DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR: Michael W. Bitner
Associate Area Counsel SB/SE, Area 5

FROM: Office of the Associate Chief Counsel (Passthroughs & Special Industries Division)

SUBJECT: Pre-Check the Box Classification

This Chief Counsel Advice responds to your memorandum dated June 04, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

X =

A =

B =

State =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

ISSUE

What is the classification of a pre-check the box business entity whose corporate charter was dissolved by the state?

CONCLUSION

Under pre-check the box law, federal law controls in determining whether a business entity that is not a per se corporation is a corporation for federal tax purposes.

FACTS

X was incorporated under the laws of State in Year 1. A is the sole shareholder of X. X was administratively dissolved in Year 2 by State for a failure to file an annual report. X continued to operate its business and hold itself out as a corporation. For Year 2, Year 3, and Year 4, X did not file timely corporate income tax returns. An agent examined the joint returns of A and B, A's spouse, for Year 2, Year 3, and Year 4. A and B's income was adjusted for those years, treating X as if it was A's sole proprietorship rather than a corporation. By Year 5, X had been reinstated as a corporation in State. Under State law, the reinstatement related back to and takes effect as of the dissolution date. State now considers X to be an active corporation. This case would be appealable to the Eighth Circuit.

LAW AND ANALYSIS

Section 301.7701-1(c) effective in Year 2, Year 3, and Year 4 provided that the classes into which organizations are to be placed for purposes of taxation are determined under the Internal Revenue Code. Under § 301.7701-1(c), it is the Internal Revenue Code rather than local law which establishes the test or standards which will be applied in determining the classification in which an organization belongs, however, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met.

Section 301.7701-2(a)(1) effective in Year 2, Year 3, and Year 4 provided that to be considered an association, an organization must possess certain characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These characteristics are: associates; an objective to carry on business and divide the gains therefrom; continuity of life; centralization of management; liability for corporate debts limited to corporate property; and free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of these characteristics. Moreover, under § 301.7701-2(a)(2) associates and an objective to carry on business for joint profit are essential characteristics (other than the so-called one-man corporation and the sole proprietorship). An organization will be classified as an association if the corporate characteristics are such that the organization more nearly

resembles a corporation than a partnership or trust. See Morrissey v. Commissioner, 296 U.S. 344 (1935).

Moreover, § 301.7701-3(h)(2) of the current regulations provides that in the case of a business entity that is not described in § 301.7701-2(b)(1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification will be respected for all periods prior to January 1, 1997 if: (i) the entity had a reasonable basis for its claimed classification; (ii) the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the 60 months prior to January 1, 1997; and (iii) neither the entity nor any member was notified in writing on or before May 8, 1996 that the classification of the entity was under examination. Additionally, both pre and post-check the box, the Service has conferred automatic corporate status on organizations established under designated domestic corporation statutes. See § 301.7701-2(b)(1); G.C.M.39693.

However, even if X had not been reinstated, the core test of corporate existence for purposes of federal income taxation is always a matter of federal law. Whether an organization is to be taxed as a corporation under the Code is determined by federal, not state law. See Burk-Waggoner Oil Association v. Hopkins, 269 U.S. 110, 114 (1925); Burnet v. Harmel, 287 U.S. 103 (1932); and Ochs v. United States, 305 F.2d 844, 847 (Ct. Cl. 1962), cert. denied, 373 U.S. 923 (1963). A corporation is subject to federal corporate income tax liability as long as it continues to do business in a corporate manner under the § 301.7701 factors, despite the fact that its recognized legal status under state law is terminated. See Messer v. Commissioner, 438 F.2d 774, 778 (3rd Cir. 1971) and Lumetta v. United States, 362 F.2d 644, 648 (8th Cir. 1966).[1]

In Lumetta, an Eighth Circuit case, the court held that while the status of a corporation whose charter was forfeited for failure to file annual statements may possibly have changed under state law, its tax status for federal purposes remains the same. Lumetta at 648. See also, Poplar Bluff Printing Co. v. Commissioner, 149 F.2d

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[1] In Suburban Investment Co. v. Commissioner, 1 B.T.A. 1121 (1925), acq. IV-2 C.B. 4 (1925) the court held that a corporation that lost its charter and had it retroactively reinstated was entitled to take corporate losses for the period when its charter was forfeited. However, Suburban was decided 7 months prior to Burk-Waggoner and because it does not address federal tax law, the court's opinion on that issue is unclear. In Brent v. Commissioner, 630 F.2d 356 (5th Cir. 1980) reversing 70 T.C. 775 (1978), the court held that a retroactive divorce decree under state law did not alter the federal tax treatment of the income earned in a prior year. Neither of these cases conflict with the proposition that the Internal Revenue Code determines entity classification rather than state law.

1016 (8th Cir. 1945). Although, the courts have adopted varying approaches to this issue, it remains clear that federal law controls. Compare Knoxville Truck Sales & Service, Inc. v. Commissioner, 10 T.C. 616 (1948), acq. 1948-2 C.B. 3 (1948). If a pre-check the box corporation loses its per se status, the factors set forth in § 301.7701, determine its classification; its classification will be respected so long as the entity had a reasonable basis.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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By: _____

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