

apparently being considered for foreign business organizations.

The notice has become widely referred to as a "check-the-box" system, because taxpayers would be allowed to do virtually just that in order to select the method of taxation that would apply to that electing organization. Although the rules may be of somewhat less concern to corporate tax practitioners than to many others (partnership tax specialists, for example, have long had to deal with the Byzantine rules of the classification regulations), the impact of the notice can hardly be overestimated. The classification regulations set forth under Section 7701 of the Code set forth a list of factors to be used in determining whether a partnership or trust should be taxed as a flow-through (partnership tax treatment) or as an entity (corporate tax treatment). The four key criteria for determining whether a partnership will be taxed as such or will be subject to corporate tax treatment are:

- Centralization of management;
- Continuity of life;
- Free transferability of interests; and
- Limited liability.

Although the Section 7701 classification regulations have been in place for quite some time, they have undergone increased scrutiny because of the advent of limited liability companies ("LLCs"), which have now proliferated in virtually every state. Applying the LLC traits to the regulations under Section 7701

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Check-the-Box System: How Far Will It Go?

by Robert W. Wood • San Francisco

Most practitioners could not fail to be caught up, at least to some extent, in the hoopla surrounding Notice 95-14, 1995-14 I.R.B. 7. In that notice, the IRS announced that it was considering simplifying the classification regulations. Under the proposal, taxpayers would be allowed to treat domestic unincorporated business organizations as partnerships or as associations taxable as corporations on an elective basis. Similar rules are

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CHECK-THE-BOX

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had become a little like putting a square peg in a round hole. Consequently, the Service earlier this year issued Revenue Procedure 95-10, 1995-3 I.R.B. 20, to provide a specialized spin on the classification criteria applicable to LLCs. Revenue Procedure 95-10 is supposed to make the classification determination much more straightforward (partnership tax treatment being the obvious goal of virtually every LLC).

Where Do I Check?

Although the check-the-box proposal is still just that, there have been suggestions that such a simplified procedure should be extended to S corporations. How could a check-the-box procedure apply to such entities? Assistant Treasury Secretary for Tax Policy, Leslie B. Samuels, recently suggested that S corporations might be allowed a limited period of time to convert to partnerships on a tax-free basis. The intended result would be continued status as a corporation under the S corporation's state law, but status as a partnership for federal income tax purposes.

If this sounds too good to be true (which perhaps it is), then perhaps it must be tempered with the notion that Mr. Samuels and others at Treasury suggested such a procedure should be an alternative to provisions included in S.758, the pending S Corporation Reform Act of 1995. To my mind, all of the provisions of the proposed S Corporation Reform Act make sense and are long overdue. Nonetheless, one Treasury official expressed what may now be the party line—that the bill fails to adequately target small businesses and might allow large C corporations to escape corporate taxation.

Wide-Ranging Implications

At this point, it is certainly too soon to predict how the debate will be resolved. Admittedly, the check-the-box notion appears to have arisen primarily out of frustration (doubtless on both sides of the fence) with the Section 7701 criteria. Anyone who has waded through those rules recognizes that the matter is often time-consuming and there are many traps that seem to serve no purpose. Since the bulk of the volume of rulings addressing such issues these days involve limited liability companies, it is the nation's foray into the LLC venue that has

changed the landscape insofar as entity classification is concerned.

From this perspective, the check-the-box notion seems likely to bear fruit. However, it seems doubtful that existing S corporations (whether small or large) will end up with a window of opportunity to convert on a tax-free basis to partnership tax status.

In the large corporate context, most businesses do not spend too much time worrying about the Section 7701 partnership classification criteria simply because corporate tax status is normally implicit. On the other hand, corporate joint ventures are increasingly common, and they generally do rely on partnership tax treatment. Ever since the Tax Reform Act of 1986, partnerships of corporations have become almost a standard feature of the corporate culture. Without the joint venture structure, and the attendant partnership tax treatment, the dividends received deduction is normally insufficient in a case of 50% ownership (say, for example, two corporations owning 50% each of a subsidiary), to be very attractive. Of course, the Section 7701 criteria that would apparently all but be obviated by the new check-the-box approach are reasonably well understood, and it is probably not likely to revolutionize much of corporate practice. ■