SINGLE MEMBER LLCS AND ESTATE AND GIFT TAX TREATMENT

by Robin L. Klomparens & Douglas L. Youmans

DISCUSSION

I. BACKGROUND

This proposed topic is submitted on behalf of the Estate and Gift Tax Committee of the Taxation Section of the State Bar of California.

A. Summary of Proposed Topic

Under the "check-the-box" regulations, entity classification is simplified. Under these rules, single member LLCs are, by default, disregarded for income tax purposes. These rules, however, do not specifically address the classification of these entities for estate and gift tax purposes.

The problem currently faced by taxpayers which is addressed by this paper, is the classification of a single member LLC from an estate and gift tax perspective. Because many states instituted their own death tax system after the repeal of the state death tax credit, the manner in which an individual holds title can affect which state imposes taxation on assets held in an entity. If property is held in an LLC with more than one member, the entity is taxable for state death tax purposes in the state of the LLC's formation and the entity is recognized for income tax purposes. There is, therefore, no reason for nonrecognition for estate and gift tax purposes.

On the other hand, if property is held in an LLC with only one member, the LLC can be disregarded for income tax purposes. If that single member LLC is also disregarded for estate and gift tax purposes, there is an argument that the entity may be subject to death tax in the jurisdiction where the assets are held (if the assets consist of real or tangible property) instead of in the jurisdiction where the LLC is formed. In essence, the underlying assets are taxed, not the LLC itself.

To "maintain" consistency between the death tax treatment of all LLCs (regardless of whether they have a single member or multiple members), this proposal is requesting clarification that a single member LLC that is disregarded for income tax purposes is not similarly disregarded for estate and gift tax purposes.

II. CURRENT LAW AND REASON FOR PROPOSED RULING

Single member LLCs are an interesting breed. Under the check-the-box regulations, they are recognized as separate entities for substantive law purposes, even though they are clearly disregarded for federal income tax purposes. Tax advisors believe it is unclear whether single member LLCs are recognized for estate and gift tax purposes under the check-the-box regulations (found under Treasury Regulations 301.7701-1 through 301.7701-3).

A. Prior Law

Prior to the check-the-box regulations, the Treasury Regulations governing the classification of entities as partnerships or, alternatively, as associations taxable as corporations, were adopted in 1960 for federal income tax purposes. These regulations were known as the "Kintner" regulations because they were a response to the decision in *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954). In the *Kintner* case, the classification issue arose because of favorable pension plan rules applicable, at that time, to corporate employees but not to partners. The *Kintner* regulations generally, made it more likely that a business entity would be classified as a partnership rather than a corporation than the previous entity classification rules.

The *Kintner* regulations provided that whether a business entity was taxed as a corporation depended on which form of entity it "more nearly" resembled (former Treas. Regs. § 301.7701-2(a)). Those regulations listed six "corporate" characteristics, two of which are common to both corporations and partnerships: the presence of associates and an objective to carry on business and divide the gains therefrom. Whether an unincorporated organization was classified as a partnership or a corporation depended on whether the entity had more than two of the remaining four "corporate" characteristics.

The four "corporate" characteristics identified in the *Kintner* regulations were as follows: (1) continuity of life; (2) centralization of management; (3) liability for entity debts limited to entity property; and (4) free transferability of interest (former Treas. Regs. § 301.7701-2). The affect of the *Kintner* regulations generally was to classify an unincorporated entity as a partnership for income tax purposes if it lacked any two or more of the four corporate characteristics, without further inquiry as to how strong or weak a particular characteristic was or how the evaluation of the factors might affect the overall resemblance to a partnership or a corporation (formerly Treas. Regs. § 301.7701-2 and; *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1).

Without going into the specifics of qualifying under each of the four *Kintner* tests, practitioners had to meet certain of the tests or fail to meet certain of the tests depending on whether they wanted classification as an unincorporated entity (such as a partnership) or as an incorporated entity. To be treated as a partnership, an entity must possess not more than two of the four corporate characteristics. If classification as a corporation was desired, it was necessary to meet three or more of the corporate characteristics.

Needless to say, these were not the clearest tests imaginable and, depending on state law issues such as what, for example, a state's partnership law (such as the Uniform Partnership Act) provided and/or what various formation documents stated, this was a cumbersome system. The *Kintner* test and other authorities dealing with these tests, however, all focused on the income tax aspects of the classification.

B. Current Law

In 1995, the Internal Revenue Service and the Treasury Department issued Notice 95-14 (1995-1 C.B. 297), stating that they were considering simplifying the entity/Kintner classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis. They recognized that there was considerable flexibility under the current rules to effectively change the classification of an organization at will (for example, by forming a new organization with different factors that would result in a different classification, and merging the old organization into it). They also acknowledged the need to simplify the rules so as to reduce the burdens the regulations placed on both the taxpayers and the Service with respect to determining the manner in which an entity would be subjected to income taxation.

The IRS issued final check-the-box regulations in December 1996, which implemented simplification of the entity classification system envisioned in Notice 95-14. The four factor test of former Treasury Regulations 7701, et seq., was replaced with an elective regime—the "check-the-box" regulations. (T.D. 8697, 61 F.ed. Reg. 66584 (12-18-96), adding new regs. §§ 301.7701-1 through 301-7701-3.) The so-called check-the-box rules generally permit unincorporated organizations to elect to be treated as associations (taxable as corporations) or as partnerships, for federal tax purposes, without regard to the number of corporate characteristics they possess. Certain business entities such as trusts are excluded from this elective regime. The check-the-box regulations were effective as of January 1, 1997.

As discussed in this paper, one of the most significant aspects of the check-the-box regulations is the treatment of single member entities. The prior regulatory scheme did not accommodate such entities due to the requirement that an unincorporated organization possess "associates" in order to be classified as a partnership or an association. The inflexibility of this classification system became more readily apparent with the enactment of state statutes that permitted the formation of single-member LLCs. The check-the-box regulations allow a single member entity to elect to be classified as an association (taxable as a corporation), or to be totally disregarded as an entity separate from its owner.

Clearly, this regime is beneficial to taxpayers because they now have greater flexibility in choosing the classification of an entity. It also makes it much easier and less expensive for sophisticated taxpayers to achieve otherwise attainable tax goals while eliminating the risk that the Service might challenge the tax classification based on the technical Kintner "corporate" characteristics. They also permit less sophisticated taxpayers, quickly and easily, to achieve the same tax results that have long been available to more sophisticated taxpayers. Finally, for all taxpayers, as well as the Service, it actually simplified the law of entity classification, eliminating a vast body of arbitrary technical rules, permitting large amounts of time to be shifted to more productive pursuits.

C. Application

Consistent with the check-the-box rules, the IRS has generally been consistent in treating single member LLCs in a manner consistent with their disregarded entity status for income tax purposes. To that extent, difficult issues have been resolved favorably from the taxpayer's standpoint. For example, the IRS issued several private letter rulings[1] stating that a single member LLC owned by an individual may own stock in an S corp without causing a termination of the corporation's S election. (Since the LLC was disregarded as a separate entity, the individual was treated as the owner of the stock.)

The IRS issued a similar private letter ruling relating to the exchange of real estate for an interest in a single member LLC owning real estate.[2] The private letter ruling concludes that the exchange qualifies for tax-free treatment under IRC Section 1031--because the LLC is disregarded, the membership interest being received by the exchangor being deemed to be an interest in real estate like-kind to the real estate relinquished.

The problem at hand arises in that Treasury Regulation 301.7701-1 states as follows: "The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and it does not depend on whether the organization is recognized as an entity under local law." This regulation is extremely broad in that it implies that it governs entity classification for all tax purposes, which would encompass estate and gift taxation.[3] This presents a problem in an estate and gift context because if a single-member LLC is not recognized for estate and gift tax purposes, then a single-member LLC formed in State A holding property in State B would be subject to estate and gift tax in State B on any transfer of membership units. In contrast, if that LLC had more than one member, or if the LLC was recognized for estate the gift tax purposes, then the estate and gift tax implications would arise in State A. The latter is preferred because more appropriate planning can be done by a taxpayer's tax practitioners and advisors in the taxpayer's state of residence. It also generates less confusion because it does not make it necessary to look at estate and gift tax statutes where the real property is actually located since any estate and gift tax issues will arise in the taxpayer's home state.

There does not seem to be a dispute that, once a single member LLC converts to a multiple member LLC (by adding members), that multiple member LLC is recognized for income tax purposes and estate and gift tax purposes. Except for the broad wording of the check-the-box regulations, there is no law, rulings or guidance indicating how a single member LLC should be classified for estate and gift tax purposes. All case law rulings, articles, hornbooks, etc., focus on classification under the check-the-box rules for income tax purposes.[4]

The check-the-box regulations are overly simple and broad in that nothing therein specifically addresses entity recognition or classification from an estate and gift tax perspective. For example, there is no box to check that allows a single member LLC to be disregarded for income tax purposes (which is the default

rule), while remaining recognized as a limited liability company for estate and gift tax purposes. In fact, there is no reference anywhere to entity classification in the transfer tax arena. Clearly, if the election is made to classify the entity as an association (taxable as a corporation), then such entity will also be recognized for estate and gift tax purposes (albeit as a state law limited liability company), and this issue is moot.

The problem with the lack of clarity in the law becomes more convoluted, complex and critical as a result of the elimination of the state death tax credit. Prior to the elimination of that credit, most states were a "pick-up" state or "sponge tax" state that merely collected the maximum state estate tax credit reported on the Estate Tax Return (Form 706). After repeal of the credit (which fully occurred in 2005), many states revised their legislation. Now, more than fifty percent (50%) of the states have a separate state death tax system. This has caused extreme complexity for persons who reside in one state and hold property in another. This problem is further exasperated because many of the states that have their own state death tax system (the so-called "decoupled states") no longer follow the federal system and have varying unified credit amounts. To track all state systems is a highly complex quagmire for tax practitioners.

Under most state death tax schemes, intangible personal property of a United States domiciliary are taxed by the state of the decedent's domicile. On the other hand, real property and tangible personal property is taxed by the state in which the property is located. Since people who own property out of state are often caught off-guard by this system, particularly with so many states decoupling, planning needs to be done to avoid unexpected state estate and/or gift tax. The planning process in and of itself is complex, and the trust, will or other estate planning documents necessarily become overly complicated and cumbersome when they try to resolve the problem.

A common method of planning is to form an LLC or other entity in the state where the client resides. LLCs are often preferred vehicles because they offer limited liability under state law but are "pass-through" entities for income tax purposes. Also, unlike partnerships, most states recognize single-member LLCs. If the clients are husband and wife, and the property in question is not the separate property of either of them, an LLC or other entity can be formed. Such an LLC will clearly be recognized for income tax purposes, and should be recognized for estate and gift tax purposes. On the other hand, if a single person, or a married person who owns separate property which is being placed in a separate entity solely for recognition of separate property treatment in the case of a marital dissolution, legal separation or other liability issues forms a single member LLC, that single member LLC will not be recognized for income tax purposes. However, that single member LLC is recognized for state law purposes.

Obviously, once a transfer of a small interest in a single member LLC is made (for example, even on a one one-thousandth interest), that multiple member LLC will then be recognized for both income and estate and gift tax purposes. There are reasons, however, whereby such transfers are not made. The taxpayer may not wish to do so because he or she may want the entity to continue to be disregarded for income tax purposes. Many taxpayers form these entities primarily for liability purposes but want to be able to exchange real property held in the single member LLC under Section 1031. The taxpayer may not have time to make a transfer prior to death. Each of these cases requires clarity-- confirmation of the single member LLC's treatment as a separate entity for state death tax planning purposes.

The Joint Committee on Taxation itself published a "Review of Selected Entity Classification and Partnership Tax Issues" which discussed these rules but concentrated solely on the income tax aspects. (Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues (JCS-6-97) April 8, 1997.) One concern that the Committee and other experts have raised was the constitutionality of the check-the-box regulations. The Joint Committee states, "The authority of the Treasury Department to issue check-the-box regulations providing for an elective entity classification regime under the statutory language has been questioned. Even some who welcome the result under the check-the-box regulations have expressed concern about the authority of the Treasury to promulgate them." That Committee goes on to state,

"The simplicity and flexibility of the check-the-box regulations have evoked universal approbation and support from private practitioners and taxpayers . . . Lost in the applause is any serious examination of how a rule that permits substantively identical entities to elect to be classified as either an association taxable as a corporation or a partnership can be promulgated under the interpretive authority of granting to the Treasury by IRC Section 7805 . . . It is of course, inevitable that some owners of interest in entities subject to the check-the-box rules will discover that a particular classification election is more to their detriment . . . [A] challenge to the validity of the check-the-box regulations may ensue. While the combination of circumstances that would prompt such a challenge is highly unusual, the probability of a challenge being successful is high if the right circumstances are present." (Joint Committee on Tax, Publication Review of Selected Entity Classification and Partnership Tax Issues, ¶ 44).

The Tax Court has raised this issue as well in *Dover Corporations v. Commissioner* (2004) 1227 T.C. 3248.[5]

To examine whether constitutional authority exists, it is necessary to look at the standard set forth by the Supreme Court in *Chevron USA, Inc. v. Natural Resources Defense Counsel, Inc., et al.*, 467 U.S. 837 (1984). This Chevron case sets forth a two-step process for review. First, whether the plain meaning of the statute determines the issue; and then, whether the agency's interpretation is a permissible construction of the statute. The second step in this analysis is used as affording considerable judicial deference to agency interpretations. [6]

Under the Chevron test, estate and gift tax inclusion under the check-the-box regulations could fail. The plain meaning of the statute did not determine the issue from an estate and gift tax perspective. Similarly, the Service's interpretation is probably not a permissible construction of the statute. There are other factors, however, that one should look at to determine the constitutionality (e.g., an analysis of the Kintner regulations which were in effect for nearly 30 years). It could also be argued that Congress approved the four-factor test set forth in the Kintner regulations, hence, it implicitly reserved to itself the power to modify that test. The authors would argue that the Treasury Department's authority to replace the Kintner regulations was thereby restricted, and that the Treasury Department should not be construed as having authority to pass regulations that affect an entity's classification for estate and gift tax purposes since that classification was not specifically addressed in Kintner nor any subsequent case.

While no constitutional challenge has been raised to the check-the-box regulations in an estate and gift tax context, there is a recent case in the Northern District of Kentucky discussing the constitutionality of the check-the-box regulations. (*Frank A. Littriello v. U.S.*, (2005-1 USTC ¶ 50, 385; 2005 WL 1173277 (W.D. Ky); 95 aftr. 2d 2005-2581.) The *Littriello* case deals with federal liens placed on a company for the company's unpaid withholding and FICA taxes. The analysis of *Chevron* in the *Littriello* case is, unfortunately, not on point to the analysis in an estate and gift tax context. It also, in the authors' opinion, does not present the best factual situation for a constitutional challenge. The first argument addressed in *Littriello* regards whether the intent of Congress is clear on the precise issue of business classification for federal tax purposes. On this issue, in *Littriello* the court discusses the fact that a partnership or "corporation" are one or the other for tax purposes. This analysis focuses on an income tax perspective, since the income tax classification differs depending on whether a corporation or partnership exists. From an estate tax perspective, a corporation, partnership or LLC would not be treated differently for transfer tax purposes. The second part of the *Littriello* court's analysis focuses on whether the agency's answer is based on a permissible construction of the statute. Here, once again, the *Littriello* court focuses on *Kintner* and on the income tax differences between an association and a partnership. The *Littriello* court holds, "Under the circumstances, the check-the-box regulations seem to be a reasonable response to the changes in the state law industry of business formation. The rise of the limited liability corporation presents a malleable corporate form incompatible with the definitions of the IRC. The newer check-the-box regulations allow similar flexibility to the *Kintner* regulations, with more certainty of results and consequences. . . ." (Emphasis added.)

While the authors do not address the constitutionality of the check-the-box regulations from an income tax perspective, there are concerns about their constitutionality for estate and gift tax purposes. As the court stated in *Littriello*, the check-the-box regulations are a reasonable response to the changes in the state law industry of business formation. There were never issues raised or addressed regarding the estate and gift tax consequences and/or the difficulties in distinguishing between associations and partnerships in this context. Similarly, from the estate and gift tax perspective, neither more certainty nor more flexibility resulted from the enactment of these check-the-box regulations, factors the court focuses on in upholding the constitutional challenges. In fact, to the contrary in the estate and gift tax arena, the check-the-box regulations have caused disparate treatment between taxpayers, complexity and uncertainty.

II. PROPOSED ACTION

While the authors recognize the impossibility of re-doing in any substantial form the check-the-box regulations, there are suggestions for clarity. These are as follows:

1. The IRS and/or Treasury should clarify whether the check-the-box regulations include classification for estate and gift tax purposes.

2. If the clarification is that the check-the-box regulations do include classification for estate and gift tax purposes, then the concern is that this could open up the check-the-box regulations to a constitutional challenge

depending on how broadly one reads the Littriello case. Note, here, that this case was decided in the Western District of Kentucky, and that no other cases, including those of a higher court, have been decided.

3. Alternatively, the check-the-box regulations should be modified to exclude classification for estate and gift tax purposes.

III. CONCLUSION

There is tremendous confusion among tax practitioners regarding this issue. The majority take the position that a single member LLC is recognized as a separate entity under the analysis discussed above. The problem presents itself with any taxpayer who holds real property or tangible personal property in a single member LLC in a state other than where they reside. Proper planning eliminates tax burdens driven by a federal tax scheme that varies from state to state. This proposal will provide clear guidance and predictability as to the tax treatment of single-member LLCs.

---

[1] PLR 9745017, PLR 9739014, PLR 200008015, and PLR 200303032

[2] PLR 200131014

[3] The author of the regulations states that this was intended. However, many practitioners and commentators have not accepted this approach. As stated above, in the *Kintner* case itself, as well as in a multitude of cases, rulings, articles, etc. discussing the check-the-box regulations, the focus has always been on income tax issues not estate and gift tax issues.

[4] Staff Joint Committee on Taxation Review of Selected Entity Classification and Partnership Tax Issues, JCS-6-97; April 18, 1997; Rev. Rul. 88-76, 1988-2 C.B. 360; *Kintner*, supra; Notice 95-14, 1995-1 C.B. 297; *Morrissey v. Commissioner* (1935) 296 U.S. 344; Initial Thoughts on the Proposed Check-The-Box Regulations, 71 Tax Notes 1679, Michael L. Schler, June 17, 1996; The Tax Nothing, David S. Miller 97 TNT 22-69.

[5] See also, W. McKee, W. Nelson and R. Witmire, Federal Taxation of Partnerships and Partners, 3-102 (3rd. ed. 1997) ¶ 3.08 raises this issue as well.

[6] One issue that exists with the *Chevron* case is that it did not involve tax regulations and its standard has not been consistently applied necessarily consistently in the judicial review of tax regulations.