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Tax Tip

"Cogito, Ergo Sum": Is that Disregarded Entity in Fact Regarded?

By Brian E. Hammell, Caroline A. Kupiec, and Ameek Ashok Ponda

In among the most famous and provocative statements from (early) modern philosophy, René Descartes asserts his very existence with the simple observation that the act of thinking requires the thinker to exist: "*Cogito, Ergo Sum* (I think, therefore I am)."[1] In among the most famous and provocative principles from modern federal tax law, the Code Sec. 7701[2] check-the-box regulations[3] dictate that certain entities with legal existence under state law shall have their existence negated for all (or nearly all) purposes of federal tax law. But the concepts of existence and its negation are not clear-cut. Questions therefore continue to arise as to when and to what extent an otherwise disregarded entity should be regarded under federal tax laws.[4]

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At its core, the question of how to treat a disregarded entity and its sole owner under the Code parallels the tension between entity versus aggregate which underlies the partnership regime of Subchapter K (Code Secs. 701–761).[5] This parallel is of course no surprise, for the concept of a disregarded entity is best understood as the ultimate expression and primacy of Subchapter K's aggregate principles over its entity principles—*i.e.*, a logical extension of the aggregate approach if a partnership could have just a single partner.[6] While numerous pronouncements from the past two decades confirm that an entity disregarded under the check-the-box regulations is likewise disregarded in the context of a particular Code provision or regulation, the occasional administrative or judicial exception to disregarded status, though well intentioned, nevertheless undercuts the predictability and clarity otherwise afforded by the check-the-box regulations.[7] Arguably then, a "formal approach" strictly adhering to the check-the-box regulations' directive of nonexistence for "all" purposes—a directive abrogated sparingly and only by explicit regulation—would enhance certainty for taxpayers.[8]

Background Under Code Sec. 7701

Code Sec. 7701 and its attendant regulations unambiguously dictate that entities which are disregarded under the check-the-box regulations should be disregarded for all purposes. Specifically, Code Sec. 7701 enumerates a list of defined terms to be used throughout the Code "where not otherwise distinctly expressed

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or manifestly incompatible with the intent thereof." By extension, therefore, the check-the-box regulations should apply for all purposes of the Code, unless they are "manifestly incompatible" with the intent of a particular Code provision.

With respect to the foundational tenets of entity classification, the check-the-box regulations provide that:

> [t]he 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 does not depend on whether the organization is recognized as an entity under local law.[9]

In addition, the check-the-box regulations specifically allow "an eligible entity with a single owner to elect to be classified as an association or to be disregarded as an entity separate from its owner"; as such, "[a] business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."[10] Given the primacy of Code Sec. 7701—*viz.*, that defined terms thereunder should be applied throughout the Code unless "manifestly incompatible" with respect to a particular provision, and given the check-the-box regulations' clear directive that an entity that elects to be (or is by default) disregarded from its owner must be treated as consubstantial with its owner to the exclusion of such entity's existence under local law, any inquiry with respect to the federal tax treatment of a single-owner entity must necessarily begin with the presumption that, if the entity is disregarded under the check-the-box regulations, then it must likewise be disregarded for all federal tax purposes.[11]

Nevertheless, the question of whether an entity should be disregarded with respect to any particular Code provision often arises as a result of the cognitive dissonance these entities foment: though nonexistent under the check-the-box regulations, disregarded entities remain creatures of local law, endowed with legal personhood and all of the accompanying rights and responsibilities such status entails. Significantly, the Supreme Court has established that the Code creates "no property rights but merely attaches consequences, federally defined, to rights [and responsibilities] created under state law."[12] For example, the Supreme Court stated in *Morgan*[13]:

> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.

Consequently, where germane state law rights and responsibilities applicable to a particular entity intersect with the check-the-box regulations' directive for nonexistence, it is not always apparent which bedrock federal tax law principle should prevail—whether federal tax law should duly recognize and "measure" state law rights and responsibilities on the one hand,[14] or whether federal tax law should treat the legal entity (and thus its rights and responsibilities) as nonexistent on the other.[15] In particular, respecting nonexistence means ignoring state law realities such as the disregarded entity's separate governance structure, its limited liability (if any)[16] and even its direct and separate contractual relationships with third parties, including employees, vendors, customers, lenders, borrowers, lessors, and lessees.[17] As demonstrated below, following the formal approach and ignoring these separate attributes (*i.e.*, not measuring them) can create tension with local law rights and responsibilities, which has occasionally led to recognition of entities (and their attributes) that would otherwise have been disregarded for all federal tax purposes on account of the check-the-box regulations' nonexistence directive.

General Approach for Disregarded Entities

In many contexts, Treasury and the IRS have dutifully followed the check-the-box regulations' directive and confirmed the nonexistence of disregarded entities in determining federal tax consequences. For example, the nonexistence directive prevails with respect to tax-exempt Code Sec. 501(a) organizations,[18] charitable contributions,[19] cancellations of indebtedness,[20] tax-free mergers,[21] S corporations,[22] like-kind exchanges,[23] tiered disregarded entities,[24] repatriations of foreign earnings to U.S. persons,[25] determining the substantial economic effect of partnership allocations,[26] federal income tax withholding with respect to the transfer of U.S. real property interests ("USRPI"),[27] and certain aspects of real estate investment trust ("REIT") asset and income testing.[28]

However, as discussed below, the IRS, Treasury, and courts do not always defer to the check-the-box regulations even though by Code Sec. 7701's construction its definitions should control for all purposes of the Code

unless “manifestly incompatible” with a particular Code provision.[29] Any such departure from the check-the-box regulations’ clear nonexistence directive potentially undercuts the predictability of the tax laws. To avoid this result, we posit that the IRS and courts should strictly adhere to Code Sec. 7701’s directive, allowing exceptions only in accordance with explicit regulations to the contrary in situations where strict adherence would be “manifestly incompatible” with the purposes of a particular Code provision.[30] Allowing Treasury to contravene the check-the-box regulations only where it issues explicit regulations to the contrary would mirror the statutory framework for QSubs and provide needed predictability to taxpayers.[31]

Departures Pursuant to Regulatory Guidance

Examining situations in which entities disregarded under the check-the-box regulations have nevertheless been regarded for certain purposes pursuant to explicit regulations yields insights into which tax concepts and provisions have been viewed as “manifestly incompatible” with the check-the-box regulations’ nonexistence directive. In turn, these insights may assist in discerning whether the IRS will respect (versus override) disregarded entity classification in novel contexts where explicit regulatory guidance is absent.

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Employment Taxes

Employment taxes are perhaps the best known circumstance of when an otherwise disregarded entity is partially regarded as separate and distinct from its owner for federal tax purposes. While early court decisions generally confirmed and adhered to the disregarded status of these entities for employment tax purposes,[32] disregarded entities are now regarded in this area. Pursuant to regulations, a disregarded entity is treated as a corporation with respect to federal employment taxes and wage reporting; thus, an otherwise disregarded entity itself (and not its sole owner) is deemed to be the employer primarily liable for withholding FICA, FUTA, and income taxes from employees’ wages and remitting them to Treasury.[33] The preamble to the amended employment tax regulations states that the partial recognition of otherwise disregarded entities in the employment tax context reflects a desire for simpler tax administration, as accomplished through Treasury’s regulatory powers.[34] Whether or not regarding the state law employer status of disregarded entities in fact enhances administrability, such an explicit regulatory departure from the check-the-box regulations’ nonexistence directive at least provides predictability in this area.

At-Risk Rules

The at-risk rules of Code Sec. 465 are another area where regulations partially regard an otherwise disregarded entity, overriding the check-the-box regulations’ nonexistence directive. Very generally, Code Sec. 465 limits the losses a taxpayer may claim from an activity to the amount for which the taxpayer is “at risk.”[35] A taxpayer’s amount at risk from an activity generally includes the cash and adjusted basis of property the taxpayer contributed to the activity as well as the taxpayer’s share of recourse liabilities with respect to the activity.[36] However, a taxpayer’s at-risk amount excludes certain liabilities, such as amounts borrowed from any person with an interest in the activity as well as amounts borrowed from related persons.[37] Conversely, a taxpayer’s share of “qualified nonrecourse financing”[38] is treated as an amount at risk even though the taxpayer is not liable for repayment of the debt.

However, the recourse liabilities of an entity that is disregarded under the check-the-box regulations are not treated as recourse liabilities of the entity’s owner—state law limited liability is simply too important to disregard when measuring the at-risk amount.[39] Treasury and the IRS have issued regulations under Code Sec. 465 that validate this approach but permit amounts to be treated as at risk where the indebtedness constitutes qualified nonrecourse financing with respect to the owner of the disregarded entity.[40] This prudent and circumspect exercise of Treasury’s regulatory powers adheres to Code Sec. 7701’s directive that its definitions apply unless “manifestly incompatible” with a particular Code provision: the Code Sec. 465 regulations prevent a disjuncture between the at-risk rules’ fundamental concepts of recourse and nonrecourse liabilities, with little to no sacrifice in predictability.

Code Sec. 752 Regulations

Similar to regulations concerning employment taxes and the at-risk rules, the regulations promulgated under Code Sec. 752 depart from the check-the-box regulations’ nonexistence directive. Very generally, Code Sec. 752 prescribes that a partner’s outside tax basis includes the amount of the partnership’s liabilities allocated to that partner.[41] A partner’s share of recourse partnership liabilities generally comprises the portion of those liabilities, if any, for which that partner or a related person bears the economic risk of loss.[42] All statutory and contractual obligations relating to the partnership liability are taken into account in determining economic risk of loss, including guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, other partners, or the partnership.[43] Furthermore, each partner is generally assumed to be able to meet its payment obligations,

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irrespective of the partner's actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[44]

While numerous pronouncements from the past two decades confirm that an entity disregarded under the check-the-box regulations is likewise disregarded in the context of a particular Code provision or regulation, the occasional administrative or judicial exception to disregarded status, though well intentioned, nevertheless undercuts the predictability and clarity otherwise afforded by the check-the-box regulations.

Acknowledging the concrete, economic consequences of the limited liability shield an otherwise disregarded entity enjoys, regulations under Code Sec. 752 provide that if a payment obligation or guarantee is owed by a partner's disregarded entity rather than directly by the partner, then the partner will be treated as having the economic risk of loss only up to the net value of the disregarded entity, *i.e.*, the fair market value of the disregarded entity's assets that may be subject to the creditor's claims under local law as reduced by the disregarded entity's obligations.[45] Effectively, these rules limit a partner's ability to increase its tax basis in its partnership interest where the partner's actual risk of loss is reduced through the interposition of disregarded entities, each having a negligible net worth. This regulatory departure from Code Sec. 7701's nonexistence directive furthers the measurement framework of Code Sec. 752 with little to no sacrifice in predictability.

Anti-Hybrid Rules

"Edge effects"[46] emerge as taxpayers and transactions approach the boundaries of the U.S. tax system. One particularly troublesome issue raised by such edge effects is the extent to which the U.S. tax system should adhere (if at all) to the check-the-box regulations' nonexistence directive when another, non-U.S. system regards an entity rather than disregards it. While this issue can be phrased as a question of whether and how much the U.S. tax system should recognize foreign law,[47] it also echoes the fundamental tension underlying the check-the-box regulations: whether the rights and responsibilities created under local law (in this case, foreign law rather than state law) should control when implicated, or whether instead the check-the-box regulations' nonexistence directive should have primacy.[48] Code Secs. 894(c) and 267A, both implicating the use of "hybrid entities" in cross-border transactions, present two instances in which the potential for mismeasurement of income was so great that Congress interceded with a statutory override to the check-the-box regulations' nonexistence directive.

Code Sec. 894(c)

Code Sec. 894(c)(1) denies reduced withholding taxes under U.S. income tax treaties on payments to a foreign person with respect to:

> an item of income derived through an entity which is treated as a partnership (or is otherwise treated as fiscally transparent) for purposes of this title if—
>
> (A) such item is not treated for purposes of the taxation laws of such foreign country as an item of income of such person,
> (B) the treaty does not contain a provision addressing the applicability of the treaty in the case of an item of income derived through a partnership, and
> (C) the foreign country does not impose tax on a distribution of such item of income from such entity to such person.[49]

Legislative history indicates that Congress enacted Code Sec. 894(c) with the clear intent to prohibit perceived mismeasurements of income between domestic and foreign taxpayers,[50] and Congress granted Treasury broad regulatory authority to achieve this end.[51] As such, applying the nonexistence directive in the context of treaty-based U.S. tax withholding relief would be "manifestly incompatible" in situations governed by Code Sec. 894(c) and the regulations promulgated thereunder. In sum, this departure from Code Sec. 7701's nonexistence directive pursuant to statute and promulgated regulations comes with minimal loss to predictability.

Code Sec. 267A

Under specified circumstances, Code Sec. 267A prevents a U.S. taxpayer from deducting interest or royalties paid

or accrued to a foreign related party. Very generally, this deduction limitation arises in the context of "hybrid transactions" or transactions involving related "hybrid entities" when the recipient's country of tax residence (1) provides no corresponding income inclusion to the foreign recipient, or (2) permits a deduction to the recipient.[52] A "hybrid entity" includes an entity that is treated as "fiscally transparent for purposes of [Chapter 1 of the Code] but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax."[53] Proposed regulations promulgated under Code Sec. 267A broadly confirm that entities disregarded under the check-the-box regulations fall under the ambit of Code Sec. 267A.[54]

As in the case of Code Sec. 894(c), the legislative history to Code Sec. 267A demonstrates Congress' clear intent to prohibit perceived mismeasurements of income between domestic and foreign taxpayers,[55] and Congress granted Treasury broad regulatory authority to achieve this end.[56] As such, respecting an otherwise disregarded entity's nonexistence in the context of a hybrid transaction or hybrid payment would be "manifestly incompatible" with Code Sec. 267A and its plain language. Once finalized, presumably the Code Sec. 267A regulations will be sufficiently clear and circumspect such that their departure from Code Sec. 7701's nonexistence directive will only minimally impact predictability.[57]

Other Examples

In addition to the above, there are other examples where clear regulatory text overrides the check-the-box regulations' nonexistence directive, either (1) to achieve administrative "simplicity"[58] or (2) to address disconnects between the tax and economic effects that would otherwise result from adhering to the formal approach.[59] Such use of Treasury's regulatory power is generally appropriate, follows the spirit and the letter of Code Sec. 7701 and the check-the-box regulations, and enhances the predictability of the tax laws.

Departures Absent Regulatory Guidance

Even absent explicit regulations, the IRS and the courts on occasion have partially regarded the status of an entity otherwise disregarded under the check-the-box regulations. We fear that such exercises of authority, however sensible or well-intentioned, negatively impact the predictability of the tax laws. Departures from the check-the-box regulations' nonexistence directive would be better handled through the promulgation of explicit regulations.

Debt Modification

In *Cottage Savings Ass'n*,[60] the Supreme Court held that a change in obligor under a debt obligation was a material difference with respect to that obligation for purposes of Code Sec. 1001 and therefore gave rise to a realized exchange of the underlying debt instrument, potentially resulting in recognition of gain or loss for federal income tax purposes. Treasury and the IRS subsequently promulgated detailed regulations under Code Sec. 1001 setting forth criteria for applying the exchange principle of *Cottage Savings* to the modification of debt instruments. Under Reg. §1.1001-3(b), a "significant modification" (as that term is defined in Reg. §1.1001-3(e)(1)) of a debt instrument results in an exchange of the original debt instrument for a modified debt instrument under Reg. §1.1001-1(a); however, Reg. §1.1001-3(b) also provides that a "modification" (as that term is defined in Reg. §1.1001-3(c)) that is not a "significant modification" is not an exchange.[61] For these purposes, a change in obligor on a recourse debt instrument is generally considered a Reg. §1.1001-3(e) significant modification,[62] while a change in obligor on a nonrecourse instrument is not.[63]

Absent such a regulation, however, the check-the-box regulations' nonexistence directive should prevail, providing predictability and administrability.

With the Code Sec. 1001 regulatory regime as a backdrop, the IRS has issued confusing guidance as to what constitutes a "modification" of debt in situations involving disregarded entity obligors. Early ruling practice in this area determined that a change in the federal tax law classification of a debtor entity pursuant to a state law "formless conversion" statute[64] did not constitute a change in the obligor of such debt, and hence was not a Reg. §1.1001-3(e) significant modification or a Reg. §1.1001-1(a) realization event. More recent IRS pronouncements have concluded that such changes in federal tax law classification are in fact modifications resulting from a deemed change in obligor but not Reg. §1.1001-3(e) significant modifications.[65]

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For example, in LTR 200315001[66] the IRS concluded that a debtor's conversion from a regarded corporation to a disregarded entity LLC pursuant to a state law formless conversion statute did not under Reg. §1.1001-3 result in a change in obligor or otherwise result in a modification of the recourse debt instrument at issue because the rights and obligations of the issuer and the holder had not changed under relevant state law. The LTR concluded that state law controls because "[g]enerally, the federal tax law looks to State law to determine legal entitlements in property." Significantly, LTR 200315001 did not explicitly state the precise basis upon which it found a lack of modification: "[n]either the conversion … nor the distribution … results in a modification of the [d]ebt for purposes of [Reg. §] 1.1001-3."

The far better approach, as demonstrated by the example of REIT security ownership, is for tax authorities to adhere to the check-the-box regulations' nonexistence directive unless Treasury has promulgated regulations that explicitly regard an otherwise disregarded entity.

In LTR 200630002,[67] the IRS again examined the state law formless conversion of a regarded corporate debtor into a disregarded entity LLC. Once more relying on the venerable principle that "federal tax law looks to State law to determine legal entitlements in property,"[68] the IRS found that the state law conversion and accompanying federal tax law classification change did not result in a Reg. §1.1001-3(e) significant modification. Unlike LTR 200315001, this ruling did not expressly state that there had been no modification of the debt. It is unclear whether the IRS based its conclusion on: (i) no change in state law obligor, (ii) a change of federal tax law obligor, but application of an exception to the significant modification rule, or (iii) a determination not to answer the question whether there had been a change in obligor because, in any event, an exception to the significant modification rule applied.[69]

The IRS subsequently embraced the application of the check-the-box regime in the debt modification context, and in LTR 200709013[70] it first expressly determined that the change in federal tax law classification of an obligor (*e.g.*, from a regarded corporation to a disregarded entity) was a Reg. §1.1001-3(c) modification for federal income tax purposes. In that instance, a corporation acquired all the stock of a target corporation, whereupon the target converted to an LLC under a state law formless conversion statute and made a check-the-box election to be a disregarded entity, thereby liquidating under Code Sec. 332. Unlike in LTRs 200315001 and 200630002, the IRS recognized for tax purposes a substitution of the obligor on the target corporation's outstanding debt as a result of the obligor's change in tax law classification and its attendant deemed liquidation. Still, though the IRS considered this change in tax law classification a Reg. §1.1001-3(c) modification of the target corporation's outstanding debt for purposes of the Code Sec. 1001 regulations, it ultimately concluded that the modification was not significant for purposes of Reg. §1.1001-3(e) and thus not a Reg. §1.1001-1(a) realization event.[71]

Gift Tax and Charitable Contributions

In a widely-analyzed 2009 decision, the Tax Court held that the check-the-box regulations are not applicable to the valuation of the transfer of property held through a single-member LLC for federal gift tax purposes.[72] While the IRS argued that the transfer of interests in a single-member LLC should be viewed as the transfer of the LLC's underlying assets,[73] the Tax Court held that the state law rights created by the state LLC statute prohibited that result. Though the Tax Court accepted that the check-the-box regulations governed how the single-member LLC would be taxed for federal income tax purposes, the Tax Court did not agree that the check-the-box regulations applied to disregard the LLC in determining what property rights were actually transferred by the gift.

The Tax Court later relied on *Pierre* in *RERI Holdings I, LLC*[74] to conclude that when a member of a single-member LLC donates interests in that LLC to a charity, then for purposes of valuing that contribution one must look at the value of the LLC interest transferred rather than the underlying assets of the LLC. Whereas this holding seemed a taxpayer victory in the gift tax valuation context of *Pierre*, the same conclusion in the charitable contribution context of *RERI Holdings I, LLC* presages devastating consequences to taxpayers because valuation discounts would presumably apply to the value of the LLC interests contributed to charity. Given the Tax Court's position, taxpayers undertaking charitable contributions of LLC interests would be wise to utilize valuations and appraisals of (regarded) LLC interests, rather than substantiating the

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value of a (disregarded) LLC's underlying assets, in order to squarely satisfy the substantiation requirements of Reg. §1.170A-13(c).

It is an open question whether *Pierre* and *RERI Holdings I, LLC* can be limited to the question of valuation in the federal gift tax and charitable deduction contexts or must instead be construed more broadly (*i.e.*, if the existence of an entity affects state legal rights, those rights should possibly override the check-the-box regulations).[75] The potential for uncertainty under *Pierre* and *RERI Holdings I, LLC* illustrates the merit of a formal approach to the check-the-box regulations' nonexistence directive for all purposes of the Code.

Application of Disregarded Status in Novel Contexts

The check-the-box regulations' directive that a particular entity must be disregarded for "all" federal tax purposes affords predictability to taxpayers and the IRS alike, aiding in efficient tax administration. The chaos that can ensue when the formal approach is not applied is demonstrated by a simple example concerning REIT ownership of securities.

An entity must satisfy a number of statutory requirements in order to qualify for taxation as a REIT under the Code.[76] Among these requirements are several limitations related to the entity's assets, including prohibitions concerning the ownership of securities.[77] Code Sec. 856(m) provides safe harbors for various arrangements whereby certain enumerated instruments are not treated as securities for purposes of Code Sec. 856(c)(4)(B)(iv)(III) (hereafter, the "10 percent value test"). In particular, pursuant to Code Sec. 856(m)(1)(B), "any loan to an individual or an estate" is not considered a security for purposes of the 10 percent value test. At first blush, this provision seems easy to apply: a REIT does not violate the 10 percent value test when it makes a loan to an individual. However, what happens if instead of making a loan to the individual, the REIT makes the loan to a wholly-owned LLC which the check-the-box regulations dictate is disregarded from that individual for "federal tax purposes"?

If taxpayers and the IRS alike cannot rest on the certainty of the check-the-box regulations' clear nonexistence directive for all purposes of the Code, then Code Sec. 856(m)(1)(B), a provision of only eight words, is turned on its head. Experts can debate the primary purpose for which Code Sec. 856(m)(1)(B) was designed, particularly given the dearth of legislative history. However, permitting a judge or an IRS agent to override the nonexistence directive would be antithetical to the goals of predictability and administrability. Rather, the formal approach's respect for an entity's nonexistence, applied in the case of a loan to a disregarded entity wholly-owned by an individual, would dictate that such a loan satisfies Code Sec. 856(m)(1)(B), and thus that a REIT holding such a loan does not violate the 10 percent value test. Of course, Treasury could change this result by promulgating regulations to override the nonexistence directive if it led to a mismeasurement of income or undue administrative complexity (in either case, as a result of "manifest incompatibility" between the check-the-box regulations and Code Sec. 856(m)(1)(B)). Absent such a regulation, however, the check-the-box regulations' nonexistence directive should prevail, providing predictability and administrability.

Conclusion

As discussed above, the clear language of Code Sec. 7701 and the check-the-box regulations requires that an entity disregarded for purposes of the check-the-box regulations must likewise be disregarded for all purposes of the Code unless manifestly incompatible with the intent of a particular Code provision. The Treasury, IRS, and courts follow this nonexistence directive in most circumstances, enhancing predictability and administrability. However, in various circumstances, such as the employment tax arena and the at-risk rules, Treasury has issued regulations that explicitly mandate some recognition of otherwise disregarded entities to promote efficient tax administration, prevent perceived mismeasurement of income, and address disconnects between the tax and economic effects that would otherwise result from respecting nonexistence. The explicit abrogation of Code Sec. 7701's clear directive, when grounded in regulations, provides predictability to taxpayers and the IRS alike. However, uncertainty and anomalous results have arisen in those circumstances where the IRS or the courts have superseded the check-the-box regulations' nonexistence directive outside of a regulatory process, such as in the case of Reg. §1.1001-3 debt modifications or for purposes of gift tax and charitable contribution valuations. This uncertainty impedes not only taxpayers' ability to competently and confidently structure their affairs but also the IRS' effective administration of the federal tax laws. The far better approach, as demonstrated by the example of REIT security ownership, is for tax authorities to adhere to the check-the-box regulations' nonexistence directive unless Treasury has promulgated regulations that explicitly regard an otherwise disregarded entity.

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ENDNOTES

[1] *See, e.g.*, Lex Newman, *Descartes' Epistemology*, The Stanford Encyclopedia of Philosophy, at §4.1 (Spring 2019 Edition), *https://plato.stanford.edu/entries/descartes-epistemology/#CogiErgoSum* (last visited April 22, 2019). *But see* Sir Rabindranath Tagore, "[m]erely to exist is not enough," Sir Rabindranath Tagore in *The International Dictionary of Thoughts*, at 269 (John P. Bradley, Leo F. Daniels, and Thomas C. Jones eds., 1969).

[2] Unless otherwise indicated, section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations promulgated thereunder.

[3] Reg. §§301.7701-1 through 301.7701-3 (herein, the "check-the-box regulations").

[4] This column pertains solely to the federal tax law treatment of disregarded entities; the state tax treatment of entities that are disregarded under the check-the-box regulations is a highly technical and complicated inquiry in its own right. *See, e.g.,* Bruce P. Ely, James E. Long Jr., and William T. Thistle, *An Update on the State Tax Treatment of LLCs and LLPs,* Doc. 2017-96612, State Tax Notes (Jan. 8, 2018); Thomas E. Rutledge, *Regarding the Disregarded Entity*, J. Passthrough Entities, Mar.–Apr. 2011, at 39; Ethan D. Millar, *State Taxation of LLCs Is Not Always Black and White: A Georgia Case Study*, Doc. 2006-14544, State Tax Notes (Sept. 18, 2006); Christina Edson Pritchard, *Nexus Considerations for Limited Liability Companies Under the Check-the-Box Regime*, Doc. 98-28496, State Tax Notes (Sept. 21, 1998). *See also, e.g., In the Matter of BTG Pactual NY Corporation,* N.Y. Tax App. Div. No. 827577 (Mar. 7, 2019) (holding that the check-the-box regulations dictate only which entity is taxed on streams of income, and thus an otherwise disregarded entity may be regarded for sourcing purposes).

[5] *See* H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954) ("Both the House provisions and the Senate amendment provide for the use of the 'entity' approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions."); Rev. Rul. 99-57, 1999-2 CB 678, *citing* H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954) ("Partnership taxation is a mixture of provisions that treat the partnership as an aggregate of its members or as a separate entity. Under the aggregate approach, each partner is treated as the owner of an undivided interest in partnership assets and operations. Under the entity approach, the partnership is treated as a separate entity in which partners have no direct interest in partnership assets and operations. In enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if the concepts are more appropriate in applying other provisions of the Code."). *See also* Monte A. Jackel, *Partnership Aggregate and Entity Outline*, Doc. 2017-63474, Tax Notes (July 25, 2017); Robert J. Staffaroni, *Partnerships: Aggregate vs. Entity and U.S. International Taxation*, 49 Tax Law. 1 (Fall 1995); Alfred D. Youngwood and Deborah B. Weiss, *Partners and Partnerships—Aggregate vs. Entity Outside of Subchapter K*, 48 Tax Law. 39 (Fall 1994).

[6] *See, e.g.*, Reg. §1.708-1(d)(3)(i) (transitory existence of single-partner partnerships). *See also E.E. McCauslen*, 45 TC 588, Dec. 27,889 (1966) (transition from partnership to a sole proprietorship); Rev. Rul. 99-5, 1999-1 CB 434 (transition from disregarded entity to partnership); Rev. Rul. 99-6, 1999-1 CB 432 (transition from partnership to disregarded entity).

[7] *See* Cassady V. Brewer, *Due Regard for Disregarded Entities*, 57 Tax Management Memorandum 167 (Apr. 18, 2016) (exploring circumstances where disregarded entities are and are not ignored for U.S. tax purposes).

[8] "No more things should be presumed to exist than are absolutely necessary." William of Occam, *Quodlibeta* (c. 1324), reprinted in *The Oxford Dictionary of Phrase, Saying, and Quotation*, 323 (Elizabeth Knowles, ed. 1997) (not found in this form in his writings, though he frequently invoked similar expressions).

[9] Reg. §301.7701-1(a)(1).

[10] Reg. §§301.7701-2(a) and 301.7701-3(a). In addition to those entities that are disregarded as a result of the check-the-box regulations, two older classes of entities are also generally disregarded from their 100 percent owners for purposes of the Code: (1) qualified REIT subsidiaries ("QRSs") and (2) qualified subchapter S subsidiaries ("QSubs"). *See* Code Sec. 856(i) ("For purposes of this title—a corporation which is a [QRS] shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a [QRS] shall be treated as assets, liabilities, and such items (as the case may be) of the real estate investment trust"); Code Sec. 1361(b)(3)(A) ("Except as provided in regulations prescribed by the Secretary … all assets, liabilities, and items of income, deduction, and credit of a [QSub] shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation" (note that unlike the QRS provision, here there is an explicit carve-out providing Treasury the authority to issue regulations to treat a QSub as a regarded entity for federal tax purposes)). While the operative language differs, all three disregarded entity regimes permit taxpayers to silo their assets and lines of business into separate wholly-owned entities, whether for liability protection or other purposes, without creating separately-regarded taxpayers.

Furthermore, we note that grantor trusts represent an even earlier codified nonexistence regime. *See* Code Secs. 671–679; Rev. Rul. 85-13, 1985-1 CB 184 (embracing an expansive view of nonexistence in the context of grantor trusts). *But cf. H. Rothstein*, CA-2, 84-1 USTC ¶9505, 735 F2d 704 (grantor must include items of income, deduction, and credit attributable to the trust in computing the grantor's taxable income and credits, but the trust is still viewed as a separate taxpayer capable of engaging in sales transactions with the grantor).

[11] *See* Reg. §1.367(e)-1(b)(2) ("For purposes of this section, stock or securities owned by or for an entity that is disregarded as an entity separate from its owner (disregarded entity) under [Reg.] §301.7701-3 of this chapter are owned directly by the owner of such disregarded entity."); Reg. §1.465-27(b)(6), Example 6 ("For U.S. federal tax purposes, A, the sole member of X, is considered to own all of the property held by X and is engaged in the activity of holding real property through X."); Reg. §1.988-1(a)(4)(iii) ("For purposes of applying [Code Sec.] 988 and the applicable regulations to transactions involving assets and liabilities … that are held by a [disregarded entity], the owner of the [disregarded entity] (within the meaning of [Reg.] §1.987-1(b)(4)) shall be treated as owning all such assets and liabilities."); Reg. §301.7701-3(g)(1)(iii) ("If an eligible entity classified as an association elects … to be disregarded as an entity separate from its owner, the following is deemed to occur: [t]he association distributes all of its assets and liabilities *to its single* owner in liquidation of the association." (emphasis added)); Reg. §301.7701-3(g)(1)(iv) ("If an eligible entity that is disregarded as an entity separate from its owner elects … to be classified as an association, the following is deemed to occur: [t]he *owner of the eligible entity* contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association." (emphasis added)); Rev. Rul. 2004-77, 2004-2 CB 119 (where P is owned for state purposes by X and L: "L is disregarded as an entity separate from its owner, X, and its activities are treated in the same manner as a branch or division of X. Because L is disregarded as an entity separate from X, X is treated as owning all of the interests in P"). *See also, e.g.,* LTR 200927014 (Mar. 20, 2009) ("An owner of an LLC that is disregarded for federal tax purposes is treated as owning the LLC's assets directly.") and LTR 9751012 (Sept. 15, 1997) (involving a like-kind exchange under Code Sec. 1031 ("the assets of the wholly-owned LLCs will be treated as assets of [the owner]")).

[12] *Nat'l. Bank of Commerce*, SCt, 85-2 USTC ¶9482, 472 US 713, 722, 105 SCt 2919 (*quoting M.G. Bess*, SCt, 58-2 USTC ¶9595, 357 US 51, 55, 78 SCt 1054). Prior to the promulgation of the check-the-box regulations, determining the federal tax classification of unincorporated entities was significantly more complicated. The guiding principle in such determination was that "it is the local law … that must be applied in determining the

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legal relationships of the members of [an] organization among themselves and with the public at large, as well as the interests of the members of [an] organization in the assets." Rev. Rul. 73-254, 1973-1 CB 613 (holding that the federal tax classification of a foreign unincorporated entity "will be determined under [Code Sec.] 7701 of the Code and the regulations thereunder."). Although this principle is possibly at odds with the directives of the check-the-box regulations, Rev. Rul. 73-254 has not been obsoleted.

[13] *J.E. Morgan*, SCt, 40-1 USTC ¶9210, 309 US 78, 80, 60 SCt 424.

[14] For more on the federal income tax laws as a "measurement" system, *see* John R. Brooks, *The Definitions of Income*, 71 TAX L. REV. 253 (2018).

[15] *Compare* Rev. Rul. 73-254, *supra* note 12, *with* the clear language of Reg. §301.7701-2(a).

[16] Indeed, the *sine qua non* of what it means to be an entity is segregation of assets and liabilities (*i.e.*, limited liability). *See* Proposed Reg. §301.7701-1(a)(5)(viii)(B)(3) and (C) (enumerating criteria for regarding separate series of a state law series LLC as separate entities for federal tax purposes). We observe that there is a less widely-held view that the nonexistence directive is not as expansive as our characterization. Under this narrower view, the check-the-box regulations do not ignore the limited liability of the entity and its other local (*i.e.*, non-tax) law attributes, but merely determine the tax effects of the disregarded entity's local law attributes to properly allocate income between entity and owner. Proponents of this narrower view emphasize that state law rights shape the relationships among a disregarded entity, its owner, and third parties, including the IRS. *See*, *e.g.*, CCA 201116019 (Mar. 21, 2011) (concluding that the IRS "can't levy on the property of a disregarded LLC to satisfy the tax liability of the LLC's sole member … [because] the sole member has no ownership interest in [the] LLC's property under local law and disregarding the LLC for federal tax purposes doesn't allow the [Internal Revenue] Service to disregard the entity for purposes of collection.").

As we describe below, the weight of the authorities acknowledges (correctly, we believe) the primacy of the nonexistence directive, and generally reflects a regime that broadly applies the nonexistence directive, imposing a limited number of exceptions when the nonexistence directive would distort the measurement of income or impinge administrability. For a description of some of these themes, *see* Romina Weiss, *Not So Plain and Not So Simple: An Alternative Paradigm for Regarding "Disregarded Entities"* (Tax Club paper, Nov. 21, 2017) (arguing that a default rule that imposes an existence directive may be more logical, but acknowledging that this would require a change in the law).

[17] This is not to suggest that these contractual relationships are or should be ignored entirely, but rather that, following the directive in Reg. §301.7701-2(a), these relationships should be treated as relationships of the entity's sole owner. *Cf.* Rev. Rul. 85-13, *supra* note 11 ("[I]t is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor"); Rev. Rul. 2004-77, *supra* note 11. The relevant query for this purpose is the relationship between the disregarded entity and its owner, and then one can overlay how those separate third party relationships feed into the disregarded entity paradigm. The law is filled with examples of relationship management between two parties that may be at odds with the relationship between one of those parties and the rest of the world. *See*, *e.g.*, Code Sec. 357(d) (allocating liabilities between a corporation and a contributing stockholder); *Fox-Greenwald Sheet Metal Co., Inc. v. Markowitz*, CA-DC, 71-2 USTC ¶9737, 452 F2d 1346 (a contractual ban on assignment is enforceable only by the contractual counterparty, and neither invalidates an assignment as between assignor and assignee nor creates any right enforceable by any third party); *D.L. Evans*, CA-7, 71-2 USTC ¶9597, 447 F2d 547 (notwithstanding a state law prohibition precluding a person from becoming a partner without the consent of the other partners, assignment of a partnership interest without consent was valid for tax purposes); Rev. Rul. 58-243, 1958-1 CB 255 (treating a "partnership" that is invalid under local law as a partnership for tax purposes). In this regard, as in so many others, "[t]axation is an intensely practical matter, and laws in respect of it should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences." *See*, *e.g.*, *Farmers Loan & Trust Co. v. Minnesota*, SCt, 280 US 204, 212 (1930).

[18] *See* Announcement 99-102, 1999-2 CB 545 (an organization exempt from taxation under Code Sec. 501(a) must include information relating to the finances and operations of its wholly-owned disregarded entity on its annual information return).

[19] *See* Notice 2012-52, 2012-35 IRB 317 (contributions to a disregarded single-member LLC that is wholly- owned by a charity will be treated as charitable contributions made directly to a branch of the charity).

[20] *See* Reg. §1.108-9(a) (the sole owner is treated as the "taxpayer" with respect to the discharge of indebtedness income of a disregarded entity, and the bankruptcy and insolvency exceptions only apply with respect to such sole owner). *See also* Rev. Proc. 2014-20, 2014-9 IRB 614 (providing a safe harbor under which the IRS will treat indebtedness that is secured by 100 percent of the ownership interest in a disregarded entity holding real property as indebtedness that is secured by real property for purposes of Code Sec. 108(c)(3)(A)).

[21] *See* Reg. §1.368-2(b)(1) (a merger into a disregarded entity of a corporation that otherwise satisfies specified requirements is eligible for statutory merger or consolidation treatment). *See also* Reg. §1.368-2(b)(1)(iii), Examples 2 and 4.

[22] *See* LTRs 200816004 (Jan. 14, 2008), 200816003 (Jan. 14, 2008), and 200816002 (Jan. 14, 2008) (each confirming that an individual holding stock in an S corporation could contribute that stock to a domestic LLC with the individual as its sole member in exchange for a 100 percent membership interest in the LLC without terminating the S corporation's election).

[23] *See* LTR 200251008 (Sept. 11, 2002) (for purposes of Code Sec. 1031, the "transfer of all the interest in [the disregarded entity] will be treated as a transfer of the assets of [the disregarded entity]").

[24] *See* Rev. Rul. 2004-77, *supra* note 11.

[25] *See* Reg. §1.956-2(a)(3) (an obligation of a disregarded entity is treated as the obligation of its owner for repatriation purposes).

[26] *See* Reg. §1.704-1(b)(1) and (2)(iii)(d)(2)(iv) (when determining whether a partnership allocation has substantial economic effect, the owner of a disregarded entity is taken into account).

[27] *See* Reg. §1.1445-2(b)(2)(iii) (a sole owner, not the sole owner's disregarded entity, is treated as the transferor of a USRPI, and thus a disregarded entity may not certify that it is the transferor of a USRPI).

[28] *See* Rev. Proc. 2003-65, 2003-32 IRB 336 (providing a safe harbor under which the IRS will treat a loan from a REIT secured by an interest in a partnership or by the sole membership interest in a disregarded entity as a real estate asset for purposes of Code Sec. 856(c)(4)(A) and (c)(5)(B) and will treat the interest on the loan as interest on an obligation secured by a mortgage on real property or on an interest in real property for purposes of Code Sec. 856(c)(3)(B)).

[29] We believe that the phrase "manifestly incompatible" in Code Sec. 7701 establishes a high hurdle whereby the definitions promulgated under that Code Sec. cannot easily be ignored. While the Code does not define the term "manifestly incompatible," we note that *Webster's Ninth New Collegiate Dictionary* defines "manifest" to mean "1: readily perceived by the senses and esp. by the sense of sight; 2: easily understood or recognized by the mind: OBVIOUS." *See Limited Inc.*, CA-6, 2002-1 USTC ¶50,353, 286 F3d 324, *rev'g* 113 TC 169, Dec. 53,533 (1999) (using Webster's Dictionary to construe statutorily undefined terms in accordance with their ordinary and natural meanings). Outside of the Code Sec. 7701 context, the Ninth Circuit Court of Appeals determined that a provision in the Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States of America (P.L. 94-241; 90 Stat. 263; 48 USC 1681) that closely mirrors the "manifestly incompatible" language of Code Sec. 7701 affords "flexibility to avoid results that are absurd on their face or that lead to internal contradictions in the application of the Code." *L. Holmes v. Dir. of Rev. & Tax'n*, CA-9, 87-1 USTC ¶9242, 827 F2d 1243.

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[30] Perhaps in extreme cases where Congress has contemplated or mandated regulations that IRS and Treasury have yet to promulgate, it could be appropriate to have "self-executing" regulations override the check-the-box regulations' nonexistence directive. *See 15 West 17th Street LLC*, 147 TC 19 (2016) (holding Code Sec. 170(f)(8)(D), which authorized but did not command the Secretary of Treasury to promulgate regulations that would provide taxpayers an alternative method to substantiate charitable contributions, inoperative because the Secretary did not exercise his authority to issue regulations). *See also* Amandeep Grewal, *Substance over Form? Phantom Regulations and the Internal Revenue Code*, 7 HOUSTON BUS. & TAX. J. 42 (2006) (chronicling, criticizing, and recommending alternatives to judicial treatment of spurned delegations); Phillip Gall, *Phantom Tax Regulations: The Curse of Spurned Delegations*, 56 TAX LAW. 413 (2003) (same).

[31] For a similar view, *see* Romina Weiss, *Plain and Simple: A Paradigm for Applying the Disregarded Entity Provisions of the Check-the-Box Regulations* (Tax Club paper, Dec. 19, 2012). While reintroducing the position that the current application of the check-the-box regulations leads to uncertainty, Weiss explores a second approach in a later article that would call for entities currently treated as disregarded from their owner under the check-the-box regulations to instead be classified as a new form of passthrough entity akin to a partnership with only one member. *See* Romina Weiss, *Not So Plain and Not So Simple*, *supra* note 16.

[32] *See, e.g., S.P. McNamee v. Department of the Treasury*, CA-2, 2007-1 USTC ¶50,515, 488 F3d 100 (owner held liable for the outstanding employment taxes of a disregarded, single-member LLC); *F.A. Littriello*, CA-6, 2007-1 USTC ¶50,426, 484 F3d 372, *cert. denied*, SCt, 552 US 1186 (2008) (sole owner held liable for the outstanding employment taxes of several disregarded LLCs); *Medical Practice Solutions, LLC*, 132 TC 125, Dec. 57,778 (2009) (sole proprietor held liable for the outstanding employment taxes of his disregarded LLC).

[33] Reg. §301.7701-2(c)(2)(iv). *See also* Reg. §§301.7701-2(c)(2)(v)(A)(5) and 301.7701-2(c)(2)(v)(B) (imposing similar rules in the Affordable Care Act penalty tax context). *Cf.* Reg. §301.7701-2(c)(2)(iv)(C)(1) and Reg. §301.7701-2(c)(2)(iv)(C)(2) (disregarded entities continue to be disregarded for back-up withholding and self-employment tax purposes).

[34] T.D. 9356, 2007-2 CB 675 ("The IRS and the Treasury Department continue to believe that recognizing disregarded entities as employers for Federal employment taxes will improve administration of the Federal tax laws and simplify Federal tax compliance with respect to reporting, payment, and collection of employment taxes.").

[35] Code Sec. 465(a).

[36] Code Sec. 465(b).

[37] Code Sec. 465(b)(3)(A).

[38] "Qualified nonrecourse financing" means indebtedness: (1) borrowed by the taxpayer with respect to the activity of holding real property; (2) borrowed from (or guaranteed by) any federal, state, or local government, from a government instrumentality, or from a "qualified person" (including a related person where the loan is commercially reasonable and on substantially the same terms as loans involving unrelated persons); (3) for the repayment of which no person is personally liable; and (4) that is not convertible. *See* Code Secs. 49(a)(1)(D)(iv) and 465(b)(6)(B).

[39] *See* LTR 199906025 (Nov. 17, 1998) (where taxpayer's interest in an activity was owned by a disregarded entity, indebtedness for which the disregarded entity was liable did not contribute to the taxpayer's at-risk amount unless the taxpayer guaranteed repayment or the debt otherwise constituted qualified nonrecourse financing).

[40] *See generally* Reg. §1.465-27(b) and (b)(6), Example 6, *supra* note 11.

[41] *See* Code Sec. 752(a).

[42] *See* Reg. §1.752-2(a).

[43] *See* Reg. §1.752-2T(b)(3)(A).

[44] *See* Reg. §1.752-2(b)(6). *Cf.* Reg. §1.752-2(j) ("An obligation of a partner … may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement … is to eliminate the partner's economic risk of loss." Reg. §1.752-2(j)(4) previously included an example of this general rule in the context of a consolidated group prior to its amendment by T.D. 9788, 2016-52 IRB 889.)

[45] *See* Reg. §1.752-2(k)(1) and (2); T.D. 9289, 2006-2 CB 827 ("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 [S]ection 752. Applying the presumption of deemed satisfaction to disregarded entities would distort the allocation of partnership liabilities in those cases."). *But cf.* Reg. §1.752-4(a) (upper-tier partnership's share of a lower-tier partnership's liabilities is treated as a liability of the upper-tier partnership).

[46] "Edge effects" is a term denoting changes in the composition of a population or phenomenon along ecological, geographic, spatial, or other boundaries. *Cf.* Brandon L. Jensen, *Litigating the Crossroads Between Sweet Home and Daubert*, 24 VT. L. REV. 169, 191 (1999) (explaining the concept in the context of ecology) and Jose M. Bueno-Barrachina, Cesar S. Cañas-Peñuelas, and Saturnino Catalan-Izquierdo, *FEM Edge Effect and Capacitance Evaluation on Cylindrical Capacitors*, JOURNAL OF ENERGY AND POWER ENGINEERING 6, 2063 (2012) (explaining the concept in the context of electrical engineering).

[47] *See* Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 FLA. TAX REV. 147 (1996) (an early exploration of whether and to what extent a hybrid entity should be recognized for U.S. tax purposes when recognized by a foreign jurisdiction).

[48] On account of edge effects, the trend has been increasingly to cede to local law realities, as ignoring them in favor of nonexistence creates too much tension. *See* Richard L. Doernberg and Kees van Raad, *Hybrid Entities and the U.S. Model Income Tax Treaty*, Doc. 1999-27587, TAX NOTES INTERNATIONAL (Aug. 23, 1999).

[49] *See generally* New York State Bar Association, *Report No. 1373—Report on the Application of Section 894 to Effectively Connected Income of Hybrid Entities* (June 13, 2017) (providing background on Code Sec. 894(c) and the policy considerations of the hybrid entity rules under Code Sec. 894(c) and the regulations thereunder).

[50] *See* H.R. Rep. 105-148, 105th Cong. 1st Sess., at 550 (1997) ("The Committee is concerned about the potential tax-avoidance opportunities available for foreign persons that invest in the United States through hybrid entities. In particular, the Committee understands that the interaction of the tax laws and the applicable tax treaty may provide a business structuring opportunity that would allow Canadian corporations with U.S. subsidiaries to avoid both U.S. and Canadian income taxes with respect to those U.S. operations. The Committee believes that such tax-avoidance opportunities should be eliminated").

[51] *See* Code Sec. 894(c)(2); Reg. §1.897-1(d).

[52] *See* Code Sec. 267A(a).

[53] *See* Code Sec. 267A(d)(1).

[54] *See* Proposed Reg. §1.267A-5(a)(7) (indicating that for purposes of the proposed regulations promulgated under Code Sec. 267A, an "entity" includes an entity treated as disregarded under the check-the-box regulations).

[55] *See* Senate Committee on Finance, Explanation of the Bill, at 384 (Nov. 22, 2017) ("The Committee believes that hybrid arrangements exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. The Committee further believes that these types of hybrid arrangements have an overall negative impact on competition, efficiency, transparency and fairness. The provision matches items of income and expense by denying the deductibility of certain interest and royalty payments or accruals to a hybrid transaction or by, or to, a hybrid entity. The Committee believes that the provision is consistent with many of the approaches to the same or similar problems taken in the Code, the OECD base erosion and profit shifting project, bilateral income tax treaties, and provisions or rules of other countries.").

[56] *See* Code Sec. 267A(e).

[57] *See, e.g.,* Carrie Brandon Elliott, *Consolidated Groups Still Facing Hybrid and DCL Problems*, Doc. 2019-13770, TAX NOTES INTERNATIONAL (Apr. 15, 2019) (noting that the proposed Code Sec.

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267A regulations do not address payments to domestic entities that are regarded for foreign purposes but disregarded for U.S. federal income tax purposes); New York State Bar Association, *Report No. 1411—Report on Proposed Regulations Under Sections 267A, 245A(e) and 1503(d)* (Feb. 26, 2019) (recommending adjustments to the proposed Code Sec. 267A regulations).

[58] *See, e.g.,* Reg. §1.1502-77(b)(1) (a disregarded entity can be treated as the successor agent of a former consolidated group); Reg. §301.6109-1(h)(1) (an entity keeps its employer identification number, even if its federal tax classification changes under Reg. §301.7701-3); Reg. §301.6221(b)-1(b)(3)(ii)(D) (a partnership with a partner that is a disregarded entity described in Reg. §301.7701-2(c)(2)(i) cannot opt out of the new partnership audit procedures under Code Sec. 6221(b)); Reg. §301.7701-2(c)(2)(iii) (liability stemming from a period before an entity elects to be disregarded can be collected from the disregarded entity); Reg. §301.7701-2(c)(2)(v) (disregarded entities treated as associations for various delineated federal excise taxes); CCA 201430013 (Mar. 24, 2014) (the trade or business of a disregarded entity can constitute a separate and distinct trade or business from that of its owner in accordance with Reg. §1.446-1(d)(1)).

[59] *See, e.g.,* Reg. §1.881-3(a)(2)(i)(C) (allowing an IRS director of field operations to regard a disregarded entity in connection with conduit financing arrangements); Reg. §1.1503(d)-1(b)(3) (regarding a disregarded entity in the "dual consolidated loss" context); Reg. §1.6038A-1(c)(1) (a domestic entity that is wholly owned by one foreign entity will be treated as an entity separate from its owner for purposes of the reporting, record maintenance, and associated compliance requirements that apply to 25 percent foreign-owned domestic corporations under Code Sec. 6038A); Reg. §301.7701-2(c)(2)(vi) (same); 31 CFR §1010.350(b)(3) (all entities created, organized, or formed under the laws of the United States must comply with the FBAR filing requirements).

[60] *Cottage Savings Ass'n*, SCt, 91-1 USTC ¶50,187, 499 US 554, 111 SCt 1503.

[61] Reg. §1.1001-3(c) provides that the term "modification" means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Reg. §1.1001-3(e)(1) provides that, in general, a modification is a "significant modification" only if based on all facts and circumstances the legal rights or obligations that are altered and the degree to which they are altered are economically significant.

[62] *See* Reg. §1.1001-3(e)(4)(i)(A).

[63] *See* Reg. §1.1001-3(e)(4)(ii).

[64] In many states, it is possible for an entity to convert to a new state law form of organization without needing to liquidate and reorganize, and without undertaking a merger. This statutory conversion is commonly referred to as a "formless conversion." Very generally under formless conversion statutes, conversion of an entity into a different form is deemed for state law purposes not to affect any obligations or liabilities of the entity incurred prior to its conversion or the personal liability of any person incurred prior to such conversion. All rights of creditors and all liens upon any property of the entity that has converted are preserved unimpaired, and all debts, liabilities, and duties of the entity that has converted attach to the converted entity and may be enforced against it to the same extent as if said debts, liabilities, and duties had been incurred or contracted by it. *See*, *e.g.*, Del. Gen. Corp. L. section 266 and Del. Lim. Liab. Co. Act section 18-214.

[65] *See* American Bar Association Section on Taxation, *Comments on Modifications of Debt Instruments Under Section 1001* (Mar. 7, 2017) (recommending changes to Reg. §1.1001-3 to address the uncertainty of how the debt modification rules interact with disregarded entities); New York State Bar Association Tax Section, *Report No. 1383 on Debt Issued by Disregarded Entities and Treasury Regulations Section 1.1001-3* (Dec. 15, 2017) (same).

[66] LTR 200315001 (Sept. 19, 2002).

[67] LTR 200630002 (Apr. 24, 2006).

[68] *Citing R. Aquilino*, SCt, 60-2 USTC ¶9538, 363 US 509, 80 SCt 1277, and *Morgan*, *supra* note 13.

[69] *See* Garlock, *Federal Income Taxation of Debt Instruments* (CCH 2019) at paragraph 1404.02[C] ("It appears that the IRS reformulated the basis for its conclusion in [PLR 200630002] because the IRS became uncomfortable with ruling that a change in tax status of the obligor was not a modification at all when such a change is generally given effect for tax purposes.").

[70] LTR 200709013 (Nov. 22, 2006).

[71] *See also* LTR 201010015 (Nov. 5, 2009) (recognizing the substitution of a new obligor for tax purposes upon a corporation's conversion to a disregarded LLC pursuant to a state formless conversion statute, but again concluding that the modification was insignificant).

Query what the ruling position of the IRS would be in the situation where foreign sourcing determinations would be affected by a change in the entity classification of a debtor. For example, if a foreign subsidiary of a U.S. person that was treated as a corporation for U.S. tax purposes under the check-the-box regulations were to elect to become disregarded from its U.S. parent, then recognizing the substitution of a new obligor for tax purposes would necessitate the conclusion that the interest payments following such an election would be U.S. source, and would possibly be subject to U.S. income taxation and withholding depending on the status of the creditors. *See generally* Code Secs. 881, 882, 1441, and 1442. While the most recent LTRs in this area have determined that there is no Reg. §1.1001-3(e) "significant modification" because there is no change in the legal rights and obligations between the debtor and its creditors, can the same hold true where U.S. tax law would impose a drastically different result on those creditors with respect to the interest payments on the outstanding debt? *See* New York State Bar Association Tax Section, *Report No. 1383 on Debt Issued by Disregarded Entities and Treasury Regulations Section 1.1001-3*, *supra* note 65 (indicating that under current Reg. §1.1001-3 no realization event occurs and suggesting a "tax status" approach to debt modification, under which a disregarded foreign finance subsidiary's election to be treated as a corporation for U.S. tax purposes would change the source of interest payments on debt issued by the subsidiary and thus constitute a change in obligor as well as a significant modification to the debt instrument).

[72] *S.J. Pierre*, 133 TC 24, Dec. 57,910 (2009).

[73] *Cf.* Rev. Rul. 99-5, *supra* note 6, *Situation 1* (sale of an interest in a single-member LLC treated as a sale of LLC assets).

[74] *RERI Holdings I, LLC*, No. 17-1266 (D.C. Cir. May 24, 2019), *aff'g* 149 TC 1 (2017) and 143 TC 41, Dec. 59,987 (2014).

[75] Any number of situations that arise under the Code could be impacted if entities are regarded generally for valuation purposes, *e.g.*, transfer pricing under Code Sec. 482, basis determinations under Code Sec. 1014, and valuing corporate distributions for purposes of Code Secs. 301, 311, and 355.

[76] *See* Code Secs. 856 and 857. *See also* Ameek Ashok Ponda, *How Much Gain Would a REIT Defer if a REIT Could Defer Gain?* Doc. 2012-10266, TAX NOTES (June 4, 2012) (explaining the key statutory requirements a REIT must satisfy under the Code).

[77] *See generally* Code Sec. 856(c)(4)(B)(iv) ("[At the close of each quarter of the taxable year] (I) not more than 5 percent of the value of [the trust's] total assets is represented by securities of any one issuer, (II) the trust does not hold securities possessing more than 10 percent of the total voting power of the outstanding securities of any one issuer, and (III) the trust does not hold securities having a value of more than 10 percent of the total value of the outstanding securities of any one issuer.").

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