constructive liquidation would be $275,000 (the $475,000 value of the property less the $200,000 liability). Under the old net value rule, the $300,000 liability would be considered recourse only to the extent of the net value of the LLC, so $25,000 of the liability would have been considered nonrecourse. Under current Reg. §1.752-2(k), the annual expected rental payments of $20,000 lead to the conclusion that there is a commercially reasonable expectation that the LLC would have the ability to pay the $25,000 in value it does not currently have. Example 2 does not make the value of the rental payments dispositive to the result, nor does it indicate what the result would have been without the expected rental payments. Under the facts and circumstances test, there is still some possibility that the capitalization of the entity would have been considered sufficient ($275,000/300,000) for there to be a commercially reasonable expectation of payment.

The Preamble to the §752 regulations indicates that ability to pay may be determined by reference to "balance sheets, income statements, cash flow statements, credit reports, and projected future financial results."[186] The facts and circumstances to consider include the factors that a third-party creditor would take into account when deciding whether or not to lend.[187] Therefore, under the facts and circumstances test, an obligation may be recognized if the obligor is generally creditworthy, even if the obligor could not currently satisfy the liability.

E. Application of §465

Section 465 limits the losses a taxpayer can claim in relation to an activity to the amount that the taxpayer is "at risk." The amount at risk is the amount of money and the adjusted basis of any property contributed to the activity, as well as certain amounts borrowed with respect to the activity.[188] Amounts borrowed generally count toward the amount at risk only if the taxpayer is personally liable for the debt,[189] or the taxpayer has pledged property (other than property used in the activity) as security for the debt.[190] In addition to these general limitations, a taxpayer is not considered to be at risk for amounts borrowed if the taxpayer is protected against loss through "nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements."[191]

1. Guarantees

The owner of a DRE may have limited liability with respect to the entity's debts. The owner, therefore, would not be personally liable for those debts, meaning they would not increase the owner's amount at risk for any of the activities of the entity. However, the IRS has acknowledged that, at least in the case of a disregarded LLC, if the owner of the entity guarantees the entity's debt, then the owner becomes personally liable and is considered at risk to the extent of the guarantee, subject to the conditions that: 1) the guaranteeing member has no right of contribution or reimbursement against any person other than the LLC; 2) the guaranteeing member is not otherwise protected against loss under §465(b)(4); and 3) the guarantee is bona fide and enforceable by creditors under local law.[192] If all three conditions are met, then the guaranteed debt increases the owner's amount at risk without regard to any right of subrogation, reimbursement, or indemnification from the LLC itself.[193]

2. Qualified Nonrecourse Financing

If a liability is "qualified nonrecourse financing," then the amount borrowed increases the taxpayer's amount at risk even though the taxpayer is not personally liable for the debt and is protected from loss.[194] Qualified nonrecourse financing is generally defined as any financing: 1) which is borrowed with respect to the activity of holding real property; 2) which is borrowed from a qualified person,[195] or from any federal, state, or

[185] Reg. §1.752-2(b)(1).

[186] T.D. 9877.

[187] Reg. §1.752-2(k)(1).

[188] §465(b)(1).

[189] §465(b)(2)(A).

[190] §465(b)(2)(B).

[191] §465(b)(4). For a more detailed discussion of when a taxpayer is protected from loss, see 550 T.M., *At-Risk Rules*, at VI.D.

[192] AM 2014-003.

[193] AM 2014-003.

[194] §465(b)(6).

[195] "Qualified person" is defined in §465(b)(6)(D) by reference to §49(a)(1)(D)(iv). Section 49(a)(1)(D)(iv) defines a qualified person generally as a person in the business of lending money, but excluding related persons, the person from whom property is acquired, and a person who receives a fee in connection with the taxpayer's investment in the property. For purposes of §465(b)(6)

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local government or instrumentality thereof, or is guaranteed by any federal, state, or local government; 3) with respect to which no person is personally liable; and 4) which is not convertible debt.[196]

If debt is owed by a partnership or DRE, then the partnership or DRE itself may be considered personally liable for the debt even if there is no pass-through taxpayer with personal liability. The §465 regulations contain special rules that allow entity-level debt to be considered qualified nonrecourse financing even though there is technically a "person" (the entity itself) who is personally liable. If other requirements are met, debts of a partnership may be considered qualified nonrecourse financing if the only persons personally liable are other partnerships, each partnership with personal liability only holds property used in the activity of holding real property and property incidental to that activity, and the lender may proceed only against that property in exercising its remedies.[197] Similar principles apply for purposes of determining whether DRE debt is qualified nonrecourse financing.[198]

Example: Assume taxpayer A is the sole owner of X LLC, a DRE. X LLC owns as its only asset Blackacre, which is real property used in the activity of holding real property. X LLC owes $1,000 to Bank Y (a qualified person), and the debt is secured only by a mortgage on Blackacre. The debt meets all the requirements to be qualified nonrecourse financing under §465(b)(6) and Reg. §1.465-27(b)(5); accordingly, despite the fact that A is not personally liable for the debt, the $1,000 amount borrowed increases A's at-risk amount with respect to the activity. Subject to other limitations, such as the passive-activity loss rules in §469, A can deduct up to $1,000 of losses from the activity under §465.

(D), a qualified person may nonetheless include a related person if the financing from such person is commercially reasonable and on substantially the same terms as loans involving unrelated persons. §465(b)(6)(D)(ii).

[196] §465(b)(6)(B).

[197] Reg. §1.465-27(b)(4).

[198] Reg. §1.465-27(b)(5).

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V. Application of Specific Code Sections to DREs

A. Section 1031 — Like-Kind Exchanges

1. Acquisition of Replacement Property by DRE

Section 1031(a)(1) mandates nonrecognition of gain or loss on certain "exchanges" of real property held for productive use in a trade or business or for investment.[199] Generally, in order for an exchange of properties to meet the requirements of §1031, the same taxpayer that holds the relinquished property must purchase the replacement property.[200] However, because DREs are disregarded as separate from their owners for federal income tax purposes, a DRE may acquire replacement property without disqualifying its owner's exchange, even if the relinquished property had been owned directly by the taxpayer. Similarly, an owner may have one DRE transfer the relinquished property and another DRE receive the replacement property.

2. Transfer of Replacement Property to DRE

A taxpayer-owner of a DRE may purchase replacement property and then transfer that property to its wholly owned single-member LLC and the taxpayer will still be considered the direct owner of the property for federal income tax purposes.[201] The transfer does not violate the rule that the replacement property must be "held" for use in a trade or business or for investment purposes. The taxpayer still "holds" the property despite having transferred it to a DRE because the DRE is not considered a separate entity.

Note, however, that taxpayers cannot exchange property with, or purchase property from, themselves. Thus, property owned by a taxpayer's DRE is not qualified replacement property for purposes of that taxpayer's §1031 transaction.

3. Acquisition of DRE Interests as Replacement Property

Section 1031 applies to exchanges only of "real property."[202] For purposes of §1031, interests in business entities generally are not real property.[203] However, a taxpayer may acquire all of the ownership interests in a DRE holding real property as qualifying replacement property.[204] Similarly, if a taxpayer transfers all of the ownership interests in an LLC disregarded as separate from the taxpayer, and the LLC owns qualifying relinquished property, the transaction should qualify under §1031.

As discussed in VI.B.2., below, when the owner of an interest in a LLC acquires all other interests in the LLC, the LLC is considered to have made a liquidating distribution of all its assets to its members, followed by the acquiring member's acquisition of the assets distributed to the other members.[205] Thus, if the LLC holds real property, the acquiring member may acquire all other interests in the LLC as qualifying replacement property.[206]

4. Deferred Exchanges

Reg. §1.1031(k)-1 governs "deferred exchanges," pursuant to which a taxpayer transfers relinquished property before it receives replacement property. One of the requirements for a deferred exchange is that the taxpayer not actually or constructively receive money or other property before the taxpayer actually receives the like-kind replacement property.[207] This includes money or property actually or constructively received by a taxpayer's agent.[208]

The regulations include four safe harbors under which the taxpayer will not be considered to be in actual or constructive receipt of money or other property for purposes of §1031.[209] One of these safe harbors involves the use of a "qualified intermediary" (QI), with whom the "taxpayer" must enter into an "exchange agreement."[210] An owner of a DRE may have the DRE transfer relinquished property to, and receive relinquished property from, a QI. In that case, even though the DRE is transferring and receiving the property, it may be prudent for the owner nevertheless to be a party to the exchange agreement with the QI.

B. Section 1033 — Involuntary Conversions

Section 1033(a)(2) provides for nonrecognition of gain on certain involuntary conversions of property, if the taxpayer "purchases" qualified replacement property.[211] Taxpayers cannot exchange property with, or purchase property from, themselves. Thus, property owned by a taxpayer's DRE is not qualified replacement property for purposes of that taxpayer's §1033 transaction.

C. Section 1400Z-2 — Use of DREs in Opportunity Zone Ownership Structure

Under §1400Z-2, taxpayers may defer (and in certain cases exclude a portion of) capital gains reinvested in a "qualified opportunity fund" (QOF).[212] The regulations specify that the benefits afforded for investments in opportunity zones are available only to "eligible taxpayers."[213] An "eligible taxpayer" is "a person that is required to report the recognition of gains during the taxable year under federal income tax accounting principles" and includes individuals, C corporations, and partnerships.[214] Because a DRE is disregarded from its owner, an eligible taxpayer may invest in a QOF through a DRE.

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[199] For a detailed discussion of §1031, see 567 T.M., *Tax-Free Exchanges Under Section 1031.*

[200] *See, e.g.*, TAM 9818003.

[201] PLR 200131014.

[202] §1031(a)(1).

[203] Reg. §1.1031(a)-3(a)(5).

[204] *See* PLR 201216007, PLR 200118023.

[205] Rev. Rul. 99-6.

[206] *See* PLR 200807005 (acquiring taxpayer may acquire, as qualifying property, 100% of interests in separate partnership holding real property because, under Rev. Rul. 99-6, the acquisition is treated as an acquisition of the partnership's assets).

[207] Reg. §1.1031(k)-1(f)(1).

[208] Reg. §1.1031(k)-1(f)(2).

[209] Reg. §1.1031(k)-1(g).

[210] Reg. §1.1031(k)-1(g)(4)(i), §1.1031(k)-1(g)(4)(iii)(B).

[211] For a detailed discussion of §1033, see 568 T.M., *Involuntary Conversions.*

[212] For a detailed discussion of opportunity zones, see 598 T.M., *Investments in Qualified Opportunity Zones.*

[213] Reg. §1.1400Z2(a)-1(a)(1).

[214] Reg. §1.1400Z2(a)-1(b)(13).

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A QOF must be an "investment vehicle which is organized as a corporation or a partnership."[215] Therefore, a DRE may not be a QOF. In addition, one of the QOF requirements is that a QOF must hold at least 90% of its assets in "qualified opportunity zone property," which includes "qualified opportunity zone stock," "qualified opportunity zone partnership interests," and "qualified opportunity zone business property."[216] Qualified opportunity zone stock and qualified opportunity zone partnership interests must be the stock and/or partnership interests of a "qualified opportunity zone business" (QOZB).[217] The regulations provide rules for "eligible entities" to qualify as a QOZB, one of which is that the entity must be a corporation or partnership for federal income tax purposes. Thus, a QOZB cannot be a DRE.[218]

"Qualified opportunity zone business property" must be property acquired "by purchase."[219] Because a taxpayer cannot purchase property from itself,[220] qualified opportunity zone business property cannot be property purchased by a QOF from an entity disregarded from it.

Practice Point: One of the more common uses of DREs in the context of opportunity zone investments is at the QOZB level. A QOZB may desire to own more than one piece of property and may want to separate the properties into different entities for state law purposes in order to limit liability with respect to each property. A QOZB is able to be the sole owner of DREs through which it purchases various properties. Note that a QOZB's purchase of property through a regarded entity of which it is a member is problematic because a QOZB is allowed to own a very limited amount of nonqualified financial property (NQFP) and an ownership interest in a corporation or a partnership is considered NQFP.

D. Section 199A — Availability of Deduction

Section 199A provides taxpayers other than corporations a deduction based on several factors, including a taxpayer's "qualified business income amount," which in part depends on the taxpayer's amount of "qualified property" with respect to each "qualified trade or business."[221] A "qualified trade or business" is "any trade or business" except for certain excluded trades or businesses.[222] For these purposes, a "trade or business" is a trade or business under §162, subject to certain qualifications.[223]

An individual operating a qualified trade or business as a sole proprietorship can be eligible for the §199A deduction.[224] Therefore, the §199A deduction is available to an individual operating a qualified trade or business through a DRE, because a DRE's activities are treated "in the same manner as a sole proprietorship, branch, or division of the owner."[225] Further, property owned by the DRE for state law purposes may be "qualified property" for purposes of §199A.

Not every for-profit real estate activity is considered a trade or business under §162.[226] Consequently, not every for-profit real estate activity is a trade or business that is eligible for the §199A deduction. However, Rev. Proc. 2019-38 provides a safe harbor for purposes of the §199A trade or business rules, under which a "rental real estate enterprise" will be treated as a single trade or business for purposes of §199A. The revenue procedure defines a "rental real estate enterprise" as an interest in real property (including in multiple properties) held for the production of rents.[227] To qualify, the interest must be held directly or through a DRE.[228]

E. Section 170 — Charitable Contributions

Section 170 allows a deduction for certain "charitable contributions."[229] In Notice 2012-52, the IRS stated that it would treat a contribution to a domestic DRE that is wholly owned and controlled by a U.S. charity as a charitable contribution to a branch or division of the charity. Further, the §170(b) percentage limitations on such contributions would apply as though the gift were made to the U.S. charity.

F. Section 108 — Cancellation of Indebtedness

Section 108 excludes cancellation-of-indebtedness income from gross income if the discharge of debt occurs in a Title 11 (i.e., bankruptcy) case (the "bankruptcy exclusion") or when the taxpayer is insolvent (the "insolvency exclusion").[230] Reg. §1.108-9 provides that, if a DRE's indebtedness is discharged in a bankruptcy case, the bankruptcy exclusion applies only if the owner of the DRE is under the jurisdiction of the court in a Title 11 case as the Title 11 debtor.[231] Similarly, the insolvency exception applies only to the extent that the owner of the DRE is insolvent.[232] These rules apply at the partner level, such that, if a partnership holds an interest in a DRE, the bankruptcy and insolvency exclusions apply by "looking to each partner to whom the income is allocable."[233]

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[215] §1400Z-2(d)(1).

[216] §1400Z-2(d)(1), §1400Z-2(d)(2)(A).

[217] §1400Z-2(d)(2)(B)(i)(III), §1400Z-2(d)(2)(C)(ii).

[218] Reg. §1.1400Z2(d)-1(a)(1)(i).

[219] §1400Z-2(d)(2)(D)(i)(I); Reg. §1.1400Z2(d)-2(b)(1)(i).

[220] *See* III.A., above.

[221] §199A(a)(1), §199A(b)(1)(A), §199A(b)(2)(B)(ii). For a detailed discussion of §199A, see 537 T.M., *Qualified Business Income Deduction: Section 199A*.

[222] §199A(d)(1).

[223] Reg. §1.199A-1(b)(14).

[224] Reg. §1.199A-1(c)(3)(i) *Ex.* 1, §1.199A-1(d)(4)(i) *Ex.* 1, §1.199A-1(d)(4)(vii) *Ex.* 7.

[225] Reg. §301.7701-2(a).

[226] *See, e.g., Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), aff'd per curiam, 218 F.2d 603 (2d Cir. 1955) (a taxpayer, who inherited a house that was already rented, continued to rent it to the same tenant, and later sold it, was not considered to be in a trade or business under predecessor to §162). *See also McCoach v. Minehill & Schuylkill Haven Ry. Co.*, 228 U.S. 295 (1913) (a corporation was not considered to be in a trade or business by leasing railroad property and merely maintaining its corporate form and distributing dividends derived from the lease payments).

[227] Rev. Proc. 2019-38, §3.02.

[228] Rev. Proc. 2019-38, §3.02.

[229] For a detailed discussion of §170, see 521 T.M., *Charitable Contributions: Income Tax Aspects.*

[230] §108(a)(1)(A), §108(a)(1)(B). For a detailed discussion of §108, see 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness.*

[231] Reg. §1.108-9(a)(2). The bankruptcy exclusion does not apply if the owner of the DRE is not the Title 11 debtor, even if the DRE itself is the Title 11 debtor.

[232] Reg. §1.108-9(a)(3). The insolvency exclusion does not apply if the owner of the DRE is solvent, even if the DRE itself is insolvent.

[233] Reg. §1.108-9(b).

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G. Sections 465 and 469 — Application of Grouping Rules

A taxpayer may combine two or more trade or business activities for purposes of applying the passive loss rules in §469.[234] The §469 regulations contain rules for grouping different trade or business activities. In general, one or more trade or business activities may be treated as a single activity if they constitute an "appropriate economic unit."[235] The examples in the regulations make clear that activities conducted through two separate legal entities may be grouped together as a single activity assuming that the activities constitute an appropriate economic unit under the facts and circumstances.[236] The regulations do not specifically discuss DREs, but the same principles apply. For §469 purposes, activities conducted by a DRE may be grouped with other activities of the taxpayer conducted through separate entities or with other activities of the taxpayer not conducted through a separate legal entity.[237]

Trade or business activities may also be aggregated for purposes of the at-risk rules in §465.[238] However, in CCA 201805013, the IRS took the view that, based on the legislative history to §465 and the underlying purpose of the section, the §465 aggregation rules are narrower than the grouping rules in the §469 regulations. The IRS analysis concluded that conducting activities through separate legal entities would not preclude aggregation under §465, but it would be a factor weighing heavily against aggregating those activities. The CCA did not specifically mention DREs,[239] but the logic of the CCA applies to DREs, especially to LLCs and other entities that provide their owners with limited liability.[240] Therefore, while activities conducted through separate DREs may be grouped for purposes of §469, the IRS is more likely to argue against aggregation of those activities for purposes of §465.

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[234] The grouping of activities is relevant to the determination of a taxpayer's material participation in those activities. For a detailed discussion of §469 and the material participation rules, see 549 T.M., *Passive Loss Rules.*

[235] Reg. §1.469-4(c)(1). Whether activities constitute an appropriate economic unit depends on all relevant facts and circumstances; the factors which are given the most weight are: 1) similarities and differences in types of trades or businesses; 2) the extent of common control; 3) the extent of common ownership; 4) geographical location; and 5) interdependencies between or among activities. Reg. §1.469-4(c)(2). Relevant interdependencies under the fifth factor include "the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records." Reg. §1.469-4(c)(2)(v).

[236] Reg. §1.469-4(c)(3) *Ex.* 2 (treating activities conducted through two separate partnerships as a single activity).

[237] For example, in *Steinberger v. Commissioner*, T.C. Memo 2016-104, the activities of a partnership and its DRE (which rented a plane to the partnership) were allowed to be grouped for purposes of §183 under similar factors to those applied in the §469 context.

[238] §465(c)(3). Special aggregation rules apply for the purposes of certain businesses described in §465(c)(2). In addition, while §465(c)(3)(C) directs the Secretary to prescribe regulations on aggregation, to date, no regulations have been promulgated.

[239] The taxpayer in the CCA sought to aggregate activities conducted through three separate S corporations and an LLC treated as a partnership. CCA 201805013.

[240] CCA 201805013 ("While the conduct of the activities through separate legal entities might not be a dispositive factor that, in itself, would prohibit aggregation of those activities under §465(c)(3)(B)(i) and (ii), we believe that conducting activities through separate legal entities that limit the liability of their owners is a probative factor that should weigh heavily against aggregation. Accordingly, we believe that conducting activities through separate entities that limit the liability of their owners generally will be strong evidence indicating that the activities do not comprise a single trade or business for purposes of §465(c)(3)(B), except when the facts and circumstances otherwise weigh heavily in favor of viewing the activities as a single integrated trade or business.").

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VI. Changes in Ownership

A. *Complete Change of Ownership — Transfer of 100% of DRE Interest*

A sale of the interests of a DRE is generally considered a sale of the assets of that entity.[241] This was the treatment of sole proprietorships before the adoption of the check-the-box regulations.[242] For example, in *Williams v. McGowan*,[243] the court ruled that the sale of a sole proprietorship should be treated as a sale of each of the individual assets of the business rather than as the sale of a single capital asset. Under the §7701 regulations, DREs are treated in the same manner as sole proprietorships, extending this treatment to single-owner LLCs.[244]

> *Example:* Taxpayer A owns all of the interests in X LLC. X LLC owns as its only asset Blackacre. X LLC is an eligible entity that has elected not to change its classification and is therefore disregarded for federal income tax purposes. A sells all of the interests in X LLC to B. For tax purposes, the X LLC interests would be ignored, and A would be treated as selling Blackacre directly to B.

1. No Separate Basis in Interests in a DRE

Because a taxpayer's ownership of interests in a DRE is characterized as the ownership of the entity's assets for federal tax purposes, the taxpayer does not separately compute basis in interests in a DRE.[245] In the example, above, A's sale of all interests in X LLC to B is treated as a sale of Blackacre, the DRE's only asset, directly to B. A has no basis in its interests in X LLC, which are ignored for federal tax purposes. The tax consequences of the transactions are determined by looking to the basis of the underlying asset. A's gain or loss on the exchange therefore depends on A's basis in Blackacre.

In the situation to which the IRS responded in AM 2012-001, a hypothetical taxpayer created separate classes of interests in a wholly owned entity. If items of income, deduction, loss, and credit were allocated to those different classes of interest according to the governing document (as in a partnership), affecting the taxpayer's outside basis in each class in different ways, a taxpayer could then control gain or loss by selling high-basis classes of interest and retaining low-basis classes of interest.

The IRS Associate Chief Counsel noted that such split interests in a DRE have no meaning for federal tax purposes. While the different classes of interest may have entitled the taxpayer to different distribution and liquidation rights under state law, they were meaningless under federal tax law, which already considered the taxpayer to directly own all of the assets of the DRE. The IRS stated that it would challenge any taxpayer attempts to structure a transaction through split interests in a DRE because it could allow a taxpayer to seek federal tax benefits based on "artificial" manipulations of legal entitlements under state law. Accordingly, any tax benefit arising from basis claimed in a DRE interest may be disallowed.

2. Effect on Status and Election

The §7701 regulations provide that an eligible entity can elect its own classification.[246] The characterization of the election as occurring at the entity level is important because it separates the identity of the owner(s) from the election itself. An election to be classified as an association will survive a change in ownership. Likewise, an entity that has not elected to be classified as an association will not be classified as an association upon a change in ownership unless the new owner makes an election to be classified as such.

The regulations provide that an eligible entity classified according to the default rules in §301.7701-3(b) retains its classification "until the entity makes an election to change that classification under paragraph (c)(1) of this section."[247] Under the default rules, a domestic eligible entity is disregarded if it has a single owner.[248] Accordingly, if a wholly owned domestic eligible entity is sold to a single buyer, it will continue to be disregarded unless the new owner causes the entity to make an election to be classified as an association.

An election also survives a change in ownership. Under the regulations, the eligible entity itself is required to file Form 8832 to elect a change in its classification.[249] Unless such election is by a "newly formed eligible entity," then the entity is barred from changing its classification by election again for the next 60 months.[250] However, if less than 60 months have passed, but more than 50% of the ownership interests have changed from the time of the first election to the subsequent election, then the Commissioner *may* allow the subsequent election to go through.[251] There are numerous PLRs granting an exception to the 60-month limitation following a sufficient change in ownership.[252] If a wholly owned entity had previously elected to be classified as an association and 100% of the interests were subsequently sold, the entity would have to file a new election to change its classification. If the entity attempted to make the subsequent election within 60 months of the prior election, it would have to seek a PLR from the Commissioner granting permission.

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[241] Rev. Rul. 99-5; T.D. 9901, 85 Fed. Reg. 43,042 (July 15, 2020) ("Under federal income tax principles, the sale of any interest in an entity that is disregarded for federal income tax purposes is considered the sale of the assets of that entity…").

[242] *Glisson v. Commissioner*, T.C. Memo 1981-379 (" It is well settled that the sale of a business is treated for tax purposes as a separate sale of each of the assets comprising the business.").

[243] 152 F.2d 570 (2d Cir. 1945).

[244] Reg. §301.7701-2(a).

[245] AM 2012-001.

[246] Reg. §301.7701-3.

[247] Reg. §301.7701-3(a).

[248] Reg. §301.7701-3(b)(1)(ii).

[249] Reg. §301.7701-3(c)(1)(i).

[250] Reg. §301.7701-3(c)(1)(iv). For further discussion of the 60-month limitation, see I.B.4.a., above.

[251] Reg. §301.7701-3(c)(1)(iv).

[252] *See, e.g.*, PLR 202247001, PLR 202050005, PLR 202021014, PLR 201926007, and PLR 201735012. *But see* PLR 202123001 (denying request for exception to 60-month limitation on election where entity was not a newly formed eligible entity and where there had not been a more than 50% ownership change in interests).

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B. Change in Number of Owners

1. Conversion from Single-Member to Multi-Member

Because a DRE can have only a single owner,[253] an addition of members either through a sale of interests at the owner level or an issuance of interests at the entity level will cause the entity to be classified as a partnership.[254] The characterization of these transactions for tax purposes is determined by Rev. Rul. 99-5 and is discussed in detail below.

In general, if a member is added through the sale of interests, the transaction is treated for tax purposes as if the seller sold the buyer an interest in each asset of the entity, with the buyer and seller subsequently contributing their interests in the assets to a new partnership.[255] If a member is added through a contribution to the entity and an issuance of interests by the entity, the transaction is treated for tax purposes as if the owner of the entity contributed all of the assets of the entity to a new partnership, with the new owner's contribution treated as a simultaneous contribution to the same partnership.[256]

a. Transfer of Less Than 100% of Interests

A DRE can be considered disregarded only if it has a single owner.[257] For this reason, a transfer of less than 100% of the interests in a DRE will often result in a change in the entity's classification.

Note that a change in the number of owners will not result in a change in status if the exchange involves only entities disregarded as separate from the same owner.

> *Example:* Assume that X wholly owns DREs A and B, and B acquires interests in DRE A. The ownership of A has not changed for tax purposes; X is still the sole owner of both entities.

If the transfer results in the entity's having two or more [regarded] owners, then the entity will automatically become a partnership for tax purposes.[258]

> *Example:* Assume that A wholly owns an LLC that is a DRE. A sells 50% of the interests in the LLC to B. The LLC is no longer a DRE but is, instead, automatically taxed as a partnership.

The creation of the "new" partnership that occurs through the sale of interests in a disregarded entity is characterized as a partial sale of the assets of the entity followed by a joint contribution of those assets to a newly formed partnership.[259] First, the existing owner is treated as selling a proportionate share of the underlying assets to the new owner. Second, the existing owner and the new owner are treated as contributing their shares of the assets to a newly formed partnership in exchange for partnership interests.

Rev. Rul. 99-5 provides an example. In the ruling, A is the sole owner of an LLC which is disregarded for federal tax purposes. B purchases a 50% ownership interest in the LLC from A for $5,000. As a result of this transaction, A is treated as selling B a 50% ownership interest in each of the LLC's assets. Then, A and B are treated as contributing their interests in those assets to a partnership in exchange for partnership interests.[260]

In the example provided by Rev. Rul. 99-5, A recognizes gain or loss on the deemed sale of assets to B. However, the contribution of the assets to the partnership by A and B qualifies for nonrecognition treatment under §721(a). Therefore, A defers recognition of gain or loss on the 50% of the assets which were treated as being retained in the transaction. A's adjusted basis in these retained assets become A's basis in the partnership under §722. B's basis in the partnership interest is $5,000, which is what he paid A for the interest, because this is the cost basis B has in the assets that B is treated as having purchased from A and then contributed to the partnership.[261]

Rev. Rul. 99-5 states that B receive a 50% interest in *each* of the LLC's assets as a result of the transaction, suggesting that, in a sale of interests, A cannot specify which assets are deemed to be sold in a way that would lead to a favorable tax outcome (*e.g.*, selling loss property and retaining gain property). A technique of deferring gain through tax-free contributions while realizing losses through sales is sometimes called "cherry picking."[262] Taxpayers have sometimes been allowed to cherry-pick gains and losses by selectively applying contribution or sale treatment in the corporate context where there is a valid business purpose for the disparate treatment.[263] It is unclear whether cherry picking would be respected in the context of a §721 partnership formation.[264] Even if cherry picking in a partnership formation that does not involve DRE interests were respected, it seems more likely from Rev. Rul. 99-5 that cherry

[253] Reg. §301.7701-2(c)(2)(i), §301.7701-3(a).

[254] Reg. §301.7701-3(f)(2).

[255] Rev. Rul. 99-5 (Situation 1).

[256] Rev. Rul. 99-5 (Situation 2).

[257] Reg. §301.7701-2(a) ("A business entity with only one owner is classified as a corporation or is disregarded . . ."); Reg. §301.7701-3(a) (". . . an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.").

[258] Reg. §301.7701-3(f)(2).

[259] Rev. Rul. 99-5.

[260] Rev. Rul. 99-5.

[261] Rev. Rul. 99-5.

[262] *See, e.g.*, Julie M. Marion, *Debt-Financed Acquisitions Under Rev. Rul. 99-5: Fictional Adventures in Taxation*, 31 Real Est. J. 299 (Oct. 2015); Scott J. Bakal and Eric M. McLimore, *Energy Transfer, Williams, and the Circular Ownership of Stock*, 33 Real Est. J. 135 (May 2017).

[263] *Brown v. Commissioner*, 27 T.C. 27 (1956); *Collins v. Commissioner*, 48 T.C. 45 (1967). *But see* Rev. Rul. 68-55 (requiring cash received as boot in corporate formation to be allocated asset-by-asset according to the relative fair market values).

[264] Cherry picking in the context of related tax-free transfers to a partnership under §721 would have been curtailed by proposed regulations to the §707 disguised sale rules in 1991. Prop. Reg. §1.707-3(e), 56 Fed. Reg. 19,055, 19,062 (Apr. 25, 1991). That provision was deleted from the final regulations. T.D. 8439, 57 Fed. Reg. 44,974 (Sept. 30, 1992). Subsequent Technical Advice Memoranda cited the deletion of this provision in the §707 regulations for the proposition that cherry picking appeared to be allowed in the generic disguised sale context and that there was no sound rationale for a different treatment in a Rev. Rul. 99-5 scenario. TAM 200540010, TAM 200512020. Both of the memoranda containing language favorable to cherry picking were later revoked and reissued to delete "incorrect" language, including the language on cherry picking. TAM 200701032, TAM 200650017. An IRS official later said that the revocation and reissuance of the memoranda was an indication that the IRS was "not blessing cherry-picking under any circumstances." Amy S. Elliot, *Katz Explains Disallowance of Cherry-Picking in Split Eligible Interest Transactions*, 2012 Tax Notes Today 133-3 (July 11, 2012). *See also William Cos. v. Energy Transfer Equity, LP*, 159 A.3d 264 (two-step merger failed because tax counsel would not issue "should" level opinion that sale of stock to partnership would be respected separately from §721 contribution of assets).

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picking would not be respected in the special case of a partnership formation that results from the sale of interests in a DRE.[265] Taxpayers may therefore reach disparate results by transacting with respect to the assets of the entity rather than the interests.

Furthermore, as previously discussed, the IRS has expressed disapproval of taxpayer techniques that involve tracking basis in different classes of DRE interests to "manipulate" gain or loss on disposition.[266] Interests in a DRE are ignored for tax purposes, regardless of the legal characteristics or entitlements of those interests under state law.[267] The memorandum laying out this position cites Rev. Rul. 99-5 to say that a taxpayer who sells a portion of an interest in a DRE is treated as selling a pro rata portion of each asset of the entity.[268]

Situation 1 in Rev. Rul. 99-5 limits itself to a scenario in which A does not contribute to the LLC *any* portion of the amount A realizes on the sale of the LLC interest to B.[269] If A did contribute some of the amount realized to the LLC, the transaction would presumably look more like what the Revenue Ruling describes as "Situation 2," which involves a contribution from B to the entity (discussed below). If A transferred some of the amount realized to the LLC, it would likely be characterized as a partial sale and partial contribution, perhaps in line with the disguised sale rules of §707 that apply generally to partnership formations.

Practice Point: B may prefer to be considered the purchaser of an existing partnership interest rather than a purchaser of assets and contributor to a new partnership. In this case, B may insist that A transfer an interest to a third party before the sale to B occurs, so that the entity becomes classified as a partnership before the sale. If the transactions are not combined or rearranged under the step transaction doctrine, B's purchase would then be governed by §742 and other provisions applicable to purchasers of partnership interests.

b. Addition of New Member Through Contribution

A DRE may add members without a sale of any interests by the existing owner, if the entity directly issues interests to another regarded taxpayer in exchange for contributions.[270] In this case, the existing owner is treated as contributing the property of the DRE to a newly formed partnership. The new owner is treated as making a contribution to the same partnership.

Rev. Rul. 99-5 describes this in "Situation 2." In that example, B contributes $10,000 directly to the LLC in exchange for a 50% ownership interest in the entity. As a result, B is treated as making a $10,000 contribution to a partnership. A is treated as contributing all of the assets of the LLC to the partnership.

Both contributions qualify for nonrecognition treatment under §721(a), meaning that A is able to defer recognition of gain or loss on all of the LLC's assets rather than just on 50% of the *assets.* Under §722, A's basis in the partnership interest is equal to A's basis in the underlying assets of the LLC; B's basis in the partnership interest is $10,000.

Practice Point: Situation 2 leaves the new partnership with twice as many assets as it had after the sale of interests in Situation 1. Rev. Rul. 99-5 specifies that the LLC uses all of the contributed cash in the business and that A and B continue to operate the business of the LLC as co-owners. Therefore, while choosing which form to follow (sale or contribution) may present a tax planning opportunity, the business rationale for the deal may drive the outcome. If A wishes to diversify rather than grow the size of the business, then a contribution from B makes less sense than a sale of interests to B.

2. Conversion from Multi-Member to Single-Member

In order to be classified as a partnership, a business entity must have at least two members.[271] If the number of members of a partnership is reduced to one, the entity will automatically be classified as a DRE.[272]

Rev. Rul. 99-6 describes two circumstances in which a partnership becomes a DRE. "Situation 1" involves a purchase by one existing partner of the interests of the other partners. "Situation 2" involves a sale of all of the partnership interests to a single third-party buyer. In both situations, any seller is treated as selling a partnership interest, but the buyer is treated as purchasing assets (except that the buyer is treated as receiving a liquidating distribution with respect to any historic interest that the buyer owns in the partnership). Each of these scenarios is discussed in detail below.

a. Purchase by One Existing Partner of All Other Partners' Interests

In Rev. Rul. 99-6, in "Situation 1," A and B are equal partners in AB, an LLC classified as a partnership for federal tax purposes. B purchases A's entire interest in AB for $10,000. Afterwards, B continues the AB business as the only remaining member. The AB partnership is treated as terminating. A is treated as selling A's partnership interest. However, to determine the tax consequences to B, the AB partnership is treated as making a liquidating distribution of all of its assets to A and B. B is then treated as purchasing A's share of the assets from A.

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[265] *See* Julie M. Marion, *Debt-Financed Acquisitions Under Rev. Rul. 99-5: Fictional Adventures in Taxation,* 31 Real Est. J. 299 (Oct. 2015) ("While there is support for a taxpayer's ability to cherry-pick in connection with actual asset transfers where the different treatment is dictated by genuine business or economic reasons, in the present case, any attempt to cherry-pick likely would not be respected because there is in fact no asset transfer.").

[266] AM 2012-001.

[267] AM 2012-001 ("For federal tax purposes, the member already owns all of the disregarded entity's property. Therefore, while a preferred interest in an eligible entity may entitle the owner of the preferred interest to preferential distribution or liquidation rights under state law, such preferences have no meaning for federal tax purposes while the same taxpayer owns one-hundred percent of all classes of interests.").

[268] AM 2012-001; Amy S. Elliot, *Katz Explains Disallowance of Cherry-Picking in Split Eligible Interest Transactions,* 2012 Tax Notes Today 133-3 (July 11, 2012) ("'If you sell an interest in a DE, Rev. Rul. 99-5 says you've sold an undivided interest in each of the assets. And so you can't create interests in a DE and sell those and have different bases in the interests,' Beverly Katz, special counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), said at a Passthroughs and Real Estate Committee meeting of the District of Columbia Bar Taxation Section.").

[269] Rev. Rul. 99-5 ("Situation 1. B, who is not related to A, purchases 50% of A's ownership interest in the LLC for $5,000. A does not contribute any portion of the $5,000 to the LLC. A and B continue to operate the business of the LLC as co-owners of the LLC.").

[270] Rev. Rul. 99-5.

[271] Reg. §301.7701-2(c)(1).

[272] Reg. §301.7701-3(f)(2).

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A recognizes gain or loss based on A's basis in the partnership interest, which is generally considered a capital asset.[273] The characterization of the transaction to B as a liquidating distribution followed by an asset purchase has no effect on A, but leads to an interesting effect on B's basis and holding period. B may recognize gain or loss on the deemed liquidating distribution, depending on B's basis in B's partnership interest and the type of property received.[274] B's holding period in the property considered distributed to B includes the holding period of the partnership.[275] B is treated as purchasing all the assets that A is considered to receive in the liquidating distribution. This gives B a cost basis in those assets; this basis does not depend on A's basis or the AB partnership's basis in the assets.[276] B's holding period in the purchased property begins on the day after the sale is treated as occurring.[277]

b. Sale of All Partnership Interests to Third-Party Buyer

In Rev. Rul. 99-6, in "Situation 2," C and D are equal partners in CD, an LLC classified as a partnership for federal tax purposes. Each partner sells that partner's entire interest in CD to E for $10,000 ($20,000 total). After the sale, E continues the CD business as the only member. The CD partnership is treated as terminating. For C and D, the transaction is treated as a sale of their CD partnership interests. For E, the transaction is treated as if C and D received liquidating distributions of the assets of the CD partnership and then sold those assets to E.

C and D recognize gain on the transaction based on their basis in their CD partnership interests, which they are considered to have sold to E for $10,000 each.[278] E is treated just as a purchaser of assets and therefore takes a $20,000 cost basis in the CD assets that E is considered to have bought from C and D.[279]

In both situations, the partnership is considered terminated at the time of the sale of interests. Following the transactions described in Situation 1 and Situation 2 of Rev. Rul. 99-6, only one partner remains. Accordingly, the business is no longer carried on in a partnership, which requires two or more members,[280] causing a termination under §708(b)(1).[281]

3. Election Issues with Change in Number of Members

A change in the number of members of the entity does not result in the formation of a new entity for purposes of the 60-month limitation, meaning that any prior election is still applicable and may not be reversible.[282] To demonstrate, in Reg. §301.7701-3(f)(4) Example 3, A and B are the owners of X, a foreign eligible entity. X is classified as an association by default but later makes an election to be classified as a partnership. Following the election, A purchases all of B's interest in X, making A the sole owner of X. By the operation of the default rules in Reg. §301.7701-3(b) and §301.7701-3(f), X is disregarded following the acquisition. The 60-month limitation from the previous election still applies, so despite the change in ownership, X is not able to change its classification by election so as to be classified as an association.

The treatment of elective changes in classifications is discussed in VII.B., below.

C. Merger Transactions

Disregarded entities may engage in merger transactions under state law. The tax characterization of these transactions depends on the classification of the merging entities.

If a DRE merges with another DRE owned by the same taxpayer, the transaction will be disregarded because the taxpayer is already considered to own all of the assets of both entities for tax purposes.

If a DRE merges with a DRE owned by another taxpayer, the transaction should be characterized as a transfer of assets. For example, in PLR 200703030, DREs owned by a subsidiary corporation merged with a DRE owned by the parent corporation. The transaction was treated as a distribution of all of the assets of the subsidiary's DREs to the parent.[283] If two DREs owned by unrelated taxpayers merge, the transaction should be treated as a contribution of all the assets of the entities to a new partnership and governed by §721 principles.

If a DRE merges with an entity classified as a partnership for tax purposes, the transaction should be governed by §708. If the newly merged entity continues the business of the partnership, it should be treated as a continuation of the partnership, regardless of whether, as a matter of state law, it is the original partnership or the DRE that survives the merger. The owner of the DRE should be treated as contributing the entity's assets to the partnership. If the owner of the DRE receives only an interest in the partnership as consideration for the merger, then the owner should not recognize gain or loss under §721.

On the other hand, if the owner of the DRE receives consideration other than a partnership interest for the merger, then the transaction would likely be governed by Rev. Rul. 99-5 principles. The owner of the DRE should be treated as selling a portion of each asset of the DRE to the partnership. The owner should then be treated as contributing the owner's remaining interest in the assets to the partnership in exchange for a partnership interest, governed by §721. Alternatively, if the business of the partnership is not continued after the merger, then the transaction would result in a termination of the partnership under §708.

[273] §741; Reg. §1.741-1(b).
[274] §731(a).
[275] §735(b).
[276] §1012.
[277] Rev. Rul. 66-7.
[278] §741; Reg. §1.741-1(b).
[279] §1012.
[280] Reg. §301.7701-2(c)(1).
[281] For both Situation 1 and Situation 2, Rev. Rul. 99-6 cites §708(b)(1)(A) for the proposition that, upon the sale of the partnership interests, the partnership would be terminated. The Tax Cuts and Jobs Act (TCJA) of 2017 amended §708(b)(1) to eliminate the "technical termination" provision of former §708(b)(1)(B). The TCJA amendment did not affect the substance of §708(b)(1)(A), but in eliminating §708(b)(1)(B), the language in §708(b)(1)(A) was collapsed into §708(b)(1) rather than remaining as an independent citation. Despite the change in the structure of the section, the language remains the same. The transactions therefore lead to a termination of the partnership under both the pre-TCJA and post-TCJA §708. Rev. Rul. 99-6 should be unaffected by the amendment.
[282] Reg. §301.7701-3(f)(3).
[283] The PLR does not specify whether any consideration was received by the subsidiary for the merger.

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VII. Changes in Classification

A. In General

As discussed in I., above, classification of a business entity under the check-the-box regulations depends on three factors: 1) whether the business entity is an "eligible entity;" 2) whether the business entity has one regarded owner or more than one regarded owner; and 3) whether the entity has made an election to change its default classification.[284] If the eligibility, number of owners, or election changes, the classification of the entity will also change. The tax consequences of a change in classification caused by a change in the number of regarded owners is discussed in detail in VI.B., above.

B. Change in Election

Changes in classification that result from an election are a typical, in that they are "transactions without actual form."[285] A change in election has no effect on a taxpayer's legal entitlements and is cognizable only for income tax purposes.

Because a change in election does not have actual form, commentators at the time of adoption of the check-the-box regulations recommended allowing taxpayers to choose the form that would apply to an elective conversion,[286] by analogy to Rev. Rul. 84-111, which involves conversion of a partnership into a corporation. The revenue ruling identifies three separate transactional forms that could be used to reach the same result. Rather than prescribing a form that applies in all cases, the revenue ruling indicates that the form chosen by the taxpayer should be respected.

The IRS rejected the commentator's recommendation, instead establishing one specific form that would apply in the case of each type of elective conversion.

The tax treatment of an elective classification change is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.[287] According to the preamble to the proposed regulations, this provision serves to ensure that taxpayers obtain the same results when they make an election as they would have obtained had they undertaken the actual transactions which are deemed to occur.[288]

As noted above, the step transaction doctrine may apply in appropriate circumstances to a check-the-box election. For example, in Rev. Rul. 2015-10,[289] membership interests in an LLC classified as an association were transferred to a downstream corporate entity. The LLC subsequently elected to be disregarded, which would normally result in a deemed liquidation of the entity, with all of the assets received in liquidation by the sole owner. The revenue ruling treats the sequence the same as if it involved an actual liquidation, thereby applying the step transaction doctrine to treat the contribution followed by the liquidation as effecting a §368(a)(1)(D) tax-free reorganization.[290]

1. Corporation to DRE

A business entity that has elected to be classified as an association remains an "eligible entity" that may later elect to be classified as a partnership or DRE, depending on the number of members.[291] In addition, a foreign eligible entity in which all members have limited liability is classified by default as an association,[292] but can elect to be disregarded or classified as a partnership, depending on the number of members.[293] If an association has a single owner and elects to be disregarded, the association is deemed to distribute all of its assets and liabilities to its owner in liquidation.[294]

The tax consequences of the deemed liquidation depend on the identity of the owner. If the owner is an individual, partnership, or other noncorporate person, the association must recognize gain or loss on all of its property as if the property were sold for its fair market value.[295] The owner is treated as receiving the property as full payment for its stock,[296] meaning that the owner recognizes gain or loss on the exchange based on the difference between the fair market value of the property received and the owner's basis in the stock. The owner's basis in the property received is equal to the property's fair market value.[297] Because the owner's basis in the property is not determined by reference to the corporation's basis before the transaction, the holding period from the association is not carried over.[298]

If the owner of 100% of the interests in the association is itself a corporation, other rules apply. Generally, under §332, neither the liquidating subsidiary nor the corporate owner recognizes gain or loss on such a liquidation.[299] The liquidating subsidiary's basis in its property carries over to the corporate owner, which thereafter owns that property with a basis equal to the property's basis in the hands of the liquidating subsidiary;[300] the holding period for the property is also tacked on.[301]

The rule mandating nonrecognition of gain or loss in a liquidation under §332 generally does not apply in the absence

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[284] Reg. §301.7701-3(a).

[285] Preamble to T.D. 8844, 64 Fed. Reg. 66,580 (Nov. 29, 1999).

[286] Preamble to T.D. 8844.

[287] Reg. §301.7701-3(g)(2)(i).

[288] See Preamble to REG-105162-97, 62 Fed. Reg. 55,768 at 55,769 (Oct. 28, 1997) ("This provision in the proposed regulations is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations."). For example, an association that checks the box to become a partnership should be treated as if the association had actually liquidated, and the shareholders should be treated as receiving the assets and then immediately contributing the assets to a new partnership. *See, e.g.*, AM 2011-003 (Aug. 26, 2011).

[289] Citing Rev. Rul. 2004-83, Rev. Rul. 67-274.

[290] *But see* Rev. Rul. 69-617 (declining to apply the step transaction doctrine to an upstream state law merger followed by a contribution of the assets to a new subsidiary).

[291] Reg. §301.7701-3(a).

[292] Reg. §301.7701-3(b)(2)(i)(B).

[293] Reg. §301.7701-3(a).

[294] Reg. §301.7701-3(g)(1)(iii).

[295] §336(a). Losses are limited or disallowed when they involve property with a carryover basis and in certain other circumstances. §336(d).

[296] §331(a).

[297] §334(a).

[298] *Cf.* §1223(2).

[299] §337, §332. Section 332 does not apply when the liquidating subsidiary is insolvent. Rev. Rul. 2003-125; AM 2011-003.

[300] §334(b).

[301] §1223(2).

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of the timely adoption of a plan of liquidation.[302] However, the check-the-box regulations dispense with the need for a formal plan in the case of a liquidation effected by revocation of an election and provide that the making of the revocation, with the effect of changing the classification of an entity from an association to a DRE, is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation.[303]

The deemed liquidation is treated as occurring immediately before the close of the day before the effective date of the election.[304] For example, if an election is effective on January 1, the deemed liquidation is treated as occurring on December 31 and must be reported as occurring on that date.[305]

The effective date of an election and the date of the deemed transactions become especially important in the context of changes in ownership. Under Reg. §301.7701-3(c)(2), an election is generally effective if it is signed either by all the members of the entity who are owners at the time the election is filed or by an officer, manager, or member who is authorized to make the election. However, special signature rules apply if: 1) an election is made effective for any period prior to the time it is filed (a retroactive election);[306] or 2) the ownership of the entity changes between the date of any deemed transactions that result from the election and the time of the filing of the election.[307] In the latter situation, any member who was an owner at the time of the deemed transactions, but is not an owner at the time the election is filed, must also sign the election.[308] The following examples illustrate these rules. This table summarizes the relevant times in each example.

	Example 1	**Example 2**
Date of redemption of member's interest	January 1	January 1
Date of mailing	January 1	January 1
Date of IRS receipt	January 2	January 3
Date of deemed transaction	January 1	January 2
Effective date of election	January 2	January 3
Election effective if signed by. . .	B and C	B alone

Example 1: A, a limited liability company that is classified as a corporation, has two owners, B and C. On January 1, A fully redeems C's interest. Also on January 1, A mails an election to be classified as a DRE for federal income tax purposes, effective January 2. On January 2, the relevant IRS Service Center receives the election.

A's election is likely considered filed on January 2, the day that the IRS receives it. Thus, A's election is filed on, and effective as of, January 2.

Under Reg. §301.7701-3(g)(1)(iii), A is deemed to distribute all of its assets to its members in liquidation. Under Reg. §301.7701-3(g)(3), that liquidating distribution is deemed to occur immediately before the close of the day before the effective date of the election. Because the election is effective on January 2, the liquidating distribution is deemed to occur immediately before the close of January 1.

Under Reg. §301.7701-3(c)(2)(i), an election generally must be signed either by all the members of A who are owners at the time the election is filed or by any officer, manager, or member of the electing entity who is authorized to do so. However, if there is any person that is an owner on the date of the deemed transactions who is not an owner at the time that the election is filed, that person must sign the election under Reg. §301.7701-3(c)(2)(iii).

C is an owner on January 1, which is the date the liquidating distribution is deemed to occur, but C is not an owner at the time the election is filed on January 2. Therefore, C must sign the election under Reg. §301.7701-3(c)(2)(iii).

Example 2: Same facts as above, except that A elected its change in classification to be effective on January 3 and the relevant IRS Service Center receives the election on January 3.

Under the same analysis as above, the election will be considered filed on, and effective as of, January 3. Further, the liquidating distribution will be deemed to occur immediately before the close of January 2. Thus, the election will be effective if it is signed by B alone, since B was the only owner of A on January 3 and there were no persons who were owners on the date of the deemed transactions but who were not owners at the time of filing.

In Rev. Proc. 2010-32, the IRS responded to concerns among foreign eligible entities that elections to change their classification from association to either partnership or DRE would be invalidated due to uncertainty about the number of owners of the entities for tax purposes. Under the revenue procedure, if a qualified entity makes an otherwise valid election and it is later determined that the number of owners of the entity made it ineligible to make the relevant election, the election will be treated as if it were the proper election. So, for example,

[302] §332(b).

[303] Reg. §301.7701-3(g)(2)(ii).

[304] Reg. §301.7701-3(g)(3)(i). An election is generally effective on the date specified by the entity on its Form 8832. Reg. §301.7701-3(c)(1)(iii). A taxpayer may specify a date up to 75 days prior to the date on which the election is filed or up to 12 months after the date on which the election is filed. Reg. §301.7701-3(c)(1)(iii). If no date is specified on the Form 8832, then the election is effective on the "date filed." Reg. §301.7701-3(c)(1)(iii). *See* I.B.4., above, for further discussion on the mechanics of making an election under the §7701 regulations.

[305] Reg. §301.7701-3(g)(3)(i).

[306] Reg. §301.7701-3(c)(2)(ii). In the case of a retroactive election, each person who was an owner between the date when the election is to be effective and when the election is filed, who is not an owner at the time the election is filed, must sign the election. Reg. §301.7701-3(c)(2)(ii).

[307] Reg. §301.7701-3(c)(2)(iii).

[308] Reg. §301.7701-3(c)(2)(ii), §301.7701-3(c)(2)(iii). Documents are generally considered filed when they are received by the IRS. *See, e.g.*, *Miller v. United States*, 784 F.2d 728, 730 (6th Cir. 1986) (citing *United States v. Lombardo*, 241 U.S. 73 (1916)). In some circumstances, the "mailbox" rule of §7502 may apply to make the postmark date the deemed delivery date of the election. However, some authority indicates that §7502 only applies when a filing is received after a deadline, so that the delivery date could be considered the time of filing in the case of timely delivery. *See Estate of Mitchell v. Commissioner*, 103 T.C. 520 (1994); 627 T.M., *Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation*, I.C.

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if a foreign eligible entity elects to be disregarded, but it is later determined that the entity had more than one owner, the IRS will treat the election as an election to be classified as a partnership. However, the relief is contingent on filing updated Form 8832 along with original or amended tax returns reflecting the proper classification before the end of the period of limitations.

Entities qualifying for this relief should still be eligible for the deemed plan of liquidation provision in Reg. §301.7701-3(g)(ii),[309] since, under the revenue procedure, the election is not invalidated, but is instead treated as if it were the proper election. However, the treatment of the liquidation may need to be reconsidered to reflect the correct ownership profile of the entity. In addition, if a foreign eligible entity does not qualify for relief under the revenue procedure and does not seek a Private Letter Ruling otherwise providing relief, the election will presumably be considered invalid, nullifying the deemed liquidation and any tax consequences thereof. Foreign eligible entities hoping to ensure liquidation treatment may therefore choose to adopt a formal plan of liquidation and liquidate under local law rather than relying on the deemed transactions of the §7701 regulations.

2. DRE to Corporation by Election

If a DRE elects to be classified as an association, the owner of the entity is treated as contributing all of its assets and liabilities to the association in exchange for stock of the association.[310] If the sole owner of the DRE continues as the "sole shareholder" of the new association, then no gain or loss will be recognized by either the entity[311] or, ordinarily, the owner on the deemed exchange of assets for stock.[312] The association takes a carryover basis in the assets that it is deemed to receive from the owner's contribution.[313] The owner's basis in the stock that is deemed to be received in the transaction is equal to the owner's basis in the property deemed to be contributed, properly adjusted for liabilities.[314] The owner has a tacked-on holding period in the stock if the property deemed contributed to the association was a capital asset;[315] the association also has a tacked-on holding period in the assets deemed received from the owner.[316]

As described above, if an elective change in classification is effective at the same time as a change in classification that results from a change in the number of members, the elective change is considered to occur before the change in the number of members.[317] The consequences of this prioritization are demonstrated by Example 1 in Reg. §301.7701-3(f)(4). In that example, A, U.S. taxpayer, owns a DRE. On January 1, 1998, A sells a 50% interest in the entity to B. A and B elect to have the entity classified as an association effective on the same day, January 1, 1998. Because the change in the number of members and the change in election occur on the same day, the change in election is considered to have occurred before the change in the number of the members. The transaction is therefore characterized as A's causing the entity to change its classification from a DRE to an association, followed by a sale of stock in the association to B. As a consequence, A is deemed to contribute all of the assets of the entity to an association before the close of December 31, 1997, the day before the election is considered effective.[318] Then, B is deemed to purchase 50% of the stock of the association on January 1, 1998. This purchase causes A to no longer be in control of the association immediately after the exchange, so the nonrecognition treatment of §351 cannot apply.[319] A recognizes gain or loss on all of the property at the time of the deemed exchange of the property for stock on December 31, 1997. After the taxable exchange, both A and the association take a cost basis in the stock or property received equal to the fair market value of the property.[320] B then purchases 50% of the stock from A, which should not cause gain or loss to A because A's basis in the stock at the time will be equal to its fair market value. B will take a cost basis in the stock.[321]

The tax consequences would be different if the change in classification resulting from the increased number of members were considered to happen before the election (which is arguably the true form of the transaction). The change in the number of members would cause the entity to be considered a partnership for tax purposes.[322] If the partnership then made an election to be classified as an association, it would be treated as if the partnership contributed all of its assets and liabilities to the association in exchange for stock of the association and then liquidated, distributing the stock of the association to the partners.[323] The contribution by the partnership would qualify for nonrecognition treatment under §351, even though the partnership would be subsequently liquidated.[324] Therefore, under this characterization of the transaction, A could potentially defer recognition of gain or loss on the assets by operation of §721 and §351.

Taxpayers may therefore be able to defer some recognition of gain or loss by delaying the effective date of a check-the-box election. However, such a delay would require the acquiring taxpayers to be considered partners in a partnership for some amount of time, even if that amount of time is negligible. Partner status may be an undesirable administrative or tax burden for some taxpayers.

C. Change in Eligibility

In some circumstances, a DRE may cease to be an eligible entity. For example, the entity could become an insurance com-

[309] *See* notes and accompanying text on the rule mandating nonrecognition of gain or loss in a liquidation under §332(b) and Reg. §301.7701-3(g)(2)(ii), above in this VII.B.1.

[310] Reg. §301.7701-3(g)(1)(iv).

[311] §1032.

[312] §351. Section 351 would not apply if the ownership of the entity changes such that the owner is not considered to be in control of the association immediately after the exchange. *See, e.g.,* Reg. §301.7701-3(f)(4) *Ex.* 1. There are other situations in which §351 might not apply. Gain may also be recognized by reason of §357(b) and §357(c).

[313] §362(a).

[314] §358(a).

[315] §1223(1).

[316] §1223(2).

[317] Reg. §301.7701-3(g)(3)(i); *see also* VI.B.3., above.

[318] Reg. §301.7701-3(g)(1)(iv), §301.7701-3(g)(3)(i).

[319] Nonrecognition treatment under §351 does not apply where there is a binding agreement before the incorporation to sell stock to a third party in a way that would violate the control requirement. *See, e.g.,* Rev. Rul. 79-70.

[320] §1012.

[321] §1012.

[322] Reg. §301.7701-3(f)(2).

[323] Reg. §301.7701-3(g).

[324] Rev. Rul. 84-111 (Situation 1).

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pany or a state-chartered bank, or ownership of the entity could be transferred to a state government.

A foreign entity could also be added to the list of per se corporations in Reg. §301.7701-2(b)(8)(i). However, when a foreign entity is added to the list, entities existing as of the effective date of the addition have generally been protected from a classification change by a grandfather provision.[325] The grandfather provisions no longer apply if persons who were not owners at the effective date own a 50% or greater interest in the entity.[326] If such a change in ownership occurs, the per se corporation classification would apply.

The §7701 regulations do not discuss the tax consequences of an eligible entity's becoming a per se corporation. Under general principles and by analogy to the elective classification rules in Reg. §301.7701-3(g), the classification change should be treated as the incorporation of the assets and liabilities of the entity. The transaction should be tax-free under §351, unless the change involves an outbound transfer to a foreign corporation, in which case §367 would apply to make the exchange taxable. In addition, liabilities of the entity could trigger gain recognition to its owner on the deemed incorporation if the amount of the liabilities deemed transferred exceeds the adjusted basis of the assets of the entity.[327]

The timing of any deemed transactions as a result of an eligibility change is unclear. If a state government purchases a DRE, the entity becomes a per se corporation under Reg. §301.7701-2(b)(6). The transaction would likely be treated as if the state government purchased the assets and then contributed them to a corporation in exchange for stock. Contrast this with the treatment of the transaction if the state government purchased the entity and then had the entity elect to be classified as a corporation. In that situation, the deemed contribution would be treated as occurring the day before the effective date of the election.[328] The state government would be treated as purchasing stock of the association and would never be considered to own the assets.[329] Since the entity ceases to be an eligible entity capable of making an election at the time it becomes wholly owned by the state government,[330] this is likely not the proper characterization of the transaction.

D. Dover Corp. Issues

By introducing electivity into entity classification, the check-the-box regulations present opportunities for tax planning. For example, the owner of the entity is able to affect the consequences of a sale for tax purposes without changing the legal form of the transaction for non-tax purposes. If the owner of an eligible entity sells interests in the eligible entity, the sale will be treated as a sale of the assets of the entity if the entity is disregarded, but as a stock sale if the entity is classified as an association. The federal tax consequences of the transaction therefore depend on the entity's election.

For example, it is sometimes advantageous for a transaction to be taxed as a sale of assets formerly held by a wholly owned foreign corporation, rather than as a sale of shares of that foreign corporation.[331] If the foreign corporation is an eligible entity that could elect to be a DRE, the owner might cause the corporation to make such an election effective shortly before a sale of the ownership interests in that entity. This strategy is known as "check-and-sell."

The validity of the check-and-sell transaction was confirmed in *Dover Corp. v. Commissioner*.[332] The case involved a retroactive election by a domestic parent to disregard a foreign operating subsidiary (which was owned through a foreign holding company) prior to the sale of all the stock of the operating subsidiary. The retroactive election changed the characterization of the transaction from a stock sale to an asset sale. The court held in favor of Dover Corp., finding that the check-the-box election should be treated identically to an actual liquidation of the foreign operating subsidiary before the sale. In the case of an actual liquidation, precedent dictated that the order of the steps would be respected.

One basis for the decision upholding the validity of the check-and-sell transaction in *Dover Corp.* was that the IRS had the authority to issue regulations that would have prevented the alleged abuse but had chosen not to do so.[333] Indeed, the preamble to the final check-the-box regulations notes that future regulations could address abuses of the election in the international context,[334] and Treasury later proposed regulations that would have prevented most check-and-sell transactions of foreign entities.[335] In particular, a foreign entity classified as an association that elected to be disregarded would be reclassified as an association if a 10% or greater interest in the entity were sold either one day before or within 12 months after the election.[336] The proposed regulations were withdrawn in 2003 following widespread public criticism.[337] Treasury has not since proposed any other regulations that would have the same effect.

One of the underlying issues in *Dover Corp.* was the clear tax relief motive of the check-the-box election. The election did not change the form of the transaction at all; the stock sale had already occurred, and the only thing that would change as a result of the election was the federal tax treatment. A purely tax-motivated transaction would lack a non-tax business purpose, which in many circumstances could lead to the transaction's not being respected under the economic substance doctrine.[338] The court in *Dover Corp.* wrote in a footnote that the check-the-

[325] *See, e.g.*, Reg. §301.7701-2(e); Notice 2013-44 (adding a Croatian *dionicko drustvo* to the list of per corporations; applying the per se corporation status to entities formed on or after July 1, 2013).

[326] Reg. §301.7701-2(e)(4) (applying grandfather provision for certain entities, subject to 50% change in ownership limitation).

[327] *See* §357(c). *See also* §357(b).

[328] Reg. §301.7701-3(g)(3)(i).

[329] Reg. §301.7701-3(f)(4) *Ex.* 1.

[330] Reg. §301.7701-3(a).

[331] *See, e.g.*, 700 T.M., *Choice of Entity: Business and Tax Considerations.*

[332] 122 T.C. 324 (2004).

[333] 122 T.C. 324, 352 (2004).

[334] T.D. 8697, 61 Fed. Reg. 66,584 (Dec. 18, 1996) ("As stated in the preamble to the proposed regulations, in light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.").

[335] REG-110385-99, 64 Fed. Reg. 66,591 (Nov. 29, 1999).

[336] REG-110385-99, 64 Fed. Reg. 66,591 (Nov. 29, 1999).

[337] Notice 2003-46.

[338] *See, e.g.*, §7701(o); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989).

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box regulations do not require a business purpose.[339] Requiring a business purpose for a check-the-box election would indeed be confounding, since a check-the-box election by its nature has no "actual form"[340] and is recognized only for federal tax purposes. There has been no authority since *Dover Corp.* to indicate that a check-the-box election requires a business purpose.

[339] 122 T.C. 324, at n. 19.

[340] Preamble to T.D. 8844, 64 Fed. Reg. 66,580 (Nov. 29, 1999).

ISBN 978-1-63359-467-8

VIII. Disregarded Entities and Corporations

A. Use of Disregarded Entities to Avoid Taxation on Distributions

Suppose P, a C corporation, owns all the stock of S, another C corporation. If S owns an appreciated asset that would be better deployed in P's hands, a direct transfer of the asset from S to P will trigger gain recognition to S under the application of §311(b). If the asset has unrealized loss, the distribution will not trigger immediate taxation,[341] but will come at the cost of forever losing that loss because of the fair market value basis rule of §301(d).

However, conversion of S into a DRE may solve both problems. If S converts into a DRE, it will be treated as liquidating into P in a transaction generally tax free under §332. S's adjusted basis in its assets will continue when those assets are transferred to P,[342] thereby preserving any loss in the assets (as well as any gain). If S, now a DRE, transfers the desired assets to P, the transfer is ignored for tax purposes because the assets are deemed owned directly by P both before and after the transfer.

B. Use of Disregarded Entities in Mergers and Consolidations

1. "A" Reorganizations

a. In General

Regulations now confirm that DREs can be used in acquisitive reorganizations.[343] In particular, the statutory merger of Target Corporation into a DRE owned by Acquiring Corporation, will be treated as a tax-free "A" reorganization so long as all the other requirements of an "A" reorganization are satisfied. This result is consistent with the general rule that assets owned by a DRE are treated for tax purposes as owned by the DRE's owner. Thus, in the case of a merger *into* a DRE, the assets of the merged corporation are deemed owned by the owner of the DRE immediately after the transaction, precisely the effect of a traditional statutory merger of Target into Acquiring.

This result is consistent with authority preceding the elective classification regulations. In *King Enterprises, Inc. v. United States*,[344] the taxpayer acquired all of the target corporation's outstanding stock for cash, notes, and equity of the taxpayer. Approximately three months later, the taxpayer acquired the assets of the target corporation and three other taxpayer-owned subsidiaries in an upstream merger. The court held the stock acquisition and subsequent merger were parts of a unified transaction qualifying as a tax-free "A" reorganization.[345]

The final regulations adopt a functional definition of an "A" reorganization as:

> a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation,[346] in which transaction, as a result of such statute or statutes, the following events occur simultaneously at the effective time of the transaction —
>
> (A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit) [the "all of the assets" requirement[347]]; and
>
> (B) The combining entity of each transferor unit ceases its separate legal existence for all purposes [the "ceasing separate legal existence" requirement].[348]

Under these regulations, a regarded corporation is called a "combining entity"[349] and a combining entity and all the DREs it owns directly or through other DREs is called a "combining unit."[350] Note that all types of DREs are included within the definition of a "combining unit," including entities disregarded under the elective classification regulations, Qualified REIT Subsidiaries, and QSubs. A "transferor unit" is the combining unit that transfers all of its assets and liabilities as part of the transaction while the "transferee unit" is the combining unit that receives the assets and liabilities of the transferor unit.[351] Partnerships are not included within the definition of a "transferee unit" or of a transferor unit;[352] rather, partnership interests are treated as assets of the partners.[353] An "A" reorganization requires that all of the assets and liabilities of the transferor unit

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[341] S cannot claim the loss on the distribution. §311(a).

[342] §334(b)(1).

[343] Reg. §1.368-2(b)(1)(i).

[344] 418 F.2d 511 (Ct. Cl. 1969).

[345] For a similar result, see Rev. Rul. 2001-46 and PLR 9539018. In the context of a "C" reorganization, see Rev. Rul. 72-405 and Rev. Rul. 67-326.

[346] Note that under the final regulations, mergers effected pursuant to foreign laws, or mergers involving foreign entities, may now qualify as "A" reorganizations. This reverses a longstanding interpretation since 1935 (for which there was no strong policy support), under which the term "statutory merger or consolidation" had been defined to exclude mergers under foreign law. *See* Reg. §1.368-2(b)(1)(iii) *Ex.* 13 and 14.

[347] As discussed further below in the context of subsidiary acquisitive reorganizations, the requirement that all of the assets of the transferor unit be transferred was not intended to impose a "substantially all" requirement on "A" reorganizations. Rather, it was intended to ensure that divisive transactions did not qualify as "A" reorganizations. Preamble to Prop. Reg. §1.368-2(b)(1), 66 Fed. Reg. 57,400, 57,401 (Nov. 15, 2001); Preamble to Reg. §1.368-2T(b)(1), 68 Fed. Reg. 3384, 3385 (2003).

[348] Reg. §1.368-2(b)(1)(ii). Note that this requirement is satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit or a member of the transferee unit (or their officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction and such actions are not inconsistent with the "all of the assets" requirement.

[349] Reg. §1.368-2(b)(1)(i)(B).

[350] Reg. §1.368-2(b)(1)(i)(C).

[351] Reg. §1.368-2(b)(1)(ii)(A).

[352] Reg. §1.368-2(b)(1)(iii) *Exs.* 5, 7.

[353] If a corporation owns two DREs and they form a partnership, the partnership is disregarded for tax purposes. The same should be true if the partnership is formed between a DRE and its owner.

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become assets and liabilities of one or more members of the transferee unit.

For example, suppose Acquiring Corporation owns DE-1 and Target Corporation owns DE-2. If Target Corporation merges into Acquiring Corporation and DE-1 and DE-2 merge (in either direction), the transaction will qualify as an "A" reorganization.[354] The same should be true if Acquiring Corporation also owns DE-0 and Target Corporation merges into DE-0 while DE-1 and DE-2 again merge in either direction.[355]

Compare this transaction to the following transaction in which the acquiring corporation owns a limited liability company classified as a DRE. The target corporation merges into the limited liability company, and the former shareholders of the target corporation receive interests in the limited liability company as consideration in the merger. This transaction will not qualify as an "A" reorganization because immediately after the transaction the acquiring entity (i.e., the limited liability company) is a partnership. Once the limited liability company has multiple owners, its status as a DRE terminates. As a result, the assets of the target corporation do not become owned by one or more transferee units because transferee units include only the acquiring corporation and the DREs it owns.[356]

What if the acquiring corporation elects to have the limited liability company taxed as a corporation as of the date of the merger? The focus of the regulations is on the entities immediately after the transaction;[357] from that perspective, the limited liability company should be classified as a C corporation and so the entire transaction should be a good "A" reorganization. Note that there is no regarded, noncorporate entity involved either before or after the transaction takes place. Note also that the election to have the limited liability company taxed as a corporation is treated as the contribution of its assets from P to a newly formed corporation in exchange for the stock of the new corporation.[358] Because the former shareholders of the target corporation become owners of the limited liability company, the deemed formation of the now-corporate limited liability company may not qualify under §351 unless the target corporation is treated as part of the transferor group on the formation. If, however, the transfer of assets by the target company is part of the same, integrated plan that results in the treatment of the limited liability company as a corporate taxpayer, the target corporation should be treated as part of the transferor group for purposes of §351.[359]

What if, instead of merging into a limited liability company in exchange for limited liability company interests, a corporate partner merges into a two-member partnership or into the other corporate partner of the two-member partnership? In other words, instead of a transaction that converts a DRE into a partnership, the transaction converts a partnership into a DRE. For example, corporations P and T are partners in partnership X, and T merges into X (or into P). Under the final regulations, the transaction qualifies as an "A" reorganization.[360] Note that the partnership terminates under §708(b)(1) as a result of the merger because the partnership has only one partner, possibly implicating Rev. Rul. 99-6.[361]

Under §731(a), gain is not recognized upon a distribution by a partnership to a partner, except to the extent the money distributed exceeds the adjusted basis of the partner's interest in the partnership. If, at the end of the transaction, X holds cash in excess of P's or T's basis in its partnership interest, should gain be triggered under §731? The principles of Rev. Rul. 99-6, if applied, would seem to say yes, but only as to P. As discussed above, the facts of Rev. Rul. 99-6 were similar in that T sold its interest in X to P. As to T, the ruling treated it as a sale of a partnership interest. But as to P, the ruling treated X as having made a liquidating distribution of all of its assets to T and P, and, following the distribution, P was treated as acquiring the assets deemed distributed to T in the liquidation. Thus, it seems that application of Rev. Rul. 99-6 would result in respecting T's merger into X as to T but deeming a liquidating distribution and tax-free transfer of assets by T in exchange for P stock as to P.

b. Conversions and Check-the-Box Elections as Mergers

As discussed above, if a corporation elects to become a DRE, it is treated as a liquidation of the corporation. However, the merger of a wholly owned subsidiary into a DRE owned by the parent should be treated as an upstream "A" reorganization under the final regulations.[362] Because a check-the-box election and a merger into a DRE of the parent lead to the same result, the question arises as to whether a check-the-box election likewise should be treated as an "A" reorganization. The final regulations take the position that checking the box to treat a corporation as a DRE does not qualify as a statutory merger or consolidation since the converted entity continues to exist in derogation of the "ceasing the separate legal existence" requirement. In addition, the check-the-box election violates the "transfer all of the assets" requirement since there is no action under state law that effects the transfer of assets in a check-the-box election.[363]

Similarly, some states permit a corporation to convert into an LLC by simply filing a form. However, the final regulations take the position that a state law conversion of a corporation into an LLC that is disregarded for federal income tax purposes does not qualify as a statutory merger or consolidation because the converted entity continues to exist in derogation of the "ceasing the separate legal existence" requirement.[364]

Consider the effect of these positions on two-step acquisitions. *King Enterprises, Inc.* involved a stock acquisition followed by an upstream merger, which the court integrated and treated as a single tax-free "A" reorganization.[365] If, in the sec-

[354] *See* Reg. §1.368-2(b)(1)(iii) *Ex.* 2; PLR 201105019 (target's transfer of its assets and liabilities to single-member LLC owned by acquirer treated as acquisition by acquirer, citing Reg. §1.368-2(b)(1)(iii) *Ex.* 2).

[355] Note that a merger of DE-0 into Target would not be tax free because it fails both the "all of the assets" requirement and the ceasing separate legal existence requirement. Reg. §1.368-2(b)(1)(iii) *Ex.* 6.

[356] *See* Reg. §1.368-2(b)(1)(iii) *Ex.* 7.

[357] Reg. §1.368-2(b)(1)(iii) *Ex.* 7.

[358] Reg. §301.7701-3(g)(1)(iv).

[359] *See* Rev. Rul. 76-123 and Rev. Rul. 68-357.

[360] *See* Reg. §1.368-2(b)(1)(iii) *Ex.* 11.

[361] The preamble requests comments on these issues. Preamble to Reg. §1.368-2, 71 Fed. Reg. 4259, 4260 (2006).

[362] This is subject to §332 treatment under Reg. §1.332-2(d) and §1.332-2(e).

[363] *See* Preamble to Reg. §1.368-2, 71 Fed. Reg. 4259 (Jan. 26, 2006).

[364] 71 Fed. Reg. 4259; Reg. §1.368-2(b)(1)(iii) *Ex.* 9.

[365] *King Enters., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). *See also* Rev. Rul. 2001-46 (integrating (i) merger of acquiring corporation's newly

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ond step, the acquired corporation liquidated in a §332 liquidation as opposed to merging upstream, the transaction has very different consequences. If the steps were integrated, it would be treated as a taxable asset acquisition. However, in Rev. Rul. 90-95, the IRS ruled that §338 is the exclusive means to achieve a cost basis under these circumstances, so the step transaction doctrine is turned off where the integrated steps would be treated as a taxable asset acquisition resulting in a cost basis. Instead, the separate steps are respected as a qualified stock purchase followed by a §332 liquidation. Thus, by taking the position that a conversion or check-the-box election does not qualify as a tax-free upstream merger, the IRS has essentially taken the position that the steps will not be integrated.[366]

2. "B" Reorganizations

A corporation can use a DRE to acquire the stock of a target corporation in a transaction that will qualify as a "B" reorganization. For example, assume X Corp. owns a DRE formed as a limited liability company. If the shareholders of Target Corporation transfer stock constituting control[367] of Target to the DRE in exchange for voting stock of X Corp., the transaction will be treated as a valid "B" reorganization. If Target is immediately liquidated into the DRE as part of the transaction, the acquisition should be recast as a "C" reorganization.[368] If the liquidation of Target is effected pursuant to a merger statute, the transaction should be recast as an "A" reorganization of Target into X.[369]

3. "C" Reorganizations

Use of a DRE to acquire the assets of the target corporation can give increased flexibility to the acquiring corporation in an acquisitive reorganization. Suppose P Corp. owns a DRE, and Target Corporation transfers all of its assets and liabilities to the DRE in exchange for P voting stock. As part of the transaction, Target distributes the P stock to its shareholders in complete liquidation. This transaction will be treated as a "C" reorganization. In a "C" reorganization the acquiring corporation can assume without limitation the liabilities of the target corporation so long as only voting stock is used as consideration in the transaction. While no corporation other than the transferee may assume liabilities of the transferor corporation,[370] this limitation should have no impact on the transaction here because liabilities of the DRE are treated as liabilities of P.[371] Assuming there is no change in payment expectations, the reorganization is not treated as a significant modification of the debt despite the change in the obligor,[372] and while the debt may have changed from recourse (to Target) to nonrecourse (to P), this should not be treated as a significant modification so long as the debt continues to be secured by its original collateral.[373]

4. Acquisitive "D" Reorganizations

An acquisitive "D" reorganization is the transfer of some or all of the assets of one corporation to another corporation if, immediately after the transfer the transferor or one or more of its shareholders is in control of the transferee corporation, but only if, in pursuance of the plan, stock or securities of the transferee corporation are distributed in a transaction described in §354 (or §354 and §356).[374] For these purposes, control is defined as 50% of the vote or value of the stock of the transferee.

Suppose P Corp. owns all the stock of two subsidiaries, Target Corporation and Acquiring Corporation. As part of a single transaction, P contributes all of its Target stock to Acquiring, Acquiring forms a limited liability company classified as a DRE, and then Target merges into the DRE. As a consequence, the assets of Target become owned under relevant local law by the DRE but for federal tax purposes are treated as owned by Acquiring. For federal tax purposes, then, the transaction represents a transfer of assets from Target to Acquiring, and the parent of Acquiring is in control of Target immediately after the transaction. Thus, the steps should be combined into a single, tax-free acquisitive "D" reorganization.[375]

5. Subsidiary Acquisitive Reorganizations

As noted above, the final regulations require that all the assets of the transferor unit must become assets of the transferee unit as part of the reorganization. However, this is not an attempt to engraft a "substantially all" requirement onto the "A" reorganization.[376] Note that the absence of a "substantially all" requirement in a statutory merger into a DRE owned by the acquiring corporation allows such a transaction to substitute for a traditional forward subsidiary merger (described in §368(a)(2)(D)) without the "substantially all" requirement imposed on the traditional forward subsidiary transaction. In particular, merger of the target corporation into a DRE allows the transaction to proceed without a vote of the shareholders of the acquiring corporation and isolates the acquired assets and liabilities in a subsidiary entity.

However, the transaction cannot be reversed in direction because merging a DRE owned by the target corporation *into* the acquiring corporation effects a division of the target corporation. For example, suppose Target Corporation owns a DRE, and the DRE (but not Target) merges into Acquiring Corporation pursuant to state law. The effect of this transaction is to

formed, wholly owned subsidiary into target and (ii) merger of target into acquiror; integrated transaction was single statutory merger of target into acquiror).

[366] In the Preamble to T.D. 9242, 71 Fed. Reg. 4259 (Jan. 26, 2006), the IRS and Treasury sought comments on whether this should be the result. *Cf.* Rev. Rul. 2008-25 (integration of (i) merger of acquiror's newly formed, wholly owned subsidiary into target accompanied by parent's acquisition of all target stock for acquiror stock plus cash, and (ii) subsequent complete liquidation of target into acquiror, would violate policy that cost basis in acquired assets should not be obtained through purchase of stock absent §338 election; consistent with Rev. Rul. 90-95, acquisition of target stock is qualified stock purchase by acquiror followed by §332 liquidation of target into acquiror).

[367] In this context, "control" means at least 80% of the voting power of all T stock entitled to vote as well as at least 80% of the number of nonvoting shares of T stock. §368(c).

[368] Rev. Rul. 67-274.

[369] *King Enters, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-46.

[370] Rev. Rul. 70-107.

[371] *See* Reg. §301.7701-1(a), §301.7701-2(c)(2).

[372] Reg. §1.1001-3(e)(4)(i).

[373] Reg. §1.1001-3(e)(5)(ii)(A), §1.1001-3(e)(5)(ii)(B)(2).

[374] *See, generally*, 772 T.M., *Corporate Acquisitions: D Reorganizations.*

[375] PLR 200445016, PLR 200430025; Rev. Rul. 2004-83 (taxable sale of sister stock to brother corporation followed by liquidation of sister).

[376] Preamble to Prop. Reg. §1.368-2(b)(1), 66 Fed. Reg. 57,400, 57,401; Preamble to Reg. §1.368-2T(b)(1), 68 Fed. Reg. 3384, 3385 (2003).

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divide the former assets of Target between Acquiring (which acquires the assets formerly owned by the DRE, assets that for tax purposes were deemed to be owned by Target) and Target (which continues to own its assets, other than those formerly owned by the DRE). Such a transaction — the merger of a DRE into a corporation is not a tax-free "A" reorganization and properly should not be.[377] On the other hand, an otherwise valid statutory merger that is preceded by a distribution of assets from the target corporation to its shareholders should remain tax free.

a. Use of Grandparent Stock

Use of a DRE by the acquiring corporation in a statutory merger effectively expands the traditional "A" reorganization into a potential three-tiered transaction. In general, the equity consideration that can be used in an "A" reorganization is stock of the acquiring corporation or stock of the parent corporation.[378] If the acquiring entity is a DRE, then this rule requires that the equity consideration consist of stock of the DRE's parent or stock of the DRE's grandparent. Of course, equity in the DRE itself cannot be used because that would convert the DRE into a partnership, and the acquiring entity in a corporate reorganization cannot be a partnership even if it is a partnership owned exclusively by corporations.[379]

b. Using a DRE to Avoid Reverse Triangular Restrictions

The merger of a subsidiary of the acquiring corporation into the target corporation will be a valid acquisitive reorganization so long as the acquiring corporation obtains "control" of the target corporation as part of the transaction and uses only its voting stock to acquire this control.[380] Thus, the consideration that can be used in a reverse triangular reorganization is substantially more constrained than in a merger or forward triangular reorganization.

However, if the surviving corporation in a reverse triangular merger is merged into a DRE of the acquiring corporation as the final step of the transaction, the reorganization should be reclassified as a forward triangular reorganization because now the target corporation is merged out of existence (and into the acquiring corporation) as the final step.[381] This eliminates the more restrictive consideration requirement that otherwise would be imposed on the acquisition.

C. Divisive Reorganizations and Related Transactions

1. Using a Merger to Effect a Division

A transfer of assets from one corporation to another will not be tax free as an "A" reorganization unless the transaction satisfies both the letter and the spirit of the reorganization provisions. Similarly, a corporate division will be tax free only if the requirements of §355 are satisfied.[382] Even if the transaction is effected pursuant to a state statute labeled a "merger" statute or something similar, if the transaction is in substance a corporate division, it must be tested against the rules applicable to divisive transactions.[383] This could be particularly relevant in cases involving mergers of DREs. For example, suppose X Corp. conducts an active trade or business and also owns a DRE that itself operates an active trade or business. If the DRE merges into Y Corp., the effect of the transaction is a division of X because the trade or business operated by the DRE immediately prior to the merger is treated as having been owned directly by X. Accordingly, the transaction will be treated as a transfer of assets from X to Y in exchange for the consideration furnished by Y in the merger.[384]

This treatment of the transaction as divisive is consistent with authority pre-dating the current regulations. In *Cortland Specialty Co. v. Commissioner*,[385] the court emphasized that a merger is the absorption of one corporation by another in which the target corporation goes out of existence. This requirement that the target corporation (technically, the "transferor unit") cease to exist is now found in Reg. §1.368-2(b)(1)(ii)(A), §1.368-2(b)(1)(ii)(B), and codifies the result of Rev. Rul. 2000-5.

Compare the following. X Corp. owns all the stock of a limited liability company taxable as a DRE. The DRE is converted into a corporation (or makes a check-the-box election to be classified as a corporation) and the stock of the corporation is distributed by X to its shareholders. The conversion of the DRE is treated as the formation of a new corporation, and the distribution of the stock of that new corporation by X should be tax free under §355 so long as the active trade or business requirements of §355 are satisfied, and the transaction is not otherwise a device for the distribution of the earnings and profits of X.[386] In the absence of such a conversion, the distribution of the DRE interests would be treated as a taxable distribution subject to §301 and §311.

2. Distributing Interests in a DRE as a Split-Up

Suppose individuals P and Q own all the stock of corporation X, that X owns all the interests of an LLC classified as a DRE, and this LLC/DRE owns all the stock of corporation Y. If X distributes the interests in the LLC to P and Q, the distribution may qualify as a tax-free distribution under §355 under the following analysis.[387] First, because the LLC is a DRE when owned by X, the distribution of the interests in the LLC should be treated as a distribution of its assets; that is, a distribution of the stock of Y. Because X is treated as owning all of the stock of Y immediately before the distribution and is treated as distributing all of the stock of Y as part of the transaction, the distribution should qualify under §355 (assuming the other requirements of §355 are satisfied).

Second, because the LLC now has two owners, P and Q will be treated as if they contributed the assets of the LLC (that

[377] Reg. §1.368-2(b)(1)(iii) *Ex.* 6.
[378] *See* §368(a)(2)(D).
[379] Reg. §1.368-2(b)(1)(iii) *Ex.* 7.
[380] §368(a)(2)(E).
[381] *Cf.* Rev. Rul. 67-274.
[382] *See generally* 776 T.M., *Corporate Separations.*
[383] Rev. Rul. 2000-5.
[384] Reg. §1.368-2(b)(1)(ii)(A), §1.368-2(b)(1)(ii)(B).
[385] 60 F.2d 937, 939 (2d Cir. 1932).
[386] PLR 200422003, PLR 200411034, PLR 200306033 (QSub used instead of LLC).
[387] For a discussion of the IRS ruling policies related to §355 (including device, business purpose, and §355(e) non-plan issues), see 776 T.M., *Corporate Separations*, and 772 T.M., *Corporate Acquisitions — D Reorganizations.*

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is, the stock of Y) to a newly formed partnership.[388] While a continuity of interest requirement applies to divisive transactions,[389] the tax-free partnership formation presumably is no different from a post-distribution tax-free reorganization.[390]

3. Replacing a Divisive Distribution with a Liquidation

Suppose corporation X owns all the stock of corporation Y that owns all the stock of corporation Z. A distribution by Y of the stock of Z will be tax free only if the distribution satisfies all of the requirements of §355. If these requirements cannot be met, an alternative transaction would be for X to create a DRE, merge Y into that DRE, and then have the DRE distribute the stock of Z. The merger of Y into the DRE owned by its parent will be treated as a tax-free subsidiary liquidation of Y into X.[391] As a result, X will be treated as owning Z directly, so the distribution of Z stock by the DRE will be treated as a non-event for tax purposes.

D. "F" Reorganizations

1. Reincorporation by Elective Classification Conversion

An "F" reorganization is a mere change in identity, form, or place of organization of one corporation.[392] While the transaction can involve only a single operating corporation, two or more entities can be involved in a transient way. So, for example, a corporation can change the state of its incorporation by forming NewCo, transferring its assets to NewCo in exchange for all the stock of NewCo, and then liquidating, distributing the stock of NewCo to its shareholders. An existing corporation might desire to be constituted as a partnership under applicable local law. If so, it could convert into a partnership and simultaneously elect to be taxed as a corporation. This transaction should be an "F" reorganization because there is no period when the assets are not in corporate solution.[393]

A similar strategy is frequently used in situations involving sales of a company. Often, for non-tax purposes, buyers want to acquire the equity of the company while keeping historic tax liabilities with the sellers. These two goals can be achieved through an "F" reorganization. The selling shareholder first forms a NewCo, into which the shares of Target are contributed. Target then converts into an LLC, which NewCo subsequently sells to the purchasers. The transaction consisting of the contribution and conversion together meets the requirements for an "F" reorganization, such that, for tax purposes, NewCo is considered the continuation of the Target. For state law purposes, however, the LLC is considered the continuation of the Target, thereby avoiding many of the complications involved in an asset sale.[394]

2. Segregating Assets and Liabilities

A DRE can be used in conjunction with an "F" reorganization to segregate safe assets from contingent liabilities in circumstances when the usual manner of segregating will not work. The usual way to segregate liabilities is to push them (along with associated assets) into a subsidiary. However, there are times when the assets or liabilities cannot be transferred, perhaps because of a lending covenant or when transfer would trigger an escape clause in a lease or license agreement.

Suppose that corporation X wishes to segregate the assets and liabilities associated with business C from those of business B, and for business reasons business, C should be held below business B but business C cannot easily be transferred.[395] To accomplish these goals, X can create a subsidiary corporation ("NewCo") and then transfer the assets of business B to NewCo. NewCo then forms a DRE, and X then merges into that DRE. This series of steps has the effect of placing the assets and liabilities of business C into the DRE, a subsidiary entity under applicable non-tax law. However, because the DRE is disregarded for federal tax purposes, all of the assets are treated as owned by NewCo, and so the effect of the transaction is a reincorporation of X into NewCo. An additional benefit of this transaction is that the assets of business C have never tainted NewCo. So, for example, if the assets of business C include real estate potentially subject to environmental cleanup obligations, those obligations do not burden NewCo or its assets. As a result, this form of segregating contingent liabilities may be ideal in anticipation of an acquisition of business B by a third party that refuses to assume the contingent liabilities associated with business C.[396]

E. Use of DREs in Consolidated Groups

Under §1501, an affiliated group of corporations may file a consolidated tax return if each member of the group consents. Once such an election is made, each "includible corporation" must join in the consolidated filing. Once the election to file a consolidated return is made, each includible corporation continues to compute its separate tax items but then those items are combined on a common return for the group as a whole. For a detailed discussion of Consolidated Returns see 754 T.M., *Consolidated Returns — Elections and Filing;* 755 T.M., *Consolidated Returns — Investments in Subsidiaries,* 756 T.M.,

[388] *See* Rev. Rul. 99-5.

[389] Reg. §1.355-2(c). Note that the continuity of interest rules in Reg. §1.368-1(e) does not apply to §355 distributions. *See* Reg. §1.368-1(b) and §1.355-2(c).

[390] *See Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966); Rev. Rul. 70-434.

[391] PLR 200104003, PLR 200129024, PLR 200035031, PLR 9822037.

[392] *See generally* 774 T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations.*

[393] PLR 200450012, PLR 200335019; *see* Reg. §1.368-2(m)(5) *Ex.* 8.

[394] *See* Rev. Rul. 2008-18 describing such a reorganization in the context of an S corporation and QSub election, concluding that the NewCo retains the EIN of the Target and that the S corporation election does not terminate. *See also* PLR 201115016 (ruling that the transfer of all the stock of an existing S corporation to a newly formed corporation and a simultaneous QSub election for the existing S corporation will be treated as an F reorganization, the newly formed corporation is eligible to be treated as an S corporation, and the S election for the existing S corporation will remain in effect for the new corporation).

[395] If business C is dropped below business B, creditors of C will have no recourse against the assets of B. The reverse is not true: If the assets of business B include stock of a subsidiary holding business C, that stock can be reached by creditors of C and so those creditors indirectly can reach business C.

[396] The step transaction doctrine should not apply to recharacterize an "F" reorganization as part of a larger transaction. Rev. Rul. 96-29, Rev. Rul. 69-516. The usual reorganization requirements of continuity of proprietary interest and continuity of business enterprise do not apply to "F" reorganizations occurring on or after February 25, 2005. Reg. §1.368-1(b).

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Computation of Consolidated Tax Liability, and 757 T.M., *Consolidated Returns — Limitations on Losses.*

1. Selective Consolidation and Deconsolidation

It may be advantageous for some but not all affiliated corporations to join in the filing of a consolidated return. However, the consolidated return rules do not permit selective consolidation.[397] Not all corporations that are affiliated in the colloquial sense are permitted to join in the filing of a consolidated return; the strategic use of unaffiliated entities can provide the missing flexibility.

For example, suppose corporation P owns three subsidiaries, corporations X, Y, and Z. P wishes to file a consolidated return with X and Y but not Z. If the P group had not yet elected to file a consolidated return, it could eschew the election entirely and then convert X and Y into DREs.[398] These conversions are treated as tax-free subsidiary liquidations, and the assets and liabilities formerly owned by X and Y are treated as owned by P. Thus, X and Y would be converted (for tax purposes) from separate corporations into divisions of P. While this is not precisely the same as consolidating P, X and Y, this approach does place all of their combined tax attributes, but not Z's tax attributes, on P's return.

If an affiliated group consists of two corporations, a parent and its wholly owned subsidiary, then conversion of the subsidiary corporation into a DRE terminates the consolidated group because the parent, now treated for tax purposes as owning the assets of its former subsidiary, cannot file a consolidated return by itself. The tax items of the former subsidiary will continue to appear on the parent's return (because the former subsidiary is now treated as a division of the parent) although the detailed rules of the consolidated return regulations will no longer apply.

2. Eliminate an Excess Loss Account

A conversion of a subsidiary into a DRE (as described above) can also have the benefit of eliminating an "excess loss account" (ELA)[399] of the parent in the subsidiary's stock.

An ELA is "for all federal income tax purposes treated as basis that is a negative amount."[400] Thus, an ELA is a negative tax attribute of the parent corporation that will be recaptured upon the occurrence of certain events such as the sale of the subsidiary stock or the deconsolidation of the subsidiary corporation.[401]

However, an ELA is not recaptured if the subsidiary corporation is liquidated into its parent member of the group in a transaction described in §332.[402] So, for example, if P and S constitute a consolidated group and S liquidates into P, the ELA is not recaptured but rather simply disappears. The same result should obtain if S converts into a DRE under the elective classification regulations[403] or if S merges into an existing or newly formed DRE owned by P.[404]

[397] §1501.

[398] If the P group has already been filing consolidated returns with X, Y and Z, it may still be possible to deconsolidate Z by breaking the chain of ownership with an intermediate partnership. P can form a partnership with X or Y and then P can transfer its ownership of Z to this partnership. A partnership cannot be part of an affiliated group of corporations, and a corporation owned by a partnership is not affiliated with the partners, even if the partnership is entirely in house. Note, however, that P could not have simply transferred its ownership of Z to a DRE that it owned (or owned by X or Y) because that entity would be ignored for tax purposes and the ownership of Z would continue to be treated as held by P (or its subsidiary).

[399] *See* Reg. §1.1502-19.

[400] Reg. §1.1502-19(a)(2)(ii).

[401] *See* Reg. §1.1502-19(b)(2)(ii).

[402] Reg. §1.1502-19(g) *Ex.* 2(d).

[403] *See* Reg. §301.7701-3(g)(1)(iii) (association reclassified as a DRE treated as liquidating into its owner).

[404] PLR 200129024, PLR 200104003.

ISBN 978-1-63359-467-8

IX. Use of DREs in Cross-Border Transactions

A. In General

DREs may be useful in cross-border transactions in three distinct ways. First, an entity may be disregarded both by the United States and by other relevant jurisdictions. In such circumstances the DRE will play a role similar to the role it plays in purely domestic transactions. More commonly, though, the entity will be characterized one way in the United States and another way in a foreign jurisdiction. When the entity is disregarded under U.S. law (or is classified as a partnership because it has more than a single owner) but is classified as a corporation under foreign law, the entity is called a "hybrid." Hybrids may be useful when intercorporate transactions will have beneficial tax implications in a foreign jurisdiction but detrimental tax consequences under U.S. tax law; in such circumstances the use of a DRE may transform the transaction into a non-event for U.S. tax law while leaving the foreign characterization of the transaction unchanged. Finally, the entity might be classified as a corporation for U.S. tax purposes but a partnership under the law of a foreign jurisdiction, referred to as "reverse hybrids."

The Tax Cuts and Jobs Act (TCJA)[405] made significant changes to the U.S. international tax system, including changes to the deferral rules such as the enactment of §951A (dealing with global intangible low-taxed income, or GILTI) and §965 (dealing with the treatment of deferred foreign income upon transition to participation exemption system of taxation). The repeal of §902 eliminates the need for a 100% owned hybrid to address the thicket of former §902 baskets that plagued the determination of the limitation on the foreign tax credit.

The TCJA also contains specific anti-hybrid provisions (discussed in IX.B.2., below) that seek to neutralize the effects of hybrid arrangements. Section 267A was enacted to address the erosion of the federal tax base from the use of hybrid instruments and hybrid entities by denying a deduction to any interest or royalty paid or accrued to a related party. To avoid the potential for double exclusions of income or similar benefits as a result of hybrid arrangements under the participation exemption system special rules were also enacted to apply to hybrid dividends. §245A(e), for example, disallows the deduction under the participation exemption system if the dividend is a "hybrid dividend" and, therefore, fully taxes the U.S. corporate shareholder with respect to the hybrid dividend.

B. An Overview of the Taxation of Foreign Business Activity by U.S. Taxpayers

1. In General; Non-Hybrid Entities

The U.S. federal income tax extends to the worldwide income of U.S. citizens and resident aliens.[406] This includes both trade and business income and passive income such as dividends, interest, rents, and royalties, except to the extent excluded (in whole or in part) by treaty. With few exceptions, the rules applicable to items of income and deductions is the same whether arising in the United States or abroad.

In the domestic context, the income of a corporation generally is not imputed to its shareholders. This principle also applies in the cross-border context so that U.S. citizens and residents generally are not taxable on the income earned by foreign corporations of which they are shareholders. However, under Subpart F (§951–§965) and the GILTI provisions (§951A), foreign corporate income sometimes is imputed to shareholders who "control" the corporation in specified ways and in specified circumstances to reduce the ability to defer U.S. taxation by accumulating earnings offshore.[407]

Subpart F applies to each U.S. shareholder, defined as a U.S. person,[408] who owns 10% or more of the total combined voting power of all classes of stock entitled to vote, or more than 10% or more of the total value of shares of all classes of stock of a controlled foreign corporation (CFC), where a CFC is a foreign corporation having more than 50% of its stock (by vote or by value) owned by U.S. persons each of whom owns at least 10% of the CFC.[409] Section 951A[410] requires that each U.S. shareholder of a CFC include in gross income the U.S. shareholder's global intangible low-taxed income (GILTI) for the tax year. GILTI includes, with respect to any U.S. shareholder for any tax year of that shareholder, the excess (if any) of that shareholder's "net CFC tested income" for the tax year over that shareholder's "net deemed tangible income return" for the tax year.[411] The income inclusion for GILTI under §951A in general is treated in the same manner as the shareholder includes any Subpart F items in gross income. However, §951A inclusions are in addition to Subpart F inclusions.

A U.S. shareholder of a CFC must include in income its pro rata share of the CFC's Subpart F income as well as the shareholder's pro rata share of the CFC's earnings invested in U.S. property.[412] Subpart F income includes: (1) income derived from insurance of U.S. risks; (2) foreign base company income; (3) certain income arising in countries engaged in international boycotts; and (4) certain illegal payments.[413] For most CFCs the most important of these categories of Subpart F income is foreign base company income.

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[405] Pub. L. No. 115-97 (Dec. 22, 2017).

[406] *See generally* 900 T.M., *Foundations of U.S. International Taxation* (Foreign Income Series).

[407] For a detailed discussion of §245A, see 6130 T.M., *Participation Exemption Regime Under Section 245A* (Foreign Income Series).

[408] For this purpose, a "U.S. person" includes citizens and residents of the United States, domestic partnerships, and domestic corporations. §957(c), §7701(a)(30).

[409] §957(a). *See* §951(b), as amended by the Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, §14214. For tax years prior to 2018, a "U.S. shareholder" was defined as a person owing 10% of the total combined voting power of all classes of stock. *See* pre-2018 §951(b). Note that this section is intended to highlight the distinctions between wholly owned corporate subsidiary status and DRE status. As such, detailed discussion of determining CFC status based on the make-up of the shareholders, and the possibility of the PFIC rules being implicated for shareholders that are not U.S. shareholders of a CFC, are beyond the scope of this section. *See generally* 6200 T.M., *CFCs — General Overview* (Foreign Income Series) and 6300 T.M., *PFICs* (Foreign Income Series).

[410] Added by the TCJA, Pub. L. No. 115-97, §14201, effective for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such taxable years of foreign corporations end. *See also* T.D. 9866, 84 Fed. Reg. 29,288 (June 21, 2019). For a detailed discussion, see 6200 T.M., *CFCs — General Overview* (Foreign Income Series).

[411] §951A(b)(1); Reg. §1.951A-1(c)(1).

[412] §951(a).

[413] §952(a).

ISBN 978-1-63359-467-8

Foreign base company income is itself composed of three categories:[414] (1) foreign personal holding company income;[415] (2) foreign base company sales income;[416] and (3) foreign base company services income.[417]

Foreign-source income that is taxed in the country of origin and also includible in the United States can generate a foreign tax credit (FTC) under §901. If a taxpayer elects to claim the FTC, then no deduction is allowed for the foreign taxes. In some circumstances a deduction will be better than the FTC,[418] although in most circumstances the value of FTC will exceed the value of a deduction. The FTC is available only for foreign income taxes and is subject to a variety of limitations in §904. The "overall" limitation in §904(a) provides that the total amount of the FTC as a proportion of the tax against which the credit is taken cannot exceed the same proportion that the taxpayer's foreign-source taxable income bears to worldwide taxable income. To limit a taxpayer's ability to manipulate the overall limitation, the same approach now is applied separately to different types of income (usually called "baskets" of income). For tax years beginning before 2007, there were eight distinct baskets of income: three pertained to special kinds of export companies;[419] two applied to income from specific industries (financial services and shipping);[420] two to various kinds of passive income;[421] and a residual basket for business income.[422] For tax years beginning after 2006 and before 2018, all income was allocated to one of two baskets: general or passive.[423] The Tax Cuts and Jobs Act (TCJA) added two new limitation categories for a total of four distinct baskets, one for GILTI, and the other for foreign branch income.[424]

If a U.S. corporation earns foreign-source income through an unincorporated branch, the foreign income is currently includible by the U.S. corporation, and an FTC is available to the extent the same income is taxed in the country in which it was earned. After 2017, foreign branch income must be allocated to a specific foreign tax credit limitation basket.[425]

However, if the same income is earned by a foreign subsidiary (and the Subpart F, GILTI rules, or the PFIC rules do not apply), U.S. taxation is deferred until the income is repatriated. When the income was repatriated prior to 2018, the U.S. corporation would have been entitled to a credit for income taxes paid by the foreign corporation by the indirect tax credit mechanism of former §902.[426] The indirect tax credit under former §902 was available only to corporate taxpayers.[427] The TCJA introduced a "participation exemption system" of taxing foreign income. Section 245A provides a 100% deduction for the foreign-source portion of dividends received (DRD) from a foreign corporation by a U.S. corporation that owns at least 10% of the stock of the foreign corporation. The §245A DRD is not available to noncorporate U.S. shareholders or S corporations that are U.S. shareholders.[428]

When a U.S. taxpayer is deciding whether to structure foreign operations through a corporate subsidiary or through a pass-through DRE (assuming that the treatment will be identical for both U.S. and all relevant foreign jurisdictions), the analysis would need to take all of the above into account.

Generally speaking, operating through a DRE would result in all income earned by the DRE being included currently in the income of the U.S. taxpayer. Creditable foreign taxes paid by the DRE can be used by the U.S. taxpayer, subject to the "overall" limitation in §904(a) and the "foreign branch income" basket in §904(d)(1)(B).

Operating through a foreign corporation would subject the U.S. taxpayer to the CFC rules, potentially resulting in current income inclusion for any subpart F income and GILTI. If neither is applicable, full deferral could be achieved until cash is repatriated as a dividend. In the case of a U.S. corporate taxpayer, the dividend will also be tax free due to the DRD under

[414] Before 2018, foreign base company income also included income from the manufacture and distribution of oil and gas products outside the United States unless the products were extracted from, or for use in, the country where the CFC was organized. *See* pre-2018 §954(a)(5).

[415] Foreign personal holding company income includes passive income such as interest, dividends, rents, royalties, and gains from the sale of assets producing these passive receipts. Foreign personal holding company income also includes substitutes for interest and dividends as well as certain commodities gains, certain foreign currency gains, and income from certain notional principal contracts. §954(c). *See* Reg. §1.954-2.

[416] Foreign base company sales income includes certain income from the sale of property for use, consumption or disposition outside of a CFC's country of organization, if sold to or on behalf of a related person. §954(d)(1); Reg. §1.954-3. Note that the related party need not be a U.S. person, so that foreign base company sales income can include income from the sales of property from one foreign corporation to another. Such a rule discourages the geographic separation of manufacturing from distribution even if such separation has no other direct impact on U.S. tax revenues.

[417] Foreign base company services income includes income derived from services performed for a related person outside the CFC's country of incorporation. §954(e); Reg. §1.954-4.

[418] *See* 6020 T.M., *The Creditability of Foreign Taxes — General Issues* (Foreign Income Series).

[419] §904(d)(1)(F) (pre-2007) (dividends from DISCs), §904(d)(1)(G) (pre-2007) (foreign trade income), §904(d)(1)(H) (pre-2007) (distributions from FSCs).

[420] §904(d)(1)(C) (pre-2007) (financial services income), §904(d)(1)(D) (shipping income).

[421] §904(d)(1)(A) (pre-2007) (passive income), §904(d)(1)(B) (high withholding tax income).

[422] §904(d)(1)(I) (pre-2007).

[423] See pre-2018 §904(d)(1). In April 2011, the IRS issued final regulations providing guidance relating to the number of separate foreign tax credit limitation categories under §904(d). The regulations also offer guidance on complying with the changes, and affect individuals and corporations claiming foreign tax credits. See T.D. 9521, 76 Fed. Reg. 19,268 (Apr. 7, 2011).

[424] §904(d)(1)(A) and §904(d)(1)(B), as added by Pub. L. No. 115-97, §14201(b)(2)(A), effective for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

[425] *See* §904(d)(1)(B), as added by the TCJA, §14302(a), effective for tax years beginning after 2017. For a detailed discussion of §904, see 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904* (Foreign Income Series).

[426] The TCJA repealed §902 for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. Pub. L. No. 115-97, §14301(a). *See generally* 6040 T.M., *Indirect Foreign Tax Credits* (Foreign Income Series).

[427] If income is includible to a U.S. corporate shareholder under Subpart F, the shareholder may claim the deemed paid credit under §960. *See* 6040 T.M., *Indirect Foreign Tax Credits* (Foreign Income Series). The same deemed paid credit is available to noncorporate shareholders taxed under Subpart F if an election under §962 is made. For tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end, §960(d) provides an indirect or "deemed paid" tax credit for any amounts includible in the gross income of a domestic corporation as GILTI under §951A. For guidance on computing GILTI, see T.D. 9866, 84 Fed. Reg. 29,288 (June 21, 2019). For a detailed discussion on GILTI, see 6200 T.M., *CFCs — General Overview* (Foreign Income Series).

[428] For a detailed discussion of §245A, see 6130 T.M., *Participation Exemption Regime Under Section 245A* (Foreign Income Series).

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§245A. If there is subpart F income or GILTI, U.S. corporate taxpayers (and individuals that make an election under §962 to be taxed as corporations) also benefit from an indirect foreign tax credit for foreign taxes paid.

2. *Anti-Hybrid Provision: Disqualified Related Party Amounts Under §267A*

The TCJA enacted §267A to address the erosion of the federal tax base resulting from the use of hybrid instruments and hybrid entities.[429] Generally, §267A denies a deduction[430] for any "disqualified related party amount"[431] that is paid or accrued following a "hybrid transaction,"[432] or by, or to, a "hybrid entity."[433] Section 267A is effective for tax years beginning after 2017, and does not provide for any grandfathering rules for payments made on or after the effective date with respect to instruments or transactions in effect prior to the effective date.[434] In 2020, final Treasury Regulations were issued under §267A,[435] providing much needed guidance for the implementation of the statute.

A "disqualified related party amount" refers to any interest[436] or royalty[437] paid or accrued to a related party if: (1) there is no corresponding income inclusion to the related party under the tax laws of the country in which the related party "is a resident for tax purposes or is subject to tax;" or (2) the related party is allowed a deduction with respect to the payment under the tax laws of such country.[438] However, a disqualified related party amount excludes any payment that is included in the gross income of a U.S. shareholder under §951(a).

A "hybrid entity" includes an entity that is fiscally transparent (i.e., a pass-through or DRE) for U.S. federal income tax purposes but not so treated for purposes of the foreign tax laws of the country in which the recipient is resident or subject to tax or an entity that is fiscally transparent for purposes of foreign tax law but not so treated for U.S. federal income tax purposes.[439]

Note that §267A applies to payments by all U.S. taxpayers, and not just U.S. corporations. Under the definition of "disqualified related party amount," the disallowance of a deduction for such an amount would apply to the extent that it was either excluded or deductible from the recipient's income under the relevant foreign tax law. Thus, assuming that all other criteria for applying §267A were satisfied, if the recipient was able to exclude or deduct 50% of the relevant interest or royalty payment in its country of residence, the U.S. payor would be denied a deduction for 50% of the payment.

The final Treasury Regulations provide that "disregarded payments" are treated as disqualified hybrid amounts that are subject to exclusion under §267A to the extent they exceed the taxpayer's "dual inclusion income" for the taxable year.[440] A "disregarded payment" is any payment of interest or royalties made to the extent that under the tax laws of the recipient, the payment is not regarded (for example, because it is treated as involving a single taxpayer or members of a group) and, if it were regarded under such tax laws, the recipient would include the payment in income.[441] "Dual inclusion income" refers to items of income or gain for U.S. tax purposes that are included in the payor's income to the extent such income or gain is also included in the income of the recipient under its tax law, (net of items of loss and deductions that are allowable to both the payor under U.S. tax and the recipient under its tax law).[442]

The final Treasury Regulations also provide for disallowance of any deduction for disqualified deemed branch payments. These are amounts allowable as deductions for deemed interest or royalty payments from a U.S. permanent establishment under an income tax treaty to its home office or other branch to the extent (1) the payment is not regarded under the home office's tax law, (2) were the payment regarded under the home office's tax law it would be included in income, and (3) the tax law of the home office provides for any exclusion or exemption for income attributable to the branch.[443]

The examples provided in the Regulations discuss situations of inbound transactions — foreign investors using hybrid entities for U.S. investments. Such a situation would involve a foreign investor forming a U.S. limited partnership that elects to be classified as a corporation for U.S. tax purposes but is transparent for the investor's home jurisdiction. If the U.S. entity is capitalized with debt by the foreign investor, in the absence of §267A, the U.S. entity would be entitled to a deduction for the interest payments made on the debt, notwithstanding that the interest payment is not included as income for tax purposes in the foreign investor's home jurisdiction. Under §267A and the final Regulations, the interest payment is a "disregarded payment"[444] and, to the extent the interest payment is

[429] Pub. L. No. 115-97, §14222.

[430] Note that the denial of the deduction under §267A is a permanent disallowance. Under Treasury Regulation §1.163(j)-3(b)(2), interest expense disallowed under §267A are not included in business interest for purposes of the limitation under §163(j).

[431] A "related party" is defined within the meaning of §954(d)(3), except that §954(d)(3) applies with respect to the payor rather than to the CFC otherwise referred to therein. §267A(b)(2).

[432] These are defined in §267A(c) as "any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties" for U.S. federal income tax purposes and that are not treated as such under the tax laws of the foreign country in which the recipient is resident or subject to tax. Because they are not directly related to the use of DREs, a full discussion of hybrid transactions is beyond the scope of this Portfolio. *See* 536 T.M., *Interest Expense Deductions*, at 536.VI.I., "Hybrid Instruments: Section 267A."

[433] *See* Pub. L. No. 115-97, §14222; H.R. Rep. No. 115-466, at 663 (2017) (Conf. Rep.).

[434] *See* Pub. L. No. 115-97, §14222(c).

[435] T.D. 9896, 85 Fed. Reg. 19,802 (Apr. 8, 2020), finalizing proposed rules in REG-104352-18, 83 Fed. Reg. 67,612 (Dec. 28, 2018).

[436] The final Treasury Regulations provides a very broad definition for "interest" for purposes of §267A. *See* Reg. §1.267A-5(a)(12).

[437] *See* Reg. §1.267A-5(a)(16) for the definition of "royalty" for purposes of §267A.

[438] §267A(b)(1)(A), §267A(b)(1)(B). Presumably, consideration of the recipient's tax treatment in nonresidence countries where the recipient is "subject to tax" refers to jurisdictions in which the recipient has a permanent establishment or similar quasi-resident status.

[439] §267A(d). *See also* OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report (2015)*; OECD, Public Discussion Draft, *BEPS Action 2 Branch Mismatch Structures* (Aug. 22, 2016).

[440] Reg. §1.267A-2(b)(1).

[441] Reg. §1.267A-2(b)(2)(i).

[442] Reg. §1.267A-2(b)(3).

[443] Reg. §1.267A-2(c).

[444] *See* Reg. §1.267A-2(b)(2).

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a "disqualified hybrid amount,"[445] the U.S. entity will be disallowed a deduction.

A similar result in an outbound case would occur if a U.S. investor forms a foreign subsidiary that is classified as a branch (DRE) for foreign tax purposes, but which elects to be classified as a corporation for U.S. tax purposes. If the U.S. investor takes out cash from the foreign subsidiary in the form of a loan, deductions for interest payments on that loan (or imputed interest payments under §7872) will be subject disallowance under §267A. Outbound cases could also arise with respect to royalty payments, in a situation where a U.S. investor forms a foreign hybrid entity that owns IP, with respect to which the U.S. investor pays royalties.

The final Regulations also provide for an exclusion under §267A for certain payments to "reverse hybrids." Reverse hybrids are defined as entities that are transparent under the tax laws of the country in which they are created, organized or otherwise established, but are not treated as transparent under the tax laws of the country of any investor in such entity.[446] Payments to such reverse hybrids are subject to the exclusion under §267A to the extent that the payment is not subject to tax in either the jurisdiction of the reverse hybrid or the jurisdiction of the investor, and such non-inclusion in the jurisdiction of the investor is a result of the reverse hybrid being treated as not fiscally transparent.[447]

The following example illustrates this rule.

Example: Foreign corporation FX (tax resident in country X) forms two subsidiaries — US1 (a U.S. corporation) and FY (tax resident in country Y). FY is classified as a DRE under the tax laws of country Y, but as opaque under the tax laws of country X. If US1 makes a payment of interest to FY, and neither FY nor FX is required to take such payment into income under the laws of country X or country Y, US1 is restricted from claiming a deduction for such interest payments under §267A.[448]

3. Branch Transactions Under §987

If a DRE uses a functional currency different from that of its foreign-corporation-owner and engages in a trade or business, then the activities of that trade or business may be considered a "section 987 qualified business unit" (§987 QBU or QBU), and the regulations under §987 would be implicated.[449] These rules address the computation and timing of recognition of income and deduction of the §987 QBU. Under regulations finalized in late 2016,[450] the QBU must divide its assets into two classes: "marked" items[451] and "historic" items.[452] Marked items are marked-to-market at the end of each tax year and changes in value give rise to unrealized gains and losses that are recognized by the QBU's owner[453] upon remittance of funds from the QBU.[454] "Marked" items include foreign currency, debt instruments denominated in a foreign currency, and similar financial instruments.[455] "Historic" items are assets or liabilities that are not marked items, including real assets such as land, plant and equipment, and portfolio stock investments.[456]

In general, the owner of a §987 QBU must determine each item of income, gain, deduction, or loss attributable to the §987 QBU in the QBU's functional currency by applying federal income tax principles.[457] When translating the §987 QBUs items of income, gain, deduction, or loss (or the item's components and related items, such as gross receipts, amount realized, basis, and cost of goods sold) into the owner's functional currency, the owner uses the yearly average exchange rate for the taxable year.[458] For example, suppose that a QBU using the euro as its functional currency purchases a depreciable asset for 100 euros at a time when one euro is worth one dollar. If the cost of this asset is properly amortized over 10 years, then the QBU is entitled to an annual depreciation deduction of 10 euros, and this depreciation deduction is then converted into dollars at the historic rate of one euro to one dollar without regard to the actual value of the euro as it varies over time.[459] As a result, the regarded owner of the QBU will report a depreciation deduction of $10 per year.

Suppose that the QBU sells this depreciable property for 60 euros after four years so that the amount realized *in euros* equals the QBU's adjusted basis *in euros.* Despite the absence of gain as computed in the QBU's functional currency, the owner of the QBU must compute its gain or loss by comparing its adjusted basis in the asset at the historic rate (that is, $60)[460] with the amount realized converted into dollars. So, for ex-

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[445] *See* Reg. §1.267A-2(b) and §1.267A-6(c)(3).

[446] Reg. §1.267A-2(d)(2).

[447] Reg. §1.267A-2(d)(1).

[448] Reg. §1.267A-6(c)(5).

[449] *See* Reg. §1.987-1(b)(3), *redesignated by* T.D. 10016, 89 Fed. Reg. 100,138 (Dec. 11, 2024) (definition of "section 987 qualified business unit"); *see also* §1.985-1(d)(2) (rules for determining functional currency), §1.985-1(b)(5)–(7) (definition of "owner" for purposes of §987 QBUs and examples of application to disregarded entities). A QBU is a business unit and not an entity. As a result, while a DRE may own assets that constitute a QBU, the DRE itself cannot be a QBU. §1.987-1(b)(4)(ii), *amended by* T.D. 10016.

[450] T.D. 9794, 81 Fed. Reg. 88,806 (Dec. 8, 2016) (determination and timing of §987 QBU taxable income and loss), finalizing proposed rules regarding the foreign exchange exposure pool (FEEP) method, among other things, in REG-208270-86, 71 Fed. Reg. 52,876 (Sept. 7, 2006), which withdrew proposed rules in INTL-965-86, 56 Fed. Reg. 48,457 (Sept. 25, 1991). *See also* T.D. 9795, 81 Fed. Reg. 88,854 (Dec. 8, 2016) (temporary regulations issued the same day); REG-128276-12, 81 Fed. Reg. 88,882 (Dec. 8, 2016) (proposed regulations issued the same day); *both finalized in part by* 9857, 84 Fed. Reg. 20,790 (May 13, 2019) (rules regarding §987 QBU combinations and separations, foreign currency gain or loss).

[451] Reg. §1.987-1(d)(1). A taxpayer may elect to treat all assets and liabilities that are attributable to a §987 QBU as marked items (a current rate election). §1.987-1(d)(2), *added by* T.D. 10016, 89 Fed. Reg. 100,138 (Dec. 11, 2024) (finalizing 2023 proposed rules in REG-132422-17), applicable to taxable years beginning after December 31, 2024.

[452] Reg. §1.987-1(e).

[453] For the definition of an "owner" of a QBU, see §1.987-1(b)(5).

[454] *See* §1.987-4(b)(2), §1.987-5(a). For computation of the appropriate exchange rate, see Reg. §1.987-1(c).

[455] *See* Reg. §1.987-1(d)(1).

[456] *See* Reg. §1.987-1(e), §1.987-1(f) *Ex.*

[457] §1.987-3(b)(1), *amended by* T.D. 10016, 89 Fed. Reg. 100,138 (Dec. 11, 2024). An item that is denominated in a nonfunctional currency (including the functional currency of the owner) must be translated into the §987 QBU's functional currency at the spot rate on the date such item is properly taken into account. §1.987-3(b)(2). The spot rate is the rate determined under the rules of Reg. §1.988-1(d)(1), Reg. §1.988-1(d)(2), and Reg. §1.988-1(d)(4) on the relevant date. §1.987-1(c)(1)(i).

[458] Reg. §1.987-3(c)(3), *amended by* T.D. 10016. *See* §1.987-3(c)(2) (exceptions to general rule).

[459] *See* Reg. §1.987-2(d)(1), §1.987-3(b)(2).

[460] *See* Reg. §1.987-3(c).

ISBN 978-1-63359-467-8

ample, if the euro is worth $1.50 at the time of sale, then the amount realized equals $90 and there is a taxable gain of $30 on the sale.

If the QBU retains the sale proceeds in its functional currency (that is, in euros), then that currency asset becomes a "marked" item. Suppose the value of the 60 euros increases during the tax year from $90 to $96 because the euro increases in value from $1.50 to $1.60. This gives rise to an unrealized gain of $6,[461] and such unrealized gain is called the QBU's "net unrecognized section 987 gain or loss."[462] Some or all[463] of the QBU's "net unrecognized section 987 gain or loss" is includible to the QBU's owner when there is a remittance from the QBU,[464] where a remittance includes not only cash transfers but also transfers of property and loans from the QBU to its owner.[465] Note that tracing is not followed so that a remittance seemingly unrelated to the transaction giving rise to the unrecognized gain or loss can trigger recognition.

In a series of Notices,[466] the IRS repeatedly deferred the date the 2016 and 2019 final regulations would become applicable and announced that it intended to amend the regulations under §987 to provide that the 2016 and 2019 final regulations would apply to taxable years beginning after December 7, 2023.[467] In November 2023, Treasury and the IRS issued proposed regulations ("2023 proposed regulations") under §987 that would replace or modify parts of the 2016 and 2019 final regulations. As a result, those final regulations were not expected to become applicable as previously stated in the notices.[468]

The 2023 proposed regulations would provide an election to treat all items of a QBU as marked items (subject to a loss suspension rule), an election to recognize all foreign currency gain or loss with respect to a QBU on an annual basis, and a new transition rule for recognizing foreign currency gains and losses. The proposed regulations were intended to maintain the approach of existing regulations, simplify the §987 regulations, and offer additional guidance regarding the determination of §987 gain or loss.[469] Final regulations issued in 2024 generally maintain the structure of the 2023 proposed regulations and apply only to corporations and individuals in taxable years beginning after December 31, 2024.[470]

Concurrent with the issuance of the 2024 final regulations, Treasury and the IRS published proposed regulations that would introduce a "recurring transfer group election" to simplify the tax accounting treatment of certain disregarded transactions between a QBU and its owner.[471]

For a detailed discussion of branch transactions under §987, see 6660 T.M., *Tax Aspects of Foreign Currency* (Foreign Income Series), at VII.B.

C. Reporting Requirements

U.S. persons (including individuals as well as domestic partnerships, corporations, trusts and estates)[472] owning a foreign DRE (an "FDE") or operating a foreign branch[473] (an "FB") are required to file Form 8858, *Information Return of U.S. Persons with Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs)*, and Schedule M (Form 8858), *Transactions Between Foreign Disregarded Entity (FDE) or Foreign Branch (FB) and the Filer or Other Related Entities*. This is an annual filing requirement and applies to any U.S. person who owned an FDE or operated an FB during any part of the tax year. This filing requirement also extends to certain U.S. persons owning an interest in a controlled foreign partnership (a "CFP") or a controlled foreign corporation (a "CFC"). Form 8858 and Schedule M are filed with the income tax return (or information return) of the person subject to the reporting obligation.

The instructions to Form 8858 provide for six categories of U.S. persons who are subject to the reporting obligations of Form 8858.

- Category 1 includes a U.S. person that is a tax owner of an FDE or who operate an FB at any time during the U.S. person's tax year or annual accounting period. Note that because a DRE itself is not a U.S. person, if a chain of DREs includes one or more foreign entities, the reporting obligation is imposed on the regarded owner of the chain.

- Category 2 includes a U.S. person that directly (or indirectly through a tier of FDEs) is a tax owner of an FDE or operates an FB. A U.S. person is not a category 2 filed solely as a result of its interest in a partnership (though it may be a filer in a different category).[474]

- Category 3 includes U.S. persons that are required to file Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, with respect to a CFC that owns an FDE or operates an FB at any time

[461] Reg. §1.987-4(d).

[462] *See* Reg. §1.987-4(a).

[463] The proportion of the QBU's "net unrecognized section 987 gain or loss" that is triggered by a remittance is based on a comparison of the amount of the remittance with the adjusted basis of the QBU's assets. *See* Reg. §1.987-5(b).

[464] The gain or loss is ordinary. Reg. §1.987-6(a). For sourcing rules, see Reg. §1.987-6(b).

[465] *See* Reg. §1.987-5(c).

[466] *See* Notice 2022-34, Notice 2021-59, Notice 2020-73, Notice 2019-65, Notice 2018-57, Notice 2017-57. *See also* Michael Rapoport, *IRS Again Delays Rules on Foreign Currency Gains and Losses*, Daily Tax Rep. (Aug. 15, 2022).

[467] Notice 2022-34, §2. Thus, for a calendar year taxpayer, the final regulations would have applied to the taxable year beginning on January 1, 2024.

[468] *See* Preamble to REG-132422-17, 88 Fed. Reg. 78,134, 78,156 (Nov. 14, 2023). Taxpayers are permitted to apply the 2016 and 2019 final regulations and 2016 temporary regulations (if applicable) to taxable years beginning after December 7, 2016, and before December 31, 2024, subject to certain conditions. Reg. §1.987-15(c), T.D. 10016, 89 Fed. Reg. 100,138 (Dec. 11, 2024).

[469] *See* Prop. Reg. §1.987-1 through Prop. Reg. §1.987-14, REG-132422-17, 88 Fed. Reg. 78,134 (Nov. 14, 2023), as corrected, 88 Fed. Reg. 84,770 (Dec. 6, 2023). Taxpayers could rely on the 2023 proposed regulations (and so much of the 2016 and 2019 final regulations as would not be modified by the proposed regulations), in some cases, for taxable years ending after November 9, 2023, and in other cases, for taxable years ending after November 9, 2023, and beginning on or before December 31, 2024.

[470] *See* T.D. 10016, 89 Fed. Reg. 100,138 (Dec. 11, 2024), *as corrected*, 90 Fed. Reg. 5506 (Jan. 17, 2025). Taxpayers must apply §987 to partnerships and S corporations and their eligible QBUs in a reasonable manner that is consistently applied pending further guidance. Reg. §1.987-7(b), Reg. §1.987-7(f). *See also* Reg. §1.987-1(b)(4) (defining "eligible QBU").

[471] Prop. Reg. §1.987-2(f)(1), REG-117213-24, 89 Fed. Reg. 99,782 (Dec. 11, 2024), proposed to be applicable to taxable years beginning after the date final regulations are published in the Federal Register. Prop. Reg. §1.987-15(e).

[472] §7701(a)(1).

[473] See Reg. §1.367(a)-6T(g) for a definition of foreign branch.

[474] *See* Instructions for Form 8858.

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during rhe CFC's annual accounting period. However, not every U.S. person required to file Form 5471 with respect to a CFC that owns an FDE or operates an FB is responsible for filing a Form 8858. Form 5471 filers are also divided into categories, and only those Form 5471 filers falling into categories 4 and 5 are captured by Form 8858.

• Category 4 includes certain U.S. persons who are required to file Form 8865, *Return of U.S. persons with Respect to Certain Foreign Partnerships*, with respect to a CFP that is the tax owner of an FDE or operates an FB during the CFP's annual accounting period. However, this category includes only U.S. persons who controlled the CFP at any time during the CFP's tax year, where "control" means more than a 50% interest (capital, profits, *or* deductions) in the CFP under §6038(e)(3). It also includes partners owning at least 10% during a period when there was no controlling partner under limited circumstances under §6038(e)(3)(C).

• Category 5 includes a U.S. person that is a partner in a partnership that owns an FDE or operates an FB and applies §987 to the activities of the FDE or FB using a method that requires the partner to recognize §987 gain or loss with respect to the FDE or FB. The U.S. person must compete the first page of Form 8858 and Schedule C-1 for each FDE and FB of the partnership. As stipulated in the Partnership Instructions for Schedules K-2 and K-3 (Form 1065), the partnership must furnish to the U.S. person all the information necessary for them to complete the above-described portions of Form 8858. A category 5 filer should check the box for "FDE of a U.S. person" (in the case of an FDE owned by a partnership). For a partnership's reporting obligations concerning dual consolidated losses, *see* Partnership Instructions for Schedules K-2 and K-3 (Form 1065). A U.S. partnership is no longer required to answer Questions 10 and 11 of Schedule G, as if it were a U.S. corporation.[475]

• Category 6 includes a U.S. corporation (other than a RIC, a REIT, or an S corporation) that is a partner in a U.S. partnership, which checked box 11 (Dual Consolidated Loss) on Schedules K-2 and K-3 (Form 1065).

Note: For tax years beginning in 2012, and subsequent years, Forms 5471, 8858, and 8865 were revised to contain a unique reference identification number for each foreign entity with respect to which reporting is required. The reference ID number is used to track the foreign entity from year to year.[476]

D. Use of Hybrids and Reverse Hybrids

1. Using Foreign DREs to Reduce Foreign Taxes

A U.S. corporation that wishes to operate businesses in high-tax foreign jurisdictions may fund the operating companies largely with debt rather than equity to reduce the net income taxable in the foreign jurisdiction. However, if interest is paid from the operating company to the parent corporation or a financing branch of the parent, U.S. tax will be imposed on the interest received. To maintain the foreign interest deduction without creating offsetting interest income, the following structure might be used.

The U.S. parent creates a holding company in a low-tax jurisdiction, perhaps Luxembourg or Ireland. This holding company then creates operating subsidiaries in the various high-tax jurisdictions, and operating funds are loaned to the operating companies from a financing subsidiary or branch of the holding company. All of the entities below the holding company are formed as DREs for U.S. tax purposes although they all are recognized as separate entities outside of the United States. This structure causes the lending transactions to be ignored for U.S. tax purposes because the loans are all between disregarded subsidiaries of the holding company. The high-tax jurisdictions, though, recognize the separate existence of the lender and creditor companies, and so the interest deduction is preserved under their tax regimes. Note that the financing company can be formed in the United States because, for U.S. purposes, the loans between brother and sister DREs will be ignored. For countries that offer some kind of consolidation system (such as Germany or the U.K.), this structure can be extended in the following way: US Co., a U.S. corporation, owns a German DRE (G-DE), and G-DE owns a German operating company (G-OpCo). A loan is made from the U.S. parent to G-DE, generating an interest deduction in the German consolidated group that can be used to reduce the foreign taxes imposed on the income generated by G-OpCo but without any offsetting U.S. income because, for U.S. purposes, the loan is ignored.

Note, that to the extent that the foreign jurisdiction has anti-hybrid rules similar to the provisions in Code §267A, this structure may not be effective, as the interest payment deduction may be denied.

2. Foreign Tax Credits

When a U.S. corporation conducts business abroad through an unincorporated branch, the branch income is taxable in the United States and is likely to be taxable in the country where it is earned. The U.S. corporation can credit the foreign income taxes against its U.S. income tax liability, assuming the foreign tax is creditable[477] and subject to limitations in §904. If the income is earned by a partnership having U.S. taxpayers as partners, the partners may each claim a proportionate amount of the foreign taxes paid by the partnership.[478]

If a taxpayer conducts business in a foreign jurisdiction through a DRE, the foreign profits generated by the entity are taxed as if earned by the entity's owner. Thus, such earnings are subject to U.S. income tax immediately. Consistent with treating the owner as earning the foreign income, the owner is also

[475] *See* Instructions for Form 8858.

[476] *See* Instructions for Form 5471, Instructions for Form 8858, and Form 8865. For a detailed discussion of the reporting requirements for Form 5471, Instructions for Form 8858, and Form 8865, see 6840 T.M., *Reporting Requirements Under the Code for International Transactions and Foreign Assets* (Foreign Income Series).

[477] A tax is creditable for purposes of the foreign tax credit if it satisfies three basic requirements. First, the levy must be imposed by the foreign jurisdiction as a tax and not as a voluntary payment or a payment for a specific right or service. Second, the foreign tax must stand alone and not be a part of a broader tax. If the levy is part of a broader tax, then the credit will apply, if at all, to the broader tax. Third, the tax must be an income tax (or a tax in lieu of an income tax within the meaning of §903) as opposed to, for example, a tax on gross sales receipts.

[478] Reg. §1.901-2(f)(4)(i).

ISBN 978-1-63359-467-8

treated as paying any creditable foreign taxes.[479] That is, the direct foreign tax credit also is available immediately.

By contrast, if the business is conducted through a subsidiary that is classified as a separate corporation under both U.S. and foreign law, the analysis becomes much more complicated. One possibility is that the earnings of the foreign corporation will be subject to immediate inclusion by its parent under the rules of Subpart F. If such inclusion is a result of Subpart F income or inclusions as a result of amounts determined under §956, then foreign taxes paid on those earnings should generate an immediate foreign tax credit for 100% of the foreign taxes attributable to such income.[480] In the case of GILTI inclusions, the foreign taxes generate a foreign tax credit based on a formula that generally results in a foreign tax credit equal to 80% of the proportionate foreign taxes paid allocable to such income inclusion.[481]

A second possibility is that Subpart F will not apply, and in that case the earnings of the foreign corporation will not be includible to the U.S. parent until repatriated by dividend or otherwise.[482] Starting with tax years starting in 2018 (after the repeal of former §902), the parent is no longer entitled to claim indirect credit for foreign income taxes paid on the repatriated earnings. If a withholding tax is imposed by the foreign jurisdiction on the dividend, that withholding levy may itself be a creditable tax that is treated as imposed on the parent directly (because a withholding obligation is treated as imposed on the *recipient* of the dividend) and so generates an immediate, *direct* foreign tax credit.

a. Foreign Tax Credits Generated by Reverse Hybrids

If the business is conducted through a reverse hybrid (i.e., an entity classified as a corporation for U.S. purposes but as a partnership or DRE for foreign purposes), the analysis traditionally tracked more closely the use of a traditional subsidiary.

> *Example:* USCo, a U.S. corporation, owned FC, a foreign entity classified as a pass-through entity in the foreign jurisdiction but classified as a corporation under the U.S. elective classification regulations. Assuming the earnings of FC were not subject to immediate taxation as income of USCo under Subpart F, no U.S. tax would have been imposed on FC's operations until the earnings were repatriated. However, because FC was classified as a pass-through entity under the laws of its state of residency, foreign income taxes were imposed, under that foreign law, on the owner of FC (i.e., on USCo). Under the "technical taxpayer" regulation, this meant that the income taxes imposed on FC would be immediately creditable to USCo under the direct credit of §901.[483]

This was a useful structure not only when the foreign corporation was owned by a domestic corporation but especially when the foreign corporation was owned by individuals, because the direct credit is available to both corporate and noncorporate taxpayers while the indirect credit is available to corporate taxpayers alone. However, this result has been reversed by §909, enacted in 2010, and by the temporary regulations promulgated under §909 in 2012 (and finalized in 2015).

Under §909, a foreign income tax paid or accrued with respect to a foreign tax credit splitting event "shall not be taken into account ... before the tax year in which the related income is taken into account."[484] The regulations promulgated under §909 identify specific splitting events including the "reverse hybrid splitting arrangement" described above.[485] Because the reverse hybrid arrangement is identified as a splitting event, foreign taxes imposed on the income of the DRE cannot be taken into account by the U.S. parent until the foreign income generating the income is includible for U.S. purposes. Note that this result does not change even if foreign law imposes the tax payment obligation only on the reverse hybrid and not on its operating subsidiaries.

b. Foreign Tax Credits Generated by Hybrids

The "technical taxpayer" regulation also offered significant tax benefits to structures involving hybrids (rather than reverse hybrids). In *Guardian Industries v. United States*,[486] a domestic parent (Guardian Industries) owned and filed a consolidated return with a second domestic corporation (IHC). IHC owned a Luxembourg eligible entity (GIE), which elected under U.S. law to be classified as a DRE. GIE in turn owned several foreign operating per se corporations, which incurred creditable foreign taxes on their operations. Under Luxembourg law, GIE and its operating subsidiaries constituted a combined group (similar to a U.S. affiliated group), which forced the liability for Luxembourg taxes on GIE. However, because GIE was a DRE for U.S. purposes, the court in *Guardian Industries* held that the Luxembourg tax liability should be treated as imposed on IHC under the "technical taxpayer" regulation described above. As a result, those foreign tax credits were immediately creditable on the U.S. consolidated return filed by IHC and its parent, Guardian Industries. And this credit was allowable even though the income of the foreign operating companies was not included until repatriated.[487]

The technical taxpayer regulations have been amended in a way that reverses the result in *Guardian Industries*. Finalized in 2012, the regulations now provide that when foreign entities combine their income for foreign income tax purposes, it is the combined group that is treated as the technical taxpayer and the foreign taxes of the group are allocated among the group

[479] Reg. §1.901-2(f)(4)(ii), T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022).

[480] Section 960(a) provides that in a case of such inclusions, the domestic corporation is deemed to have paid so much of the subsidiary corporation's foreign income taxes as properly attributable to such items of income. *See also* pre-2018 §960(a)(1), which provided for an indirect foreign tax credit under former §902. The Tax Cuts and Jobs Act (TCJA) repealed §902 for tax years beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. Pub. L. No. 115-97, §14301(a).

[481] §960(d).

[482] If the foreign earnings are repatriated by liquidation of the foreign corporation or sale of the stock of the foreign corporation, some of the liquidation or sales proceeds will be recharacterized as dividend income for computing both the parent's U.S. income and the allowable indirect foreign tax credit.

[483] Reg. §1.901-2(f). *See* Rev. Rul. 72-197.

[484] §909(a).

[485] Reg. §1.909-2(b)(1), T.D. 9710, 80 Fed. Reg. 7323 (Feb. 10, 2015).

[486] 65 Fed. Cl. 50 (2005).

[487] Holland, *Special Report: U.S. Check-the-Box Rules in the Cross-Border Context*, Tax Notes Int'l 255, 258–60 (July 18, 2005).

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members as they generated the underlying income.[488] In particular, on the facts of *Guardian Industries* described above, GIE and its operating subsidiaries will be treated as a single combined group and so the foreign taxes imposed by Luxembourg law on the hybrid are pushed down to the operating companies. As a result, there is no immediate foreign tax credit for the hybrid's U.S. parent because neither the parent nor the hybrid that it owns is deemed to pay the foreign income taxes imposed by Luxembourg on the foreign-source income.

3. Effects on Financing Transactions

For a U.S. corporation, the choice between using a regarded or disregarded foreign subsidiary can have significant effect on financing transactions including both loans within a group of related corporations and loans to or from unrelated third parties. What follows is an overview of the basic rules applicable to financing transactions with the understanding that there can be additional tax consequences that follow from such transactions and that these tax results can be modified by treaties (the effect of which often is to reduce the tax imposed or the withholding obligation of a payor).

a. Foreign Subsidiary Lender

Suppose USCo, a U.S. corporation, owns FCo, a foreign subsidiary. If FCo is a regarded entity taxable as a corporation under U.S. law, then loans made by FCo will be treated as made by a foreign corporation. Interest paid to FCo on those loans can be taxable to FCo under §881(a)(1). If the interest paid to FCo is not "effectively connected" to a U.S. trade or business, the interest paid by USCo will be subject to a flat 30% tax (imposed as a withholding obligation on USCo) unless the debt qualifies for the portfolio interest exception in §881(d). Almost all income received from unrelated third parties will qualify for this exception, where related in this context means a "10-percent shareholder."[489] A special set of attribution rules apply to this determination,[490] and 10% is defined by reference to voting power rather than to value of a corporation's stock.[491]

If FCo makes a loan to a related U.S. taxpayer, the borrower will be required to withhold and remit 30% of the interest payable to FCo. Not only is this a disadvantageous result, but if FCo is a controlled foreign corporation, the same income may be includible to USCo under Subpart F.[492] If, however, FCo is a DRE, then the loan is treated as if made by USCo and so the interest will be deemed paid to USCo. As a result, the interest will not be subject to a withholding obligation and the loan itself will not be treated as a repatriation event so that the transaction is not more burdensome than inclusion under Subpart F.

If the borrower is not related to FCo, the advantage of the DRE disappears: interest paid to a regarded FCo by an unrelated borrower generally avoids the withholding imposition because it qualifies as portfolio interest (which is exempt from withholding).[493] If income from FCo is includible to USCo under Subpart F, the taxation of the interest to a regarded FCo will mimic the taxation to a disregarded FCo, but if Subpart F (and the PFIC rules) can be avoided, U.S. taxation on the interest will be deferred until the income is repatriated.

b. Subsidiary Borrower

In general, interest is sourced by reference to the residence of the payor. Accordingly, if USCo owns a domestic subsidiary that pays interest, such interest will be U.S.-source income to the recipient regardless of whether the subsidiary is a DRE or a regarded entity.[494] On the other hand, if the subsidiary is a foreign FSub that pays interest, the source of such interest income will depend on whether the FSub is regarded or disregarded — it will be U.S.-source income to the recipient if FSub is a DRE and foreign-source income if FSub is a regarded entity. The sole exception to this general sourcing rule that might convert income paid by FSub into foreign-source income (even if FSub is a DRE and USCo is a domestic corporation) would be if USCo is a domestic bank. In that case, interest paid by FSub will be foreign-source income under the special rule applicable to foreign branches of U.S. banks.[495]

c. Apportionment Computations

The choice whether to operate a foreign subsidiary as a regarded or disregarded entity should include the impact of the subsidiary on the parent's foreign tax credit limitation. This will be particularly important if there is an inside/outside basis disparity in the subsidiary[496] or if the subsidiary will generate

[488] Reg. §1.901-2(f)(3)(i), T.D. 9576, 77 Fed. Reg. 8120 (Feb. 14, 2012). The combined income with respect to each foreign tax that is imposed on a combined basis, and combined income subject to tax exemption or preferential tax rates, is computed separately, and the tax on that combined income base is allocated separately. Reg. §1.901-2(f)(3)(i).

[489] §871(h)(3). Income received from U.S. bank deposits also is exempt if not connected to a U.S. trade or business. §881(d).

[490] §871(h)(3)(C).

[491] §871(h)(3)(B)(i). If the debtor is a partnership, a "10-percent shareholder" includes any person owning 10% or more of the capital or profits of the partnership. §871(h)(3)(B)(ii).

[492] In addition, the loan from FCo to a related U.S. borrower will be treated as an investment in U.S. property for purposes of §956 and deemed a repatriation. However, the amount otherwise determined under §956 with respect to a corporate U.S. shareholder for a tax year of a CFC is reduced to the extent that the corporate U.S. shareholder would be allowed a §245A dividend received deduction, had the distribution been an actual dividend. *See* Reg. §1.956-1(a)(2), T.D. 9859, 84 Fed. Reg. 23,716 (May 23, 2019). For a further discussion of §956 and the finalized regulations, see 6260 T.M., *CFCs — Investment of Earnings in United States Property* (Foreign Income Series).

[493] Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided the withholding agent with a statement certifying that the beneficial owner is not a U.S. person. §871(h)(2). Portfolio interest does not include interest received by a 10% shareholder (§871(h)(3)), interest that is "contingent" within the meaning of §871(h)(4)(A)(i), and interest on a loan made by FCo in the ordinary course of its trade or business (i.e., if FCo is a foreign bank). §881(c)(3)(A).

[494] The sole exception is if the payor is an "existing 80/20 company." *See* §871(l) and former §861(a)(1)(A) (removed by Pub. L. No. 111-226, tit. II, subtit. B, §217(a)), former §861(c)(1) (removed by Pub. L. No. 111-226, tit. II, subtit. B, §217(c)(1)). If the payor is a regarded corporation, the determination of this status is made at the payor level. If it's a DRE, it's determined at the parent level.

[495] §861(a)(1)(A)(i), as redesignated by the Education Jobs and Medicaid Assistance Act of 2010, Pub. L. No. 111-226, §217(a).

[496] If the taxpayer elects to source based on asset basis (*see* Reg. §1.861-9(g)(1)(ii)), converting a subsidiary from a regarded entity to a DRE will change the sourcing computation because asset basis rather than stock basis will be used. Note that for tax years beginning after 2017, taxpayers must value their assets under either the tax book value method or alternative tax book value method with respect to allocations and apportionments of interest expense between domestic-source income and foreign-source income; the fair market value method for apportioning interest is not allowed. *See* §864(e)(2),

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Subpart F income. The following examples show that, depending on the amount of leverage in the subsidiary, the decision whether to operate the subsidiary as a DRE is highly fact specific.[497] In each example, all of the subsidiary's income is assumed to be Subpart F income to the parent and allocation of the income expense is made using the asset method.[498]

Example (1): Suppose USCo has $1,200 in total assets, of which $900 are operating assets used by USCo in a domestic business and $300 are the ownership of FSub. USCo has debt of $400 while Fsub has operating assets of $900 and debt of $600. Assume that all operating assets generate annual income of 10%,[499] that interest on all debt is payable at a rate of 10%, and that Fsub must pay a foreign income tax liability of $12 on its operating profit of $30 (operating income of $90 less interest expense of $60). USCo's tax liability is $16.80 (($50 + $30) × 21%).

If FSub is a regarded entity, USCo's $40 direct interest expense is one-quarter foreign source ($10) and three-quarters domestic ($30). USCo's foreign-source income therefore is $20 ($30 less interest deduction of $10) and its domestic income is $60 ($90 less interest deduction of $30). Accordingly, USCo's foreign tax credit limitation under §904 is $4.20 ($20/$80 × $16.80).

If FSub is a DRE, there is combined interest expense of $100, of which $50 is foreign source and $50 is domestic source (because the interest expense is allocated in proportion to source under the asset method). As a result, USCo's foreign-source taxable income is $40 (income from FSub's operations of $90 less interest deduction of $50) and its domestic-source taxable income is $40 (income USCo's operations of $90 less interest deduction of $50). USCo's foreign tax credit limitation under §904 accordingly is $40/80 × $16.80, or $8.40.

Example (2): Assume the facts in *Example (1)* above. Assume instead that FSub has assets of $300 and no debt. This does not change the analysis if FSub is a regarded entity, but, if FSub is a DRE, there is combined interest expense of only $40, of which $10 is foreign source and $30 is domestic source. As a result, USCo's foreign-source taxable income is $20 (income from FSub's operations of $30 less interest deduction of $10) and its domestic-source taxable income is $60 (income from USCo's operations of $90 less interest deduction of $30). USCo's foreign tax credit limitation under §904 accordingly is 20/80 × $16.80, or $4.20, precisely the same as if FSub were a regarded entity.

4. *Subpart F Planning*

a. *Check and Sell to Avoid Foreign Personal Holding Company Income*

Suppose a U.S. company owns a controlled foreign corporation (CFC), which in turn owns a second-tier foreign operating company. Dividends paid by the second-tier corporation to the CFC will constitute taxable Subpart F income to the domestic parent as foreign personal holding company income.[500] Sale by the CFC of the second-tier subsidiary produces the same result. However, if the business activity of the second-tier subsidiary were conducted directly by the CFC, the passive dividends would be replaced by active operating income, which might avoid the Subpart F inclusion rules. Of course, retention of earnings by the second-tier subsidiary should avoid Subpart F inclusion as well. Thus, operation of the second-tier subsidiary as a regarded entity might be optimal.

However, sale of the stock of the second-tier subsidiary will force inclusion of any gain by the U.S. parent. This inclusion can be avoided (assuming the assets of the second-tier subsidiary were used in the active conduct of a trade or business) if the second-tier subsidiary is liquidated prior to the sale. If that is done, the sale is converted from a stock sale into an asset sale, and so long as the CFC can be treated as using the assets of the second-tier subsidiary in the conduct of an active trade or business, the asset sale should avoid Subpart F inclusion.

If the second-tier subsidiary is liquidated immediately prior to the sale, the government could argue that its assets have never been *used by the CFC* in the active conduct of a trade or business. However, when a wholly owned corporate subsidiary converts to a DRE, the conversion is treated as a subsidiary liquidation under §332. The taxpayer will argue that when a controlled subsidiary liquidates into its parent under §332, the parent is treated as taking on the business history of the subsidiary. That was the conclusion of the IRS in Rev. Rul. 75-223 in the context of an actual subsidiary liquidation followed by a partial liquidation of the parent corporation, confirmed in a General Counsel's Memorandum.[501] In *Dover v. Commissioner*,[502] the Tax Court addressed this Subpart F inclusion issue in the context of a deemed liquidation triggered by an entity conversion followed by a sale of the assets deemed distributed.

In *Dover*, the Tax Court was careful to note that "the fact that the regulation gives rise to a perceived abuse is 'a problem of respondent's own making,' a problem that respondent has allowed to persist by choosing not to amend the regulations to correct the problem."[503] This observation was prompted by regulations proposed in 1999 that would have invalidated an election by an eligible foreign entity to be classified as a DRE in certain circumstances.[504] The proposed regulations were intended to shut down so-called "check-and-sell" transactions designed to avoid Subpart F. The proposed regulations would have treated a foreign entity as a corporation if it had been in-

as amended by the TCJA, Pub. L. No. 115-97, §14502(a); Reg. §1.861-9(g)(1)(ii), T.D. 9882, 85 Fed. Reg. 29,323 (May 15, 2020).

[497] The idea behind these examples is adapted from Baneman and Cohen, *Check-the-Box-Planning in the International Context*, in Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (PLI 2003).

[498] *See* Reg. §1.861-9T(g). For allocation rules in connection with Subpart F income, see Reg. §1.954-1(c)(1)(i).

[499] Assume for purposes of this example USCo and FSub meet the exemption from the limitation on business interest in §163(j)(3).

[500] §954(c). *See* Reg. §1.954-2.

[501] GCM 37054 (Mar. 21, 1977); *see also* PLR 200301029.

[502] 122 T.C. 324 (2004).

[503] 122 T.C. 324 at 352 (quoting *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398, 411 (1994), aff'd, 62 F.3d 136 (5th Cir. 1995)).

[504] Former Prop. Reg. §301.7701-3(h).

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volved in an "extraordinary transaction" within the period beginning one day before and ending 12 months after the effective date of that foreign entity's change in classification to a DRE, and that foreign entity was classified as a corporation at any time within the 12-month period prior to the extraordinary transaction.[505]

The IRS announced the withdrawal of these proposed regulations on June 25, 2003 in Notice 2003-46. The IRS formally withdrew Prop. Reg. §301.7701-3(h) effective October 22, 2003.[506] The remaining portions of the proposed regulations were finalized without substantial change.[507]

Notice 2003-46 indicated that the approach in the proposed regulations was widely criticized as overly broad and potentially damaging to the increased certainty promoted by the entity classification regulations issued in 1996. The Notice also indicated the IRS and Treasury remain concerned about cases in which a taxpayer, seeking to dispose of an entity, makes an election to disregard it merely to alter the tax consequences of the disposition. The Notice stated the IRS would continue to pursue the application of other principles of existing law (such as the substance-over-form doctrine) to determine the proper tax consequences in such cases.

Notice 2003-46 also indicated the IRS and Treasury were examining the potential use of the entity classification regulations to achieve results inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties. The Notice stated the examination would focus on ensuring that the substantive rule of particular Code provisions and U.S. tax treaties reach appropriate results notwithstanding changes in entity classification. This is consistent with the IRS's historic approach. The IRS has previously attempted to police the use of DREs in the foreign context through Subpart F and other substantive Code provisions — it has never proposed invalidating an entity classification election.[508]

Note, however, that while the use of this "check-and-sell" structure still generally works to avoid Subpart F income, the benefit of such structure has been diminished as a result of the enactment of the Tax Cuts and Jobs Act. Even if gain on the deemed sale of the assets is not treated as Subpart F income, it would constitute "tested income" under §951A(c)(2) for purposes of GILTI inclusions.

b. Full Inclusion Rule

The "full inclusion rule" of §954(b)(3)(B) taints 100% of a CFC's gross income as Subpart F income if more than 70% of that gross income is foreign base company income or gross insurance income. A CFC faced with the application of this rule might selectively conduct some of its activities in regarded entities and some in DREs; income from the active conduct of a trade or business by the CFC generally will not constitute foreign base company income.[509]

5. Intercompany Transfers

a. Transfers to Controlled Corporations

Both §367(a) and §367(d) overrule the general nonrecognition rule of §351, with §367(a) applicable to all appreciated property (but subject to several exceptions) and §367(d) applicable to intangibles.[510] These two provisions are avoided if the controlled corporation is converted to a DRE prior to the transfer of such appreciated property; once that is done, the transfers are ignored for U.S. tax purposes because assets owned by the DRE are treated as continued to be owned by its parent.[511]

b. Sales by Foreign Subsidiary to U.S. Parent

A sale of property from a foreign subsidiary to its U.S. parent will in general give the U.S. parent a cost basis in the property subject to §482 and its transfer pricing rules. If the income recognized by the foreign subsidiary avoids Subpart F income and GILTI inclusion to the U.S. parent, the result is deferral until the foreign gain is repatriated.

> *Example:* Suppose USCo pays fair market value of $65 to regarded FSub for an asset having an adjusted basis of $40 in the hands of FSub. If USCo subsequently sells the asset for $100, there will be income of $35 to USCo. If, however, FSub were a DRE, the purchase by USCo would be ignored and so the taxable gain on the subsequent sale would be $60. Note also that if the purchase by USCo is disregarded, there may be a foreign income tax paid on the transfer but no foreign-source income generated by the transaction, potentially causing foreign tax credit limitation problems.
>
> Thus, the calculus to be considered is whether the benefit of an immediate tax on USCo's $25 gain on the sale to a regarded FSub with a potential avoidance of all U.S. tax on the subsequent $35 is outweighed by the deferral of all taxes on a sale to a disregarded FSub with a U.S. tax on the entire $60 upon the future sale by the FSub.

c. Sales by U.S. Parent to Foreign Subsidiary

A sale of property from a U.S. parent to a foreign subsidiary will in general give rise to taxable income to the selling U.S. parent. However, subject to the application of §482 and Subpart F, any gain resulting from a subsequent sale by the foreign subsidiary will then escape U.S. taxation until the earnings are repatriated.

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[505] Former Prop. Reg. §301.7701-3(h)(1).

[506] *See* Announcement 2003-78.

[507] *See* T.D. 9093.

[508] *See, e.g.,* Notice 98-11, Notice 98-35; Prop. Reg. §1.954-9; CCA 199937038.

[509] *See* §954(a).

[510] *See* §367(d)(4), added by the 2018 Consolidated Appropriations Act, Pub. L. No. 115-141, div. U, §401(d)(1)(D)(viii)(I), for the definition of intangible property for purposes of §367(d).

[511] The TCJA repealed the active trade or business exception previously found in §367(a)(3). Pub. L. No. 115-97, §14102(e).

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Example: Suppose regarded FSub pays fair market value of $65 to its U.S. parent for an asset having an adjusted basis of $40 in the hands of the parent. If FSub then sells the asset for $100, FSub's gain of $35 may avoid U.S. taxation. If, however, FSub were a DRE the eventual sale for $100 would yield taxable income of $60 to the U.S. parent.

Here, too, the immediate U.S. tax on some of the gain, together with a benefit of the potential future avoidance of the remainder of the gain, must be weighed against the deferral of all immediate gain with a future U.S. tax on all of the gain.

ISBN 978-1-63359-467-8

X. State and Local Taxes

An entity that is disregarded for purposes of federal taxes may or may not be disregarded for purposes of state and local taxes. Such taxes include sales and use taxes (as well as the potential obligation to collect such taxes) and income taxes imposed on the entity or on its owner.[512] These taxes are considered in turn, below.

A. Sales and Use Taxes

If a DRE is formed in one state (state X) but its owner is domiciled in a second state (state Y), the question arises whether state X may impose its sales and use taxes on the activities of the owner of the DRE and whether it can require that those taxes be collected and remitted.

In 1992, in *Quill Corp. v. North Dakota*,[513] the U.S. Supreme Court forbade North Dakota from imposing a use tax collection obligation on an out-of-state seller whose only connection with the state was sending catalogs into the state by mail and then shipping by common carrier goods ordered by buyers within the state. The Court held that the Due Process Clause demands that a seller have minimum contacts with a state before the state can impose a tax collection obligation.[514] The Court further held that the Commerce Clause requires a physical presence in the state (either employees or property) before a use tax collection can arise.[515]

These nexus rules (minimum contacts and physical presence) formed the basis of constitutional analysis in this arena until these rules were upended in the Court's 2018 decision in *South Dakota v. Wayfair, Inc.*[516] In *Wayfair*, the Supreme Court ruled that the substantial nexus requirement can be met notwithstanding the fact that the taxpayer has no physical presence in the state; and held that economic and virtual contacts in a state, and minimum sales thresholds can establish nexus.

As such, the physical presence standard of *Quill* is no longer the test for determining whether an out-of-state seller is subject to a state's sales and use tax laws, under the Commerce Clause. For a detailed discussion of the constitutional restrictions on the imposition of sales and use taxes, see 1420 T.M., *Limitations on States' Jurisdiction to Impose Sales and Use Taxes* (Multistate Tax Series).

An entity that is disregarded for federal tax purposes also may be disregarded for state sales tax purposes.[517] If so, then the activities of the DRE will be imputed to its owner, and if the DRE engages in business conduct within a state, that conduct should constitute the minimum contacts necessary to impose a sales and use tax collection obligation on the owner of the DRE. Note that this obligation will apply to all business activity of the owner of the DRE and not simply to the activities imputed to it through the DRE.[518]

For example, suppose Y Corp. manufactures and sells animal foods, and that Y forms DE, a DRE, in state X. Assume that DE's only business is the retail sale of dog food within state X, and that Y Corp. has no activity in state X beyond that of DE. If DE is classified as a DRE by state X, then any sales made by DE within state X will be subject to sales tax, and any sales by Y Corp. shipped to state X can be subjected to a use tax in state X that Y Corp. must collect. Note that this use tax collection obligation applies not only to dog food sold directly by Y Corp. but to cat food and other products shipped to state X; because the activities of the DRE are imputed to Y Corp., Y Corp. has sufficient minimum contacts with state X to satisfy the Due Process Clause. Further, the assets and employees of the DRE will be treated as assets and employees of Y Corp. and so Y Corp. will also have a physical presence in state X sufficient to satisfy the Commerce Clause.

If DE is treated under state law as a DRE because of an affirmative election made by DE or by its owner with respect to the state, the nexus analysis presented above seems unassailable.[519] But if state X treats DE as a DRE based on the election made at the federal level, the nexus analysis is problematic. If a corporation does business in state X, shareholders of that corporation do not, by reason of their status as shareholders alone, have sufficient nexus to state X to support a tax collection obligation. It is not clear that an election made for federal income taxes should be sufficient to change that.[520] Because the nexus requirement is of constitutional dimension one might expect that something beyond the filing of a piece of paper is required to create minimum contacts or a physical presence. This issue is especially acute in the typical situation under the elective classification regime, where a single-member LLC is classified as a DRE of the parent by default rather than due to an affirmative election.

If a subsidiary corporation acts as its parent's agent in State X, that agency conduct should be sufficient to satisfy the

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[512] *See generally* McLoughlin and Hellerstein, *State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-the-Box*, 8 State and Local Tax Law. 1 (2003); Am. Bar Ass'n, *Report of the Task Force on Business Activity Taxes and Nexus of the ABA Section of Taxation State and Local Taxes Committee*, 62 Tax Law. 935 (2009); Ely, Grissom, and Thistle II, *An Update on the State Tax Treatment of Limited Liability Companies and Limited Liability Partnerships*, 87 Tax Notes 2 (Jan. 8, 2018).

[513] 504 U.S. 298 (1992), overruled by *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018) on the physical presence issue under the Commerce Clause but not the minimum contacts issue under the Due Process Clause.

[514] In *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 345 (1954), the Supreme Court wrote that the due process clause "requires some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax." Similarly, the Court wrote in *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940), that "the controlling question is whether the state has given anything for which it can ask in return."

[515] The Court's conclusion was based on an analysis of the four-part test enunciated in in *Complete Auto Transit, Inc v. Brady*, 430 U.S. 274 (1977), where the Supreme Court held that a state may impose a tax on interstate commerce if the tax (1) is applied to an activity having a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state. See also *Goldberg v. Sweet*, 488 U.S. 252 (1989), applying the four-part *Complete Auto* test.

[516] 138 S. Ct. 2080 (2018), 2100.

[517] *See generally* Ely, Grissom, and Thistle II, *An Update on the State Tax Treatment of Limited Liability Companies and Limited Liability Partnerships*, 87 Tax Notes 2 (Jan. 8, 2018).

[518] *See General Trading Co. v. State Tax Comm'n of Iowa*, 322 U.S. 335 (1944).

[519] *See Nelson v. Sears Roebuck & Co.*, 312 U.S. 359 (1941) (sales and use tax collection obligation sustained because of physical presence in taxing state).

[520] *See generally* Pritchard, *Special Report: Nexus Considerations for Limited Liability Companies Under the Check-the-Box Regime*, 98 State Tax Notes 182-30 (Sept. 21, 1998); McLoughlin and Hellerstein, *State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-the-Box*, 8 State and Local Tax Law. 1, 16–17 (2003).

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nexus requirement for the parent.[521] The Supreme Court has on two occasions held that the conduct of independent contractors on behalf of an out-of-state seller will support a use tax collection obligation.[522] But this reasoning should not extend to a parent and subsidiary when the subsidiary acts solely on its own behalf and not as an agent for its parent. To date, there is no clear answer whether the federal election to treat a wholly owned entity as disregarded justifies a sales and use tax collection obligation by the residence state of the DRE imposed on the parent corporation.

B. State Income Taxes

A state can impose an income tax on entities conducting business within its borders. Such a tax can be imposed even on dividends paid to nonresident shareholders on the theory that such a tax remains a tax on the entity.[523] And states have for many years taxed nonresident corporate partners operating in partnership form on their shares of undistributed partnership profits, presumably on the theory that the business activity of a general partnership is properly treated as the business activity of each of the partners.

Presumably the owner of a DRE will not be treated more favorably than the owner of a limited partnership interest in a conventional partnership, and every state save one[524] imputes a partnership's activities to its partners, limited and general alike. Particularly when the entity is disregarded for state as well as for federal tax purposes, imputation of the entity's activities to the owner seems inescapable.

C. State Property Taxes

South Carolina provides for a reduced rate of property taxes on certain residential real estate parcels of not more than five acres. One such parcel was held by a DRE, and the Supreme Court of South Carolina held that the owner of the DRE was entitled to the reduced rate of taxation.[525] The court relied on a provision of South Carolina law providing that "[f]or South Carolina tax purposes: (1) a single-member limited liability company, which is not taxed for South Carolina income tax purposes as a corporation, is not regarded as an entity separate from its owner." Because neither the language of this statute nor its placement in the state's legislative code purported to limit its reach to income taxes, the court held that its application extended to state property taxes.[526]

D. State Transfer Taxes

Many jurisdictions impose a tax on the transfer of certain specified assets, most commonly on the transfer of real estate. Because an interest in a limited liability company is an intangible without regard to the assets held by the LLC, the transfer of an interest in an LLC should not trigger such taxes unless they extend to the transfer of intangibles (which is highly unusual) or the LLC is disregarded for these purposes.

States vary on how they address this issue. As one example, until 2001 Georgia provided by statute that entities disregarded under federal tax law would also be disregarded for Georgia tax purposes. However, in 2001 that statute was amended to provide that such entities would be disregarded only for Georgia income tax purposes, thereby presumably treating single-member LLCs as regarded entities for state transfer tax purposes.[527] Other states (such as Alabama) continue to disregard a single-member LLC for all purposes.[528] And in Florida, a transfer of real estate to a single-member LLC followed by a conveyance of the LLC interest will avoid the state real estate stamp tax only if the conveyance occurs more than three years after the property was transferred to the LLC.[529]

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[521] *Scholastic Clubs, Inc. v. State Bd. of Equalization*, 207 Cal. App. 3d 734 (1989); Appeal of Borders Online, Inc., SC OHA 97-638364 (Sept. 26, 2001) (allowance of in-state returns satisfies nexus requirement). *But see Bloomingdale's by Mail Ltd. v. Commonwealth Dep't of Revenue*, 591 A.2d 1047 (Pa. 1991), cert. denied, 504 U.S. 955 (1992).

[522] *Tyler Pipe Indus. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960). Note that the presence of traveling salespeople will not support imposition of a sales tax collection obligation even though it is sufficient to force a use tax collection obligation. Compare *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327 (1944) with *General Trading Co. v. State Tax Comm'n*, 322 U.S. 335 (1944).

[523] *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940); *Int'l Harvester Co. v. Wis. Dep't of Trans.*, 322 U.S. 435 (1944).

[524] *See* 34 Tex. Admin. Code §3.546(c)(12) and §3.586(d)(12). But see *Lanzi v. Ala. Dept. of Rev.*, 968 So. 2d. 18 (Ala. Civ. App. 2006), holding that the Due Process clause prevents imposition of Alabama's state income tax on a nonresident's distributed income from an Alabama limited partnership absent sufficient minimum contacts between the nonresident and the state, citing *Shaffer v. Heitner*, 433 U.S. 186 (1977).

[525] *CFRE, LLC v. Greenville Cnty. Assessor*, 395 S.C. 67 (2011).

[526] The quoted statutory provision was in the "General Provisions" portion of the South Carolina statute dealing with a variety of state taxes, including income taxes, property taxes, and sales and use taxes. 395 S.C. 67 at 75 (2011).

[527] *See* Millar, *State Taxation of LLCs Is Not Always Black and White: A Georgia Case Study*, 41 State Tax Notes 823 (Sept. 18, 2006).

[528] Millar at n. 9.

[529] Ely, Long, and Thistle, *An Update on the State Taxation of Passthrough Entities and Their Owners*, 60 State Tax Notes 883 (June 20, 2011).

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XI. Qualified Subchapter S Subsidiaries (QSubs)

A. Definition and Qualifications

A "qualified subchapter S subsidiary" (referred to in this Portfolio as a QSub, but also sometimes referred to in practice as a QSSS) is a domestic corporation whose stock is owned entirely by a single electing S corporation, is not ineligible,[530] and with respect to which the S corporation makes an election to be classified as a QSub.[531] Unlike an S corporation, a QSub may have multiple classes of stock outstanding so long as all outstanding shares are owned by a single S corporation. However, if the QSub has outstanding any instruments, obligations or arrangements other than those held by the parent S corporation, those instruments, obligations or arrangements must not amount to equity or the QSub election is invalid. If such instruments, obligations or arrangements are not treated as a second class of stock under the single-class-of-stock regulations applicable to S corporations, they will not be treated as equity for determining QSub status.[532] The regulations provide that stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for federal income tax purposes.[533] So, for example, if an S corporation owns a DRE and that DRE owns stock of a subsidiary corporation, the subsidiary can qualify as a QSub despite the non-tax interposition of the LLC. Note that because there is no restriction on the ability of an S corporation to own stock of a C corporation, a wholly owned subsidiary need not be a QSub. However, because an S corporation cannot have a corporate shareholder,[534] a subsidiary of an S corporation cannot itself be an S corporation.

For a comprehensive discussion of the taxation of S corporations, see 730 T. M., *S Corporations: Formation and Termination*; 731 T.M., *S Corporations: Corporate Tax Issues*; and 732 T.M., *S Corporations: Shareholder Tax Issues.*

B. Taxation

1. QSub Is Disregarded

A QSub is disregarded for tax purposes and all assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation parent.[535] Consistent with ignoring the existence of the QSub, the stock of the QSub thereafter is ignored for tax purposes.[536]

So, for example, a state law partnership owned by the parent S corporation and the QSub will be treated for federal tax purposes as a DRE because all of the partnership interests are treated as owned by the parent.[537] Similarly, transactions between the parent and the QSub are disregarded, including transfers from the parent to the QSub (which might be characterized as contributions to capital under applicable local law) as well as transfers from the QSub to its parent (which might be characterized as dividends under applicable local law).

A QSub will be disregarded in determining the character of income for the passive limitation in §1362(d)(3).

> *Example:* Assume that X, an S corporation, owns all of the stock of Sub, a QSub. Sub owns directly and through single-member LLCs (classified as DREs) interests in several limited partnerships that operate commercial real estate as general partnerships. X is treated as holding the general partnership interests directly, and so the rents received by the partnerships are not treated as passive investment income.[538]

2. Tax Effect of Making QSub Election for Subsidiary

When an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation as of the close of the date before the election becomes effective.[539] If the parent is a C corporation and its S corporation election is effective on the same date as the QSub election, the deemed liquidation of the QSub is deemed to occur immediately *before* the corporation becomes an S corporation. That is, the liquidation of the QSub is deemed made while its parent is still a C corporation.[540] If an existing S corporation forms a subsidiary and makes a QSub election for the subsidiary effective on the date of formation, the formation is ignored and no liquidation is deemed to occur.[541] This rule is particularly important if encumbered assets are transferred to the QSub and the amount of the encumbrances exceeds the adjusted basis of the assets.[542]

The liquidation of a QSub into its parent is subject to all the rules generally applicable to liquidating distributions of a corporation including (when appropriate) the step transaction doctrine. As a result, the acquisition of the stock of a corporation by an S corporation followed by a QSub election can be recharacterized as parts of a larger transaction.[543] For example, if the S corporation acquires stock of a corporation in exchange for voting shares of the S corporation and elects to treat the acquired corporation as a QSub, the transaction may be treated as a "C" or "D" reorganization.[544] However, if the stock of an un-

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[530] Ineligible corporations are described in §1361(b)(2) and include certain financial institutions and insurance companies.

[531] §1361(b)(3)(B). *See* 730 T.M., *S Corporations: Formation and Termination*, for a detailed discussion of the QSub election.

[532] Reg. §1.1361-2(b)(2).

[533] Reg. §1.1361-2(b)(1).

[534] §1361(b)(1)(B), §1361(c).

[535] §1361(b)(3)(A); Reg. §1.1361-4(a)(1)(ii).

[536] Reg. §1.1361-4(a)(4).

[537] *See* Rev. Rul. 2004-77. As a technical matter this ruling speaks only to partnerships formed by a regarded entity and its wholly owned subsidiary that is disregarded under the elective classification regulations, but the reasoning applies with equal force to a partnership formed by an S corporation and its QSub or between a REIT and its QREITs.

[538] PLR 200143012; *cf.* PLR 200218033 (rents from properties owned directly and through a partnership are not passive investment income under §1362(d)(3) where taxpayer provided various operational services to the properties, solicited new tenants, and negotiated leases for the properties).

[539] Reg. §1.1361-4(a)(2)(i), §1.1361-4(b)(1). If valid QSub elections are made with respect to a tiered group of corporations, the electing S corporation may specify the order in which the deemed liquidations are treated as occurring. If no ordering is specified in the elections, then the liquidations are treated as occurring from the bottom up, so that the lowest corporation in the tier is treated as liquidating first. Reg. §1.1361-4(b)(2).

[540] Reg. §1.1361-4(b)(1).

[541] Reg. §1.1361-4(a)(2)(i).

[542] *See* §357(c).

[543] Reg. §1.1361-4(a)(2)(i).

[544] Reg. §1.1361-4(a)(2)(ii) *Ex.* 2.

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related corporation is acquired for cash or for cash and short-term notes, the QSub election will not be stepped together with the stock purchase because of the independent status of a purchase under §338.[545]

If the deemed liquidation of the QSub is not treated as part of a larger plan, the liquidation should be taxable under §332 applicable to subsidiary liquidations. For purposes of satisfying the requirement of adoption of a plan of liquidation under §332, unless a formal plan of liquidation that contemplates the QSub election is adopted on an earlier date, the making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation.[546] Note that if the subsidiary corporation is insolvent on the date its QSub election becomes effective, its deemed liquidation should be a taxable event under long-standing authority.[547]

Assets treated as distributed to the S corporation as part of the deemed liquidation will be subject to the tax on built-in gains under §1374 for a five-year period, beginning on the date of the deemed liquidation to the extent that the S corporation parent takes a carryover basis in those assets under §334(b).[548] Computation of the §1374 tax to such assets is done independently of its application to any assets owned by the parent when it converted to S corporation status.[549]

If an existing entity is converted into a QSub, that entity retains its employer identification number (EIN).[550] If a QSub is newly incorporated, it may apply for its own EIN. However, the QSub must use its parent's EIN for all federal tax purposes except as specified in regulations or other published guidance. For example, a DRE is generally treated as a corporation for purposes of employment taxes and related reporting requirements,[551] as well as certain excise taxes.[552]

3. *QSub Election for Existing C Corporation Subsidiary — Special Issues*

a. *Section 1374 Built-in Gains Tax*

The §1374 tax on built-in gains applies if an S corporation acquires an asset from a C corporation in a transaction in which the S corporation's basis in the asset is determined by reference to the asset basis in the hands of the transferor C corporation.[553] Accordingly, if an existing S corporation makes a QSub election for an existing C corporation subsidiary, the assets owned by the QSub potentially will subject the S corporation parent to the tax on built-in gains. If, though, the parent corporation is itself a C corporation that files an election to become an S corporation effective on the same day as the QSub election, then the assets held by the QSub will implicate the §1374 tax on built-in gains as part of that section's general application to assets held at the time of S corporation conversion because the deemed liquidation of the QSub is deemed to occur on the day immediately *prior to* the effective date of the QSub election.[554]

b. *Carryover of Tax Attributes*

The deemed liquidation of an existing, solvent subsidiary upon conversion to a QSub is a transaction described in §381(a)(1). As a result, the parent S corporation succeeds to and must take into account various tax attributes of the QSub including its earnings and profits and methods of accounting. This may trigger LIFO recapture under §472(d) if the QSub is required to change its inventories from the first-in, first-out method to the last-in, first-out method.[555] If the parent corporation makes an S corporation election effective at the same time, that election may also trigger LIFO recapture.[556]

4. *Termination of QSub Election*

A QSub election can terminate in four ways: (1) the owner of the QSub can revoke the QSub election; (2) the owner of the QSub can cease to be an S corporation; (3) an event occurs that renders the QSub ineligible to be a QSub,[557] or (4) ownership of the QSub is transferred to another S corporation (by sale or reorganization) other than in a "F" reorganization as described in §368(a)(1)(F). Generally, the effect of a termination of QSub status is that the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation.[558] In determining the tax consequences of this constructive corporate formation, general principles of tax law (including the step transaction doctrine) apply.[559] If QSub elections terminate for tiered QSubs on the same day, the formation of any higher-tier subsidiary precedes the formation of its lower-tier subsidiary.[560]

Example (1): Assume that S Corp. owns all the stock of X Corp., which owns all the stock of Y Corp., which owns all the stock of Z Corp. Assume S Corp. is a valid S corporation and that S has filed QSub elections for X, Y and Z.[561] If S Corp's status as an S corporation terminates, S

[545] Reg. §1.1361-4(a)(2)(ii) *Ex.* 1.

[546] Reg. §1.1361-4(a)(2)(iii).

[547] Reg. §1.332-2(b); *Commissioner v. Spaulding Bakeries Inc.*, 252 F.2d 693 (2d Cir. 1958); Rev. Rul. 56-387, *modified by* Rev. Rul. 73-264.

[548] *See* §1374(d)(7) and §1374(d)(8). For further discussion, see 731 T.M., *S Corporations: Corporate Tax Issues.*

[549] Reg. §1.1374-8(b).

[550] Reg. §1.1361-4(a)(7), T.D. 9356, 72 Fed. Reg. 45,891 (Aug. 16, 2007).

[551] Reg. §1.1361-4(a)(7).

[552] Reg. §1.1361-4(a)(8). Specifically, a QSub is treated as a separate corporation for purpose of: "(A) Federal tax liabilities imposed by Chapters 31, 32 (other than §4181), 33, 34, 35, 36 (other than §4461), 38, and 49 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes; (B) Collection of tax imposed by Chapters 33 and 49 of the Internal Revenue Code; (C) Registration under sections 4101, 4222, and 4412; (D) Claims of a credit (other than a credit under §34), refund, or payment related to a tax described in paragraph (a)(8)(i)(A) of this section or under §6426 or 6427; and (E) Assessment and collection of an assessable payment imposed by §4980H and reporting required by §6056."

[553] §1374(d)(8).

[554] Reg. §1.1361-4(b)(1).

[555] Reg. §1.381(c)(5)-1(e)(6)(ii)(B), T.D. 9534, 76 Fed. Reg. 45,673 (Aug. 1, 2011), applicable to corporate reorganizations and tax-free liquidations described in §381(a) that occur on or after August 31, 2011.

[556] §1363(d)(1).

[557] Reg. §1.1361-5(a)(1).

[558] §1361(b)(3)(C)(i); Reg. §1.1361-5(b)(1)(i). For an example of the termination of a QSub election in the context of a D reorganization, see PLR 201010023.

[559] Reg. §1.1361-5(b)(1)(i).

[560] Reg. §1.1361-5(b)(1)(ii).

[561] Note that because X is disregarded, S is treated as the direct owner of Y and it is S that must elect QSub status for Y. And because Y is thus disregarded, S is treated as the direct owner of Z and so again S must make the QSub election for Z.

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will be treated as contributing to a newly formed corporation (X Corp.) all the assets and liabilities of X, Y and of Z. X Corp. will then be treated as contributing to a newly formed corporation (Y Corp.) all the assets and liabilities of Y and Z. Finally, Y Corp. will be treated as transferring to a newly formed corporation (Z Corp.) all the assets and liabilities of Z.[562] Section 351 should apply to each of these deemed incorporations.[563]

The exception to the general treatment described above is in the case of a termination by reason of a sale of stock of the QSub. Such termination is treated as if (1) the sale were a sale of an undivided interest in the assets of the QSub (based on the percentage of the QSub's stock sold), and (2) the sale were followed by an acquisition by a new corporation of all of its assets (and the assumption of all its liabilities) in a transaction to which §351 applies.[564] This treatment typically results in a more beneficial outcome. Under this rule, the requirements for §351 will always be met, thereby only resulting in recognizing gain on the proportionate amount of assets deemed being sold.

Observation: Note that the statutory language only refers to a "sale" of QSub stock. Any transfer of QSub stock in a tax-free transaction or other transaction that does not constitute a "sale" will still be governed by the more general rule, i.e., as a transfer to a newly formed corporation followed by the transfer of the interests of the new corporation.

Example (2): Assume the facts in *Example (1)* above. If S Corp. does not lose its status as an S corporation but instead transfers some of the shares of X Corp. outside of the context of a sale (e.g., as a gift), S will be treated as contributing to a newly formed corporation (X Corp.) all of the assets and liabilities of X, Y and Z *immediately prior* to the sale of the X Corp. shares. If S transfers no more than 20% of the shares of X, the deemed incorporation should be described in §351 because S is "in control" of X immediately after the incorporation. However, if S transfers more than 20% of the stock of X Corp., the deemed formation of X Corp. will not be tax free because S is the only transferor of property on the exchange but S is not "in control" of X immediately afterward.[565] Note that the transfer of 21% of the stock of X Corp. will trigger recognition of 100% of the gain in the corporation's assets. Any losses in those assets can be recognized subject to the related-party rules of §267.[566] On the other hand, if the transfer is pursuant to a sale, then the special rule will apply such that only the proportionate amount of gain will be recognized, on the deemed sale of the assets, with no additional gain generally being recognized on the contribution to the newly formed corporation, as the buyer and seller will together be "in control" of X immediately afterward.

Because X Corp. no longer is disregarded, X becomes the owner of Y and Z for tax purposes, and this change of ownership causes deemed formations of both corporations.

However, if a valid S corporation election is filed for X Corp. effective upon its deemed formation (which is only possible if S Corp. transfers 100% of the shares of X to individuals or trusts eligible to hold shares of an S corporation), then X Corp. can file a QSub election for Y and for Z. If these elections also are effective immediately upon the deemed formation of X, Y and Z, then the deemed formation and liquidation of Y and Z will be disregarded and they will be treated as continuing their disregarded existences as QSubs without interruption. A similar result occurs if S Corp. transfers 100% of X Corp. to another S corporation. On the other hand, if S Corp. transfers 100% of X Corp. to a C corporation, it is treated as a transfer by S Corp. of all of the assets of X Corp. to that C corporation, followed by a contribution by that C corporation of those assets to a newly formed corporation.[567]

The merger of a QSub into an unrelated corporation should be treated as the transfer of assets to the acquiring corporation; the same should be true of the merger of a QSub into an unrelated limited liability company. However, the merger of a QSub into a DRE owned by the parent of the QSub should be ignored for tax purposes because the assets, for tax purposes, remain at all times owned by the parent. This assumes that the acquiring entity remains disregarded after the transaction.

Suppose, though, that the acquiring entity becomes regarded as part of the transaction. For example, assume S Corp. owns X Corp., a QSub, and P, a single-member LLC treated as a DRE. X is merged into P and then 40% of P is sold to a third party, all as part of a single plan. Note that as a result of this final step, P becomes a regarded entity taxable as a partnership.

As before, the merger of X into P should be ignored for tax purposes.[568] However, transformation of the LLC into a partnership is treated as an asset transfer by S Corp. to the third party, followed by a joint formation of the partnership by S and the third party. As a result, S recognizes 40% of the unrealized gain and loss in the X Corp. assets because X is treated as selling an undivided 40% interest in each of the assets.[569]

Query how to treat the following situation: A single-member LLC which has elected to be classified as a corporation under the elective classification regulations is acquired 100% by an S corporation. A QSub election is subsequently made with respect to the LLC. If the S corporation subsequently transfers all or a portion of the LLC interests, or otherwise terminates the QSub election, does the LLC revert to being a C corpora-

[562] Reg. §1.1361-5(b)(3) *Ex.* 6.

[563] For purposes of determining the application of §351 to the deemed incorporation, instruments, obligations, and other arrangements that are not treated as stock under the one class of stock regulations, Reg. §1.1361-2(b), are disregarded for purposes of determining "control" as defined in §368(c). *See* Reg. §1.1361-5(b)(1).

[564] §1361(b)(3)(C)(ii). Note that the regulations have not been updated to reflect this rule. *See, e.g.*, Reg. §1.1361-5(b)(3) *Ex.* 1.

[565] Reg. §1.1361-5(b)(3) *Ex.* 1. The example, which discusses a "sale" of the shares of the QSub, is technically no longer good law (because it has not been updated to reflect the rule in §1361(b)(3)(C)(ii)). However, the conclusion reached by the example should still be correct in a case of other transfers that don't constitute "sales."

[566] *See* Reg. §1.1361-5(b)(3) *Ex.* 1.

[567] *See* Reg. §1.1361-5(b)(3) *Ex.* 9.

[568] Reg. §1.1361-5(b)(3) *Ex.* 2(ii).

[569] Reg. §1.1361-5(b)(3) *Ex.* 2(ii), (iii).

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tion? Or does it revert to its default status as partnership/DRE? Assuming it is available (i.e., if the original election to be classified as a C corporation was an initial election or more than five years have passed), it is recommended that a check-the-box election be made to cause the LLC to be classified as a DRE. Other methods for avoiding this situation would be to cause the QSub to be merged into, or transfer all its assets to, a newly formed LLC held by the parent S corporation.

a. Termination by Revocation

A QSub election can be revoked at any time by the parent of the QSub. The revocation of a QSub election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.[570]

A QSub election that is revoked effective on the first day the election was supposed to go into effect is not treated as a termination of QSub status for purposes of the prohibition on re-elections within five years.[571] Because the QSub election is revoked before it goes into effect, there is no need to restrict the timing of a new QSub election.

The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent S corporation and the QSub, if any. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under §6037.[572] A revocation is ineffective if filed after the QSub election has been terminated either because the parent no longer is a S corporation or the QSub no longer is eligible to be a QSub.[573]

The revocation generally should be tax free because the S corporation parent continues to own all of the outstanding shares of the former QSub and so §351 will apply to the constructive formation. However, if nondeductible liabilities of the former QSub exceed the adjusted basis of its assets, gain will be recognized under §357(c)(1).

b. Termination by Parent Losing S Corporation Status

Because a QSub's owner must be an S corporation, if the owner of a QSub ceases to be an S corporation, the QSub's election terminates.[574] The parent's S corporation election can terminate for any of a variety of reasons, including revocation or failure to maintain its qualification as an S corporation. Regardless of the reason for termination of the parent's election as an S corporation, the impact on the QSub is the same: the QSub is deemed to transfer all of its assets and liabilities to a new corporation. However, if the parent's S corporation election terminates because it becomes a member of a consolidated group (and no election under §338(g) is made), the principles of the end-of-day rule apply both to the S corporation and to the QSub. As a result, the parent S corporation and the QSub become members of the consolidated group at the *beginning* of the day of the termination of the S corporation.[575]

c. Termination by QSub Losing Its Eligibility

The most common event causing the ineligibility of a QSub to qualify as such is a transfer of all or a portion of the QSub stock to another entity (other than an entity that is disregarded from the transferor S corporation). In the case of a transfer of only a portion of the stock, the corporation will become ineligible regardless of the identity of the transferee, as a corporation is only eligible for QSub status if it is owned entirely by one single S corporation. In the case of a transfer of all of the QSub stock, the QSub technically only become ineligible if the transferee is not itself an S corporation. However, as discussed below, even in such a situation, the status as a QSub nonetheless terminates.

As discussed above, the tax consequences of the QSub terminating depends on whether the ineligibility comes about as a result of a "sale" or some other reason.

When a QSub election terminates due to an event that renders the subsidiary ineligible for QSub status, the S corporation must attach to its return for the taxable year in which the termination occurs a notification that a QSub election has terminated, the date of the termination, and the names, addresses, and employer identification numbers of both the parent corporation and the QSub.[576]

d. Termination by Transfer of QSub Stock to Another S Corporation

Under the elective classification regime, a domestic noncorporate eligible entity with a single owner is by default classified as a DRE, and if such an entity has elected corporate treatment it can (that is, the entity itself can) elect to be classified as a DRE. Note that as a technical matter this election is made by the entity itself rather than by its owner.[577] If the owner of such a DRE transfers all the ownership interests of the DRE to another owner, the entity's tax classification as a DRE continues.[578]

By contrast, the election to treat a wholly owned corporate subsidiary of an S corporation as a QSub is made by the parent S corporation.[579] This technical difference is what explains the IRS's unfortunate position that on the transfer of all the stock

[570] Reg. §1.1361-3(b)(2).
[571] Reg. §1.1361-3(b)(4).
[572] Reg. §1.1361-3(b)(1).
[573] Reg. §1.1361-3(b)(3).
[574] Reg. §1.1361-5(a)(1)(ii).
[575] Reg. §1.1502-76(b)(1)(ii)(A)(2), as amended by T.D. 10018, 89 Fed. Reg. 106,848 (Dec. 30, 2024). The S corporation parent's tax year ends for all federal income tax purposes at the end of the preceding day. *Id.* Proposed regulations would require extraordinary items resulting from transactions that occur on the termination date (but before or simultaneously with the event causing the corporation's status as an S corporation to terminate) to be allocated to the corporation's tax return for the short period that ends on the previous day. Prop. Reg. §1.1502-76(b)(1)(ii)(B)(2), REG-100400-14, 80 Fed. Reg. 12,097 (Mar. 6, 2015), applicable to corporations becoming or ceasing to be members of consolidated groups on or after the date these regulations are published as final regulations in the Federal Register.
[576] Reg. §1.1361-5(a)(2).
[577] Reg. §301.7701-3(c)(1)(i).
[578] Rev. Rul. 2004-85 (*Situation 1*).
[579] §1361(b)(3)(B)(ii).

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of a QSub from one S corporation to another S corporation, the QSub election terminates because it cannot be transferred from one S corporation parent to another.[580] The only time such an election will continue (so that the QSub election does not terminate) is when the transfer is incident to an F reorganization of the parent S corporation.[581] In such a reorganization the transferee is treated as a continuation of the transferor.[582]

Because of this rule, the transfer of the stock of a QSub from one S corporation to another will, in general, be treated as a transfer of the assets held by the QSub followed by an incorporation of the assets into a new C corporation.[583] However, if the transferee is an S corporation and it makes a QSub election effective immediately upon acquisition of the QSub stock, the deemed incorporation and immediate liquidation is ignored.[584] In effect, then, the QSub election continues in these circumstances.[585] This rule is particularly important because if a QSub election is not made immediately by the transferee, a QSub election cannot be made for five years.[586]

5. EIN Issues

The §6109 regulations contain rules for the EINs of qualified subchapter S subsidiaries ("QSubs") that are similar to those for DREs. Entities that have an EIN "retain" that EIN if a QSub election for that entity is made or is terminated.[587] QSubs must "use" the parent S corporation's EIN for federal tax purposes.[588] However, for purposes of employment and certain excise taxes, a QSub is treated as a corporation separate from its parent, so it must obtain its own EIN for those purposes.[589] If an entity's QSub election terminates, it may no longer use the EIN of its parent, and must acquire and use its own EIN if it did not already have one.[590] These rules are illustrated by Revenue Ruling 2008-18, which addressed the EIN a QSub should use on the following facts:

> *Situation 1:* B, an individual, owns all of the stock in Y, an S corporation. Y's EIN is 22-2222222. In Year 1, B forms Newco and contributes all of the Y stock to Newco. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Y as a qualified subchapter S subsidiary (QSub), effective immediately following the transaction. The transaction meets the requirements of a reorganization under §368(a)(1)(F). In Year 2, Newco sells a 1% interest in Y to D.
>
> *Situation 2:* C, an individual, owns all of the stock of Z, an S corporation. Z's EIN is 33-3333333. In Year 1, Z forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merges with and into Z, with Z surviving and C receiving solely Newco stock in exchange for Z stock. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub, effective immediately following the transaction. The transaction meets the requirements of a reorganization under §368(a)(1)(F).

On the facts of Situation 1, the IRS held that Y must retain its EIN and "must use its original EIN *any time* the QSub is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes)."[591] Further, since NewCo sold to D a 1% interest in Y, Y's QSub election terminated, and it had to use its original EIN following the termination. The IRS held that NewCo must obtain a new EIN.

On the facts of Example 4, the IRS held that Z must retain its EIN and "must use its original EIN *any time* the QSub is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes)."[592] The IRS added that NewCo must obtain a new EIN.

C. Planning Opportunities

A common use for a QSub or other DRE is to isolate risky assets. For example, suppose S Corp. owns two businesses: a food factory and a hang glider factory. Concern that potential liability from the hang glider factory could consume the food factory, the hang glider factory could be placed into a QSub, limiting recovery by the creditors of the hang glider factory to the assets of that business alone. Note that the hang glider factory is potentially at risk to creditors of the food factory because ownership of the hang glider factory is an asset of the S corporation parent. Thus, the risky assets must be placed in the lower-tier QSub rather than in the upper-tier S corporation.

It could be the case that the risky assets are difficult to transfer. For example, the hang glider factory might include property subject to a lease that precludes transfer or sublease. Alternatively, loan agreements encumbering the hang glider factory might include an acceleration clause triggered by transfer of the assets. In such circumstances the hang glider factory cannot be transferred to the QSub because while such a transfer is ignored for tax purposes, it is not ignored for other, non-tax purposes.

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[580] Rev. Rul. 2004-85 (*Situation 2*); Reg. §1.1361-5(b)(3) *Ex.* 9. *See also* PLR 200845027 (S corp's plan to separate lines of business, involving distribution of its QSub's shares in exchange for shares of S corp held by certain individual and trust shareholders, will terminate QSub election), PLR 200845026 (S corporation's plan to separate business lines by distributing all of its wholly owned subsidiary's stock to shareholders pro rata will terminate subsidiary's QSub election).

[581] Rev. Rul. 2004-85 (*Situation 1*). *See, e.g.,* PLR 201007043 (QSub election in effect for second-tier subsidiary was not affected by parent S corporation's merger into first-tier subsidiary, treated as F reorganization). *See also* Rev. Rul. 2008-18 (S election remains in effect when S corporation merges into newly formed corporation in reorganization qualifying under §368(a)(1)(F) and the newly formed surviving corporation also meets the requirements of an S corporation). Note that if the stock of the QSub is actually owned by a parent QSub, and the parent QSub distributes the stock of the lower tier QSub to its regarded S corporation parent, this transfer of the stock of the lower-tier QSub does not terminate the QSub election of the lower-tier QSub. Reg. §1.1361-5(b)(3) *Ex.* 3. The same outcome should result if the upper-tier QSub is replaced with a DRE under the elective classification regulations.

[582] Reg. §1.381(b)-1(a)(2).

[583] Reg. §1.1361-5(b)(3) *Ex.* 9.

[584] Reg. §1.1361-5(c)(2). In the event that the transferee S corporation fails to timely make the QSub election, it can apply for relief under Rev. Proc. 2013-30, *amplified by* Rev. Proc. 2022-19.

[585] Note that no government consent is required to make this election. Reg. §1.1361-5(c)(3) *Ex.* 2.

[586] Reg. §1.1361-5(c)(1).

[587] Reg. §301.6109-1(i)(1).

[588] Reg. §301.6109-1(i)(2).

[589] Reg. §1.1361-4(a)(7), §1.1361-4(a)(8).

[590] Reg. §301.6109-1(i)(3).

[591] Rev. Rul. 2008-18 (emphasis added).

[592] Rev. Rul. 2008-18 (emphasis added).

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The owners of S Corp. can form a new S corporation, New Co., and then transfer all of the shares of S Corp. to New Co. New Co. can then elect to treat S Corp. as a QSub and that election should be tax free under the rules applicable to subsidiary liquidations. (Indeed, the entire transaction arguably should be recharacterized as an "F" reorganization.) With the assets now safely in the hands of the lower-tier corporation, S Corp. can divide up the food factory in a transaction that is ignored for tax purposes. This properly isolates the risky assets in the lower-tier corporation.

A QSub can be a good choice when an S corporation owns a C corporation that it would like to liquidate but an actual liquidation is difficult for non-tax reasons. For example, the C corporation might have loans that must be repaid if the corporation is liquidated or it might be a lessee on favorable terms that cannot be transferred. In such circumstances converting the C corporation subsidiary into a QSub offers the advantage of liquidation for tax purposes while continuing the C corporation entity alive for non-tax purposes.

A partnership in which a QSub is a partner is not able to elect out of the centralized partnership audit regime because partnership structures with QSubs as partners can have far more than 100 ultimate partners.[593] In announcing its intent to propose regulations making the §6221(b) election unavailable to a partnership with a QSub as a partner, the IRS stated that allowing such a potentially large partnership to elect out of the centralized partnership audit regime would give rise to significant enforcement concerns and frustrate the efficiencies introduced by the regime.[594]

D. Comparison of QSubs and Single-Member LLCs

In general, a QSub offers few benefits and significant detriments as compared with a single-member LLC classified as a DRE. There are a variety of ways in which a QSub can lose its disregarded status, triggering an immediate incorporation of the QSub's assets.[595] This incorporation can be a taxable event in itself and may lead to a taxable liquidation if the assets of the QSub ultimately will be removed from corporate solution. Therefore, it is almost always more advantageous to convert any QSub into a limited liability company that is classified as a DRE. The use of QSubs should therefore generally be limited to situations where there are non-income tax considerations that make such a conversion difficult or prohibitively expensive.

1. Formation of Newly Created Entity

The transfer of assets from an S corporation to a DRE is a non-event for tax purposes whether the transferee is a single-member LLC classified as a DRE or a QSub. Accordingly, if there is no doubt that the entity will be disregarded, no formation issues arise in either case.

But suppose the transferor corporation subsequently is determined not to have been eligible to be an S corporation when the transfer was made. If the transferee nominally is a QSub, then the failure of the transferor to qualify as an S corporation causes the transferee to be disqualified as a QSub. Accordingly, what was intended to be a non-event for tax purposes becomes the incorporation of assets. Under some circumstances an incorporation can be a taxable transaction,[596] and even if the incorporation is tax free there remains the problem that the assets now are in corporate solution and potentially subject to the corporate double tax.

On the other hand, if the transferee is a DRE under the elective classification regulations, then the tax status of the transferor becomes irrelevant. As a result, even if it is determined that the transferor was a C corporation rather than an S corporation, the entity remains disregarded and the transfer remains tax free.

If third parties will have interests in the transferee entity, then use of a QSub poses additional risks that may be avoided if the transferee is a single-member LLC. If the QSub has more than a single equity owner, it fails to qualify as a QSub and instead becomes a C corporation. Any debt security issued by the QSub must therefore be very carefully structured to ensure that there is no risk that it could be reclassified as equity for tax purposes. While the single-class-of-stock regulations promulgated under the S corporation provisions give some comfort to QSubs as well,[597] the consequences of running afoul of those rules is substantial. If, on the other hand, third parties have interests in a single-member LLC, the entity will be reclassified as a partnership but the formation likely will remain tax free[598] and the assets will not end up in corporate solution.

2. Operation of the Entity

As with formation, there is no difference in the operation of a QSub and an entity disregarded under the elective classification regulations so long as both entities properly are disregarded. But a single-member LLC is less vulnerable to accidental conversion into regarded form. For example, if the parent S corporation terminates its S corporation election, the DRE will continue to be disregarded. A QSub, in contrast, ceases to be eligible to remain a QSub if its parent's S corporation election terminates.[599]

Further, if a traditional DRE is forced to convert into regarded form because of the introduction of additional equity owners, it will be classified as a partnership rather than as a corporation. This conversion is less likely to be taxable and, if taxable, is likely to result in a smaller amount of taxable gain (though this result is mitigated under the current rules in the case of a sale of shares of the QSub).

[593] *See* Reg. §301.6221(b)-1(b)(3)(ii)(G). For a discussion of the post-2017 centralized partnership audit regime, see 629 T.M., *The Partnership Audit Rules Under the Bipartisan Budget Act*, and for a discussion of the pre-2018 partnership audit rules 624 T.M., *Audit Procedures for Pass-Through Entities*.

[594] *See* Notice 2019-6.

[595] *See* Reg. §1.1361-5(b)(3) Ex. 1.

[596] *See* §351(e) (transfer of property to an investment company), §357(b) (transfer subject to liability with principal purpose of tax avoidance), §357(c)(1) (transfer subject to liability in excess of basis).

[597] Reg. §1.1361-2(b)(2).

[598] The transfer of encumbered assets will trigger recognition of income to the transferor only if the transferor's share of liabilities declines by more than the adjusted basis of the transferred property (*see* §752(b) and §731(a)(1)), or the transaction is part of a disguised sale (*see* §707(a)(2)(B)). Transfers of property to a partnership that would be an investment company if incorporated can trigger the recognition of gain but not loss. *See* §721(b).

[599] §1361(b)(3)(C).

ISBN 978-1-63359-467-8

3. Termination of the Entity

An S corporation parent of a DRE can terminate the disregarded subsidiary in at least four ways. First, the assets of the entity could be transferred back to the parent and then the subsidiary could be liquidated under applicable local law. Second, the entity could be converted into a wholly owned regarded subsidiary. Third, the entity could be converted into an entity with multiple owners. Fourth, ownership of the entity could be transferred to a third party.

a. Transfer of Assets and Liquidation of the Entity

For federal tax purposes, there should be no difference between the liquidation of a QSub and the liquidation of an entity disregarded under the elective classification regulations; in each case, the transfer of the entity's assets subject to the entity's liabilities to its parent is ignored because the assets and liabilities are treated as belonging to the parent even while the DRE is in existence.[600] Note that this is true even if the entity is chartered in a foreign jurisdiction or is insolvent at the time of the liquidation.[601] However, the transfer of assets might be classified as a dividend distribution for foreign tax purposes if the subsidiary is classified as a corporation under applicable local law. If the entity is disregarded under local law as well as for federal tax purposes, the distribution should be ignored in its entirety.

b. Conversion into Regarded Subsidiary

A conversion of a disregarded single-member LLC into a C corporation should be treated as the incorporation of assets to a newly formed entity subject to all the rules generally applicable to incorporations.

There would not appear to be an analogous type of transaction in the case of a QSub, as a QSub already is a corporation for non-tax purposes. If a QSub "converts" into a new corporation for non-tax purposes (e.g., to switch jurisdiction of organization) in what would be treated as an F reorganization (absent the application of the QSub rules), the new corporation would likely retain its QSub status. However, to remove all doubt, it may be advisable to make a protective QSub election for the "new" corporation.

In the QSub context, interests in the entity that are disregarded under the one-class-of-stock regulations[602] are also disregarded for determining "control" under §351.[603] Note that no similar safe harbor exists in the elective classification regulations.[604]

c. Introduction of Additional Owners

If the parent S corporation transfers any equity interest in a QSub to another owner, the QSub election of the subsidiary terminates. As described above, the tax treatment of such transfer (including whether the deemed contribution will meet the "control" test for purposes of §351) will depend on whether the transfer is a "sale" or not.[605] Even if the requirements of §351 are met, if the liabilities of the QSub exceed the adjusted basis of its assets, the transaction can be taxable to the extent of the excess liabilities.[606]

Introduction of additional equity owners when the entity is disregarded under the elective classification regulations will convert the entity into a partnership.[607] There is no "control" test applicable to the transfer of property to a partnership, and encumbrances will trigger the recognition of income only if the transferor's share of partnership liabilities immediately after the transfer declines by more than the adjusted basis of the transferred property.[608]

If the new partners contribute assets directly to the entity in exchange for newly issued equity interests, the transaction will be treated as the joint formation of a new partnership by the parent S corporation and the new partners.[609] This transaction will be tax free under §721–§722 unless there are taxable liability shifts or the partnership is captured by the investment partnership rule of §721(b). However, if the third parties receive their interests directly from the S corporation parent in exchange for cash or property received by the parent, the transaction will be treated as an exchange of a proportionate part of the entity's assets followed by a joint formation by the S corporation and the new partners.[610] As a result, the transaction will be taxable to the extent the recharacterized asset exchange is deemed to occur immediately prior to the deemed partnership formation.

d. Transfer of the Entity

The transfer of all equity interests in a QSub to any new owner (other than a DRE owned by the existing S corporation parent) will trigger termination of the QSub election. This is true even if the new owner is itself an S corporation so that a new QSub election could immediately be made.[611] The S corporation seller will recognize gain on the deemed transfer of assets, either due to a failed §351 transaction due to a lack of "control" (if the transfer is not a "sale" of the stock for purposes of §1361(b)(3)(C)(ii)), or due to its being treated as a sale of the assets to the buyer (if the transfer is treated as such a "sale"). In either case, the QSub will be classified as a C corporation after the transfer, unless the new owner is an S corporation that makes a new QSub election effective as of the date of the acquisition of the entity.

In contrast, the transfer of ownership of a disregarded single-member LLC does not affect the tax classification of the entity.[612]

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[600] Reg. §301.7701-2(a).

[601] If a regarded foreign subsidiary liquidates into its parent, the transfer of assets may be taxable under §367(b). If an insolvent corporation liquidates into its parent, §332 does not apply and the transaction will be subject to the usual rules applicable to the transfer of property. Reg. §1.332-2(b).

[602] Reg. §1.1361-2(b).

[603] Reg. §1.1361-5(b)(1)(i).

[604] *See* Reg. §301.7701-3(g)(1)(iv).

[605] §1361(b)(3)(C). As noted above, this is in contradiction with Reg. §1.1361-5(b)(3) *Ex.* 1, which has not been updated to reflect the 2007 amendment.

[606] §357(c).

[607] Reg. §301.7701-3(b).

[608] §752(b).

[609] Rev. Rul. 99-5 (*situation 2*).

[610] Rev. Rul. 99-5 (*situation 1*).

[611] Rev. Rul. 2004-85 (*situation 2*). *See also* Reg. §1.1361-5(b)(3) *Ex.* 9.

[612] Rev. Rul. 2004-85 (*situation 1*).

ISBN 978-1-63359-467-8

XII. Qualified Real Estate Investment Trust Subsidiary (QRS)

A. Definition and Qualifications

A real estate investment trust (REIT) is a corporation, trust or association for which a valid election under §856(c)(1) is in effect. Operating essentially as a mutual fund for real estate investments, a REIT is limited in the assets it may hold and in the kinds of income it may receive. In exchange, the REIT avoids taxation on distributed profits.[613] To qualify as a REIT, an entity must satisfy eight organizational requirements along with continuing operational tests speaking to the entity's assets, income, and annual distributions.

For a detailed discussion of REITs, see 742 T.M., *Real Estate Investment Trusts.*

A "taxable REIT subsidiary" (TRS) is any corporation (subject to a few exceptions)[614] in which a REIT directly or indirectly owns stock and for which the REIT and the corporation make a joint election to treat the corporation as a TRS. The election is revocable with the consent of both the REIT and the TRS.[615] Note that there is no minimum stock ownership requirement; in particular, the TRS may have owners other than the REIT. However, a TRS election automatically applies to any subsidiary of the TRS if the TRS owns more than 35% of the subsidiary's stock (by vote or by value), unless such subsidiary is itself a REIT, or is a qualified REIT subsidiary.[616]

Subject to the exceptions for operation or management of a lodging or health care facility, a TRS may engage in any business activity including those that would disqualify the REIT if engaged in directly. In particular, a TRS may provide services to REIT tenants even if such services were not customarily provided in connection with the rental of real property. Under limited circumstances, a REIT is permitted to lease property to the TRS.[617] Note that the total value of TRS securities owned by a single REIT, along with non-real estate assets held by the REIT, cannot exceed 25% of the REIT's total assets.[618] In addition, the value of all securities issued by one or more TRS cannot exceed 20% (25% for taxable years beginning before January 1, 2018) of a REIT's total assets.[619]

A qualified real estate investment trust subsidiary (QRS) is a corporation that is owned entirely by a REIT and is not a TRS.[620] The law governing the taxation of QRSs mirrors that of QSubs,[621] providing that a corporation that is a QRS is not treated as a separate corporation,[622] and that all assets, liabilities, and items of income, deduction, and credit of a QRS are treated as assets, liabilities, and such items (as the case may be) of the REIT.[623] There is limited guidance on the taxation of QRSs. Because of the parallel statutory language in the QRS and QSub provisions, it makes sense to look to the QSub rules and regulations for the details of QRS taxation.

Any corporation wholly owned by a REIT is automatically a QRS unless the corporation is a TRS. Note that, unlike for a QSub, the classification of a corporate wholly owned subsidiary of a REIT as a QRS is automatic. No election is required to qualify a corporate wholly owned subsidiary of a REIT as a QRS, nor is there an ability to elect out of QRS status (other than by electing to be treated as a taxable REIT subsidiary).

Practice Point: This can be a trap for the unwary. It is not uncommon for an investment structure to consist of a parent REIT holding the interests of one or more subsidiary REITs. Because the requirement for a REIT to have at least 100 shareholders only begins in the second year of the REIT's existence, it is likely that upon formation, the subsidiary REITs will be wholly owned by the parent REIT. Notwithstanding the intention for the subsidiaries to qualify as REITs, the subsidiaries will instead be treated as QRSs until they have at least one additional regarded shareholder.

B. Formation or Acquisition of a QRS

If a REIT forms a corporate subsidiary, presumably the formation will be ignored and the QRS will be ignored for tax purposes.[624] If a REIT acquires the stock of an existing corporation, the corporate subsidiary should be treated as liquidating immediately as of the date of the acquisition.[625] The legislative history of the current QRS statute provides: "Where the REIT acquired an existing corporation, any such corporation is treated as being liquidated as of the time of the acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the rules of section 337)."[626]

A subsidiary liquidation generally is tax free to the distributing corporation under §337(a). However, when the parent corporation is a REIT, the regulations provide that rules similar to those found in §1374 (with certain modifications) apply with respect to any built-in gain property held by the subsidiary at the time of such liquidation.[627] Under these rules, the corporation's net unrealized built-in gain is not immediately taxable but will be taxable under §1374 if recognized during the five-year recognition period beginning on the conversion date.[628]

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[613] *See* §857(b)(2)(B).

[614] A TRS does not include any corporation that operates or manages a lodging or health care facility or that provides rights to operate or manage a lodging or health care facility under a brand name. §856(l)(3). For discussion of taxable REIT subsidiaries, see 742 T.M., *Real Estate Investment Trusts.*

[615] §856(l)(1).

[616] §856(l)(2).

[617] §856(d)(8).

[618] §856(c)(4)(B)(i).

[619] §856(c)(4)(B)(ii), as amended by Pub. L. No. 114-113, div. Q, §312. *See* PLR 201315007 (for purposes of 25% test of §856(c)(4)(B)(ii), mortgage loans from REIT to TRS secured by real property owned by TRS and mezzanine loans from REIT to TRS secured by partnership interest in partnership or sole membership interest in DRE were not treated as securities).

[620] §856(i)(2).

[621] *See* §1361(b)(3)(A).

[622] A QRS is treated as a separate corporation, however, for purposes of (1) tax liabilities for any taxable period for which the QRS was treated as a separate corporation, (2) tax liabilities of any other entity for which the QRS is liable, and (3) refunds or credits of tax. Reg. §1.856-9(a).

[623] §856(i)(1).

[624] *Cf.* Reg. §1.1361-4(a)(2)(i), §1.1361-4(a)(1) (QSub rule).

[625] *Cf.* Reg. §1.1361-4(b)(3) (QSub rule).

[626] H.R. Rep. No. 105-220, at 698–99 (1997).

[627] *See* §337(d); Reg. §1.337(d)-7(a)(1), §1.337(d)-7(b). The regulations also provide for special rules that reduce built-in gains tax exposure in like-kind exchanges and involuntary conversions and in transfers by tax-exempt entities. Reg. §1.337(d)-7(d)(3), §1.337(d)-7(d)(4).

[628] Reg. §1.337(d)-7(b)(2)(iii), as amended by T.D. 9810, 82 Fed. Reg. 5387 (Jan. 18, 2017), applicable to conversion transactions occurring after February 17, 2017. For conversion transactions that occurred on or after Au-

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However, the §1374 tax may be reduced if the income arising from the disposition of assets subject to §1374 also is subject to taxation under §856(b)(5) because the disposition is a "prohibited transaction" (as to the REIT) as defined in §856(b)(6).[629]

In the alternative, the REIT may elect, instead, to have the subsidiary treated as selling its assets to itself for fair market value immediately prior to the REIT's acquisition.[630] However, no such sale is deemed to occur if it would result in the recognition of a net loss to the corporation.[631] If a sale is deemed to occur, then the REIT takes a fair market value basis in each of the assets.[632] However, for computing the recognized gain on the deemed sale, loss assets previously contributed to the corporation in a §351 transaction are ignored if they were contributed as "part of a plan a principal purpose of which was to reduce the gain recognized by the C corporation in connection with" the deemed sale triggered by the REIT acquisition.[633] The election to treat the conversion to a QRS as triggering an immediate taxable sale is made by attaching to the final return of the corporation a statement reading: "[Insert name and employer identification number] elects deemed sale treatment under section 1.337(d)-7(c) with respect to its property that was converted to property of, or transferred to, a RIC or REIT, [insert name and employer identification number of REIT]."[634] This election once made is irrevocable.[635]

Under regulations finalized in June 2019, with respect to transactions in which property of a C corporation becomes the property of a REIT following certain corporate distributions of controlled corporation stock (under §355), the REIT is automatically treated as having made the election.[636] However, the regulations provide rules to prevent recognition of gain in excess of the amount that would have been recognized if a party to a spin-off had instead transferred assets directly to a REIT.[637] In particular, the regulations require that gain immediately recognized by a C corporation engaging in a §355 distribution and a conversion transaction within the 10-year period following the §355 distribution be limited to gain on property traceable to the §355 distribution. The limitation is available to a distributing corporation or a controlled corporation (and a successor) and provides that, if a C corporation is treated as making a deemed sale election but has not actually made such an election, the C corporation is treated as making the election only with respect to its distribution property.[638] The term "distribution property" means property owned immediately after a §355 distribution by a distributing corporation, a controlled corporation, or a member of a separate affiliated group of which the distributing corporation or the controlled corporation is the common parent. No formulation of the step transaction doctrine is used to determine whether property acquired after the distribution is distribution property.[639] The C corporation's property that is not distribution property would be subject to §1374 treatment.[640]

C. Taxation of the QRS

A QRS is a DRE for all tax purposes, and the assets and liabilities of the QRS are treated as assets and liabilities of the parent REIT.[641] As a result, the income of the QRS is aggregated with the income of the parent REIT in applying the various tests applicable to REIT income. A partnership formed by the parent REIT and one or more of its QRSs is disregarded, as is a partnership whose only partners are QRSs with a common parent. Transactions between the parent REIT and a QRS are disregarded.

As a general rule, a REIT cannot use the stock of a QRS as part of a like-kind exchange because stock cannot qualify for like-kind treatment.[642] While the QRS is ignored while owned by the REIT, a disposition of the QRS stock should convert the disregarded QRS into a C corporation immediately *prior* to the transfer. Accordingly, the parent REIT wishing to satisfy §1031 should cause the QRS to distribute its properties to the parent REIT prior to the exchange, and then the transaction can be done as a traditional, assets-for-assets exchange. Alternatively, the assets of the QRS could be transferred to a single-member LLC or other entity disregarded under the elective classification regulations and then the membership interests of the DRE could be used in the like-kind exchange.[643]

However, it should be possible for the parent REIT to exchange the stock of the QRS for qualifying like-kind property (or even stock of another QRS) if the transferee is itself a REIT. As discussed above, the transfer of stock of a QRS to another REIT should be treated as an asset transfer to both parties to the exchange. Accordingly, in such circumstances the exchange of stock of the QRS may qualify under §1031.

While a QRS generally is disregarded as an entity separate from its parent REIT, it can be recognized as a distinct entity for certain purposes. Under Reg. §1.856-9, a QRS will be regarded with respect to federal tax liabilities of the QRS relating to any taxable period for which the QRS was treated as a separate corporation, for federal tax liabilities of any other entity for which the QRS is liable, and for refunds or credits of federal tax. Examples of these situations can be found in the regulations.

D. Termination of QRS Status

A corporation under applicable local law that is treated as a QRS for federal tax purposes can lose that tax status in any

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gust 8, 2016, and on or before February 17, 2017, see pre-T.D. 9810 Reg. §1.337(d)-7T(b)(2)(iii) (10-year recognition period). However, taxpayers may apply Reg. §1.337(d)-7(b)(2)(iii) to conversion transactions that occurred on or after August 8, 2016, and on or before February 17, 2017. For conversion transactions that occurred on or after January 2, 2002, and before August 8, 2016, see pre-T.D. 9770 Reg. §1.337(d)-7(b)(2)(iii). Reg. §1.337(d)-7(g)(2)(iii).

[629] Reg. §1.337(d)-7(b)(2)(i). For more on the application of §1374 to assets acquired by a REIT in a carryover basis transaction from a C corporation, see 742 T.M., *Real Estate Investment Trusts*, at 742.VI.C.4.c.

[630] Reg. §1.337(d)-7(c)(1), §1.337(d)-7(c)(3).

[631] Reg. §1.337(d)-7(c)(1).

[632] Reg. §1.337(d)-7(c)(2).

[633] Reg. §1.337(d)-7(c)(4).

[634] Reg. §1.337(d)-7(c)(5).

[635] Reg. §1.337(d)-7(c)(5). For more on the deemed-sale rules, see 742 T.M., *Real Estate Investment Trusts*, at 742.VI.C.4.d.

[636] Reg. §1.337(d)-7(c)(6), §1.337(d)-7(f).

[637] *See* T.D. 9862, 84 Fed. Reg. 26,559 (June 7, 2019) (generally applicable to conversion transactions occurring on or after June 7, 2019).

[638] Reg. §1.337(d)-7(c)(6), §1.337(d)-7(f).

[639] Reg. §1.337(d)-7(a)(2)(viii).

[640] Reg. §1.337(d)-7(c)(6)(ii).

[641] §856(i).

[642] *See* §1031(a)(1).

[643] *See* V.A.3., above.

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one of three ways. First, the REIT can elect to treat the corporation as a taxable REIT subsidiary. Second, some of the equity interests in the corporation can become owned by a person other than the REIT (either by a transfer of interests from the REIT or by issuance of new interests). Third, the REIT parent can lose its status as a REIT. Regardless of the manner of termination, the statute provides: "For purposes of this subtitle, if any corporation which was a qualified REIT subsidiary ceases to [qualify as a qualified REIT subsidiary], such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the real estate investment trust in exchange for its stock."[644]

1. Conversion to a Taxable REIT Subsidiary (TRS)

While there is no requirement that a TRS be wholly owned by a REIT, only a wholly owned subsidiary can be converted from a QRS into a TRS because only a wholly owned subsidiary can be a QRS.[645] The election to treat a corporation as a TRS is made jointly by the REIT and by the subsidiary on Form 8875. Once such an election is made, the assets and liabilities of the subsidiary are treated as contributed to a new corporation.[646] This deemed incorporation of the wholly owned subsidiary should be tax-free under §351.

2. Addition of Second Equity Owner

If a new equity owner is introduced, the QRS becomes a regarded C corporation; its assets and liabilities are deemed contributed to a new corporation in exchange for its stock. The statute makes clear that this deemed incorporation takes place immediately prior to the event that terminates the subsidiary's QRS status. The tax consequences of this transaction may turn on whether the new equity owner acquires its interest directly from the QRS or from the REIT parent.

If equity is transferred from the REIT owner to a new equity owner, the resulting deemed incorporation will be taxable if the REIT is not "in control" of the subsidiary immediately after the transaction, where "control" is defined in §368(c) to mean ownership of stock possessing at least 80% of the total combined voting power of all classes entitled to vote and at least 80% of the total number of all other classes of stock of the corporation. Because the incorporation is treated as occurring immediately before the equity interest is transferred, relinquishment of "control" by the REIT parent should be fatal to the application of §351.[647] Note that a post-transaction disposition of stock will not violate the continuity of proprietary interest requirement of a corporate acquisitive reorganization,[648] but this rule has never been extended to the §351 context. Of course, if the equity interest of the new owner is less than 20% of the corporation's stock, the REIT will remain in control of the subsidiary and the formation will be tax free. Note also, that, unlike the special beneficial rule[649] applicable in the case of termination of QSub status as a result of a sale of QSub shares,[650] the statute setting forth the tax consequences of a QRS termination was never amended. Therefore, regardless of whether the termination was caused by a sale of QRS shares or otherwise, the tax treatment will be the same — as a formation of a new subsidiary corporation by the REIT immediately prior to the transfer or other event causing the QRS termination.

If the new equity owner joins by making a direct contribution to the QRS in exchange for stock, the tax consequences of the transaction are less clear. The statute is clear that the incorporation is deemed to occur immediately before the contribution by the new equity owner, but that does not directly speak to whether the deemed incorporation by the REIT and the subsequent contribution by the equity owner can be stepped together into a single transaction. However, it seems likely that they should be treated as a single transaction, given that the subsequent contribution is the immediate cause of the deemed incorporation.

If the deemed incorporation and the immediately subsequent contribution are treated as a single, integrated transaction, then both parts of the transaction should be tax free because the transferor group includes both the REIT and the new equity owner.[651] If the two transactions are treated as separate, then the deemed incorporation should be tax free because the REIT owns 100% of the stock of the subsidiary at that time, and then the contribution by the new equity owner will be taxable unless the new equity owner acquires "control" in exchange for the contribution of property.

3. Termination of Parent's REIT Status

Termination of the parent's REIT status necessarily terminates the subsidiary's QRS status because a QRS must be owned by a REIT. No guidance speaks to the order of these two events. Assuming there is no gain recognized on the deemed contribution, the ordering does not seem to have federal income tax consequences. However, if there is gain recognized,[652] then the ordering of the events would seem to have an impact — i.e., whether the gain is treated as being recognized by a REIT or by a regular C corporation. In the context of S corporations and their subsidiaries, if an existing S corporation ceases to qualify as an S corporation, any QSubs owned by the S corporation are deemed to liquidate at the close of the last day of the parent's last taxable year as an S corporation *prior to* the conversion into a C corporation.[653]

4. Transfer to Another REIT

If a parent REIT transfers ownership of a QRS to a new REIT parent, the QRS should continue to be ignored and the transaction should be treated as a transfer of assets from one REIT to another. Alternatively, the QRS could be treated as converting into a C corporation in the hands of the transferor and then converting back into a QRS in the hands of the REIT

[644] §856(i)(3).
[645] §856(i)(2).
[646] §856(i)(3).
[647] *See, e.g., Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976); Reg. §1.1361-5(b)(3) *Ex.* 1 (termination of QSub status); CCA 200350016.
[648] Reg. §1.368-1(e).
[649] §1361(b)(3)(C)(ii).
[650] *See* XI.B.4.d., above.
[651] *See* Rev. Rul. 78-294.
[652] For instance, if the QRS has liabilities in excess of basis, the deemed incorporation will result in taxable gain to the REIT under §357(c) to the extent of such excess.
[653] Reg. §1.1361-5(a)(1)(ii), §1.1361-5(a)(4) *Ex.* 1.

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transferee. While there is no direct guidance on this matter, the parallels from the S corporation arena and the elective classification regulations strongly support the first (asset transfer) result.

The transfer of a single-member LLC from one owner to another does not change the elective classification status of the entity while the transfer of a QSub from one S corporation to another does. This difference can be explained by the different ways in which disregarded status is elected. In the case of an entity disregarded under the elective classification regulations, the election is made by the entity itself, and that election continues when ownership of the entity is transferred.[654] The election to treat a corporate subsidiary as a QSub, though, is made by the parent S corporation, and that election is not imputed to a subsequent owner.[655]

In this context, a QRS seems more like a single-member LLC than a QSub because no parental election is required for a REIT subsidiary to be classified as a QRS. Thus, there is no need to impute one taxpayer's election to another taxpayer. In addition, even in the context of a QSub the disregarded status can, in effect, be continued from transferor to transferee if the transferee makes a QSub election that is effective on the date of acquisition of the subsidiary. If that is done, the deemed formation and liquidation are disregarded.[656] Because the status of a REIT subsidiary as a DRE is automatic, the transfer of a QRS should be treated as the equivalent of a transfer of a QSub coupled with an immediate QSub election by the transferee.

[654] Reg. §301.7701-3(c)(1)(i).

[655] Rev. Rul. 2004-85 (situation 2); Reg. §1.1361-5(b)(3) *Ex.* 9.

[656] Reg. §1.1361-5(c)(2).

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