

## Module 3.9: Electing How to be Taxed

We have already learned that there are default classification for legal business formats. To review:

- A business with one owner by default is a sole proprietor or single-member LLC
- A business with two or more owners by default is a partnership or multi-member LLC
- A business that is incorporated by default is a corporation or can choose S election

While most businesses have the same format at the state and federal level, it may be advantageous to be taxed differently at the federal level than at the state level. In other words, your tax liability may be better as a partnership at the state level, but your tax liability may be better as an S corporation at the federal level.

This is rarely done for a couple of reasons. Most people don't even know it is possible. And it takes a thorough analysis of the tax implications which normally could only be done by a Master Tax Advisor or IRS Enrolled Agent who specializes in business taxation. Since one main purpose of this course is to minimize your tax liability, I have included it here for your consideration.

### Check the Box Election

Entity classification regulations were created in 1997 by the Internal Revenue Service (IRS) under Internal Revenue Code Section 7701. These are commonly known as "Check-the-Box" or CTB regulations and are available for all domestic and foreign "eligible" entities. The regulations essentially allow the taxpayer to choose the type of entity desired for US federal tax purposes. If the entity is automatically classified as a corporation, it cannot choose to be something else.

The reason for these elections is because LLCs are not specifically mentioned in the federal tax code and thus there are no federal regulations governing their taxation like there are for corporations and partnerships. Instead, LLCs may decide to be taxed under one of the following classifications by filing Form 8832.

As you have learned, the LLCs are only a state designation and does not exist at the federal level. So, the IRS created these elections so that LLCs can decide how to be taxed at the federal level if they don't want to use the default classifications.

For instance, an LLC with only one member may choose to be taxed as a:

- Disregarded entity (Sole Proprietorship)
- Corporation (e.g. C Corporation, personal holding company, personal services corporation or professional corporation) or a,

- S Corporation

However, an LLC with more than one member (owner) can elect to be taxed one of three ways:

- Partnership
- C Corporation, or a
- S Corporation

The election to change tax treatment is made on Form 8832, *Entity Classification Election*, and filed with the appropriate IRS Service Center. The election must be hand signed by each owner of the business *or* by an officer, manager, or owner authorized under local law or the entity's organizational documents to make the election.

The authorized person must sign under penalty of perjury that he or she is authorized to sign on behalf of the entity. If a person is authorized to make an election, then it would seem that unanimous consent of the owners is not required. The election can be filed up to 12 months in advance, or it can become effective on the date it is filed.

A copy of the hand-signed election is filed with the federal tax return for the year in which the election takes effect. If a return is not required to be filed, such as a sole proprietor, then a copy of the election is filed by the owners with their tax returns.

Before making this election, the business owners should take into consideration the additional paperwork requirements that may be involved. For instance, for a single-member LLC, instead of filing a Schedule C with their personal return, they would need to file a Form 1120 or 1120-S and issue a K-1 to themselves as well as issue W-2s. While an S corporation could save them money on self-employment taxes, would the additional costs of doing a corporate return make it the best choice?

You also have to take the state taxes into account. Some states just take the federal figures as the base of their returns and others start their returns from scratch. How would the difference figure into saving you money at the state level? As I said before, this is a business decision that takes a lot of analysis and planning, but could save you a lot of money in the long run.

### **Missing the Deadline**

The Check The Box election is effective on the date specified by the taxpayer on the Form 8832. If a date is not specified, then the election is effective on the date it is filed. The effective date cannot be more than 75 days prior to the date the election is filed (this is a retroactive date) and not more than 12 months after the date the election is filed (this is a prospective date).

What if you just learned about this option and missed the deadline for filing the Form 8832 this year? The IRS provides a simplified procedure to request relief for a late initial classification election ([Rev. Proc. 2002-59, 2002-2 CB 615](#)).

Relief is available if an entity fails to get its desired classification because of a late filed Form 8832 as long as the tax return due date of the entity's default classification (without extensions) has not passed and it has reasonable cause for its lateness.

If the classification election is made late:

1. Write on Form 8832 "Filed Pursuant to Rev. Proc. 2002-59".
2. Provide an explanation for the reason a timely classification election was not filed.

An business that intended to elect to be treated as a corporation but failed to file a timely Form 8832 could request relief from the IRS. Relief will be granted if evidence presented shows that the LLC acted in good faith and relief will not prejudice the government ([Letter Ruling 200501002](#)).

An entity can change its classification in a one-time election. Except in special situations (e.g., a business transferred to another business), no additional changes can be made for a period of 60 months once the elected status is established.

And remember that if you want to be treated as an S corporation, the Form 2553 must also be filed to change it from a C corporation to an S corporation.

### **Entity Classification in an International World**

In the international context, entity classification issues arise all the time. For example, many foreign nationals form single member US LLCs. How might entity classification cause problems with a seemingly benign US LLC?

In the US LLC context, let's say that we have a nonresident alien husband, Mark, and that he is married to Cheryl, a US citizen. Assume the couple is domiciled in a community property jurisdiction such as Switzerland (or even China). Mark uses funds from his solely titled bank account into which he deposits his salary in order to set up a US LLC. He believes that he is the sole member and that as such, the LLC is a "single member disregarded entity".

Since the couple is domiciled in a community property jurisdiction, Switzerland, the community property regime there applies (unless the couple elects otherwise by written documentation). Under the Swiss regime, Wanda is deemed to own one-half of the LLC (as well as one-half of Henry's bank account). The LLC will be treated under US tax default rules as a "partnership" for

US tax purposes; it cannot be a single member disregarded entity since under the law, it has two members.

US tax consequences will result and must be sorted out for Mark, for Cheryl, and even for the entity. For example, if treated as a partnership, the entity itself will have **withholding obligations** with respect to Mark. Cheryl will be required to report and pay tax on her share of the partnership income even if she did not think she was a partner in the LLC.

If instead, Mark had created a LLC under the laws of a foreign country and if all members have limited liability under those laws, the default characterization for US tax purposes would be that of a “corporation” rather than a “partnership”. See [26 CFR § 301.7701-3\(b\)\(2\)\(i\)](#). This raises issues for Cheryl as a US person – for example, she will be required to report dividend income on her US tax return and pay tax on the amount, she will have tax information reporting duties (e.g, Form 8938, Form 5471) and will have anti-deferral tax regime concerns as well.

We also see entity classification issues when an entity exists under foreign law, and we have no precise “equivalent” under US law. For example, “Stiftungs” organized in Liechtenstein and Switzerland can possibly be treated as trusts or “associations” taxable as corporations for US tax purposes. Depending on the tax classification, the tax results will differ. International law could be a whole course by itself!

Let’s move onto our final module...