The Sliver Investor: May We Disregard You for Tax Purposes?

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INTRODUCTION

I am often asked to address whether local-law partners of partnerships, local-law members of limited liability companies, local-law shareholders of corporations, and local-law investors in other foreign-law entities may be disregarded for federal tax purposes due primarily to the small size of their equity interest (i.e., whether a “Sliver Investor” may be disregarded for federal tax purposes). The situations in which this issue can arise are countless. This article describes a few of those situations, addresses the legal issues one needs to analyze to arrive at a conclusion, and considers a potential alternative approach.

FIRST ILLUSTRATIVE SITUATION

X and Y are domestic corporations. X owns 99.99999% of Y. Due to prior services rendered on behalf of Y, an individual shareholder (“Sliver Shareholder”) owns 0.00001% of Y. Sliver Shareholder no longer works for X or Y.

X wants to use certain tax attributes of Y that it cannot otherwise use under the current structure, and X understands that it can acquire those attributes via a tax-free liquidation pursuant to §§332 and 337. However, X wants the assets and liabilities of Y to remain in a separate limited liability entity.

X and Y might prefer not to contact Sliver Shareholder about this transaction for a multitude of reasons, among them the fear that Sliver Shareholder will delay the transaction or will demand an unreasonable amount of money from X or Y to gain Sliver Shareholder’s cooperation. Alternatively, X and Y might be willing but not able to contact Sliver Shareholder due to X and Y not having current contact information for Sliver Shareholder or due to Sliver Shareholder actively resisting contact for fear that it may lead to Sliver Shareholder’s discovery by the authorities, such as the state police, the Immigration and Naturalization Ser-

1 For purposes of this article “local law” means all state, local, and foreign laws other than federal tax laws.

2 See §381.
vice (the “INS”), or the Internal Revenue Service (the “Service”).

Due to these actual (or perceived) constraints, X simply wants Y to convert to a domestic limited liability company (an “LLC”) under state law. A state-law, formless conversion of Y from a domestic corporation to a domestic LLC should be treated as a tax-free liquidation of Y into X pursuant to §§332 and 337 and should prevent Y’s assets and liabilities from being commingled for non-tax purposes with X’s assets and liabilities. However, if Sliver Shareholder is not disregarded as an equity holder of Y, the expected tax results of the transaction could be frustrated or limited due to the fact that Y would be treated as a partnership (not a disregarded entity) after such conversion for federal tax purposes.

So, X and Y want to disregard the existence of Sliver Shareholder as a “member” or “owner” of Y under the entity classification regulations (i.e., the “check-the-box regulations”) in order to reach the conclusion that, immediately after the conversion of Y to an LLC, Y is disregarded as a separate entity from X in accordance with Regs. §301.7701-2(c) (rather than a partnership between X and Sliver Shareholder). Is it appropriate for X and Y to take this position?

**ANALYSIS OF TAX ISSUES**

**Statutory Authority**

To start the analysis, let us look at the Internal Revenue Code (the “Code”). The Code contains definitions of “corporation,” “shareholder,” “partnership,” and “partner.” Of particular interest are the definitions of “shareholder” and “partner.” A “partner” is defined to include “a member in . . . a syndicate, group, pool, joint venture, or [other unincorporated] organization.” A “shareholder” is defined to include “a member in an association, joint-stock company, or insurance company.” Each of these definitions uses the term “member.” However, §7701 does not contain a definition of “member.” So, overall, it seems that the Code does not offer much help in determining whether Sliver Shareholder may be disregarded as an equity holder (or member) of Y.

**Regulatory Authority**

The check-the-box regulations, which interpret the entity and investor definitions in §7701(a), must define what a “member” is, right? Let us review the basics of the check-the-box regulations first. These regulations first require the practitioner to make a determination of whether an arrangement rises to the level of an “entity” or is entitled to some special tax treatment, such as a REMIC or a qualified cost-sharing arrangement. If the arrangement rises to the level of an “entity” that is not otherwise entitled to some special tax treatment, the regulations then require the practitioner to determine whether the entity constitutes a “trust” under Regs. §301.7701-4. If the entity does not constitute a “trust,” the entity is defined as a “business entity.” The regulations then require the practitioner to determine whether such business entity constitutes a corporation that cannot change its classification by election (i.e., a “per se” corporation, which includes, for example, corporations organized under state law). If such business entity does not constitute a “per se” corporation, it is an “eligible entity.” If the entity is an eligible entity, the regulations require the practitioner to determine whether such business entity has elected to be treated as either a corporation, partnership, or disregarded entity. The regulations provide that an eligible entity that has two or more “members” can elect to be classified as either a corporation or a partnership, and an eligible entity that has one “owner” can elect to be classified as either a corporation or a disregarded entity. If there is no entity classification election made with respect to the eligible entity, the regulations require the practitioner to determine the “default” classification of the eligible entity. If the eligible entity is domestic and has two or more “members,” its default classification is as a partnership. If the eligible entity is domestic and has only one “owner,” its default classification is as a disregarded entity. The default classification rules for foreign eligible entities are somewhat different, since such rules look not only to the number of members or owners but also to whether such members

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3 This agency is now called “U.S. Citizenship and Immigration Services”—USCIS.
4 Such a conversion from a state-law corporation to a state-law LLC generally can be accomplished by filing a single form with the relevant Secretary of State.
5 Cf. Regs. §301.7701-3(g)(1)(iii).
6 See Regs. §301.7701-2(a), (c)(1), (2).
7 §7701(a). See also §761.
8 §§761(b), 7701(a)(2).
9 §7701(a)(8).
10 Regs. §301.7701-1.
11 Regs. §301.7701-2(a).
12 Id.
13 Regs. §301.7701-2(b).
14 Regs. §301.7701-3(a).
15 Regs. §301.7701-3(a).
16 Regs. §301.7701-3(b)(1).
17 Id.
have limited liability for the debts of the entity.\textsuperscript{18} Nonetheless, the determination of whether an eligible entity (domestic or foreign) can elect to treat itself (or be treated by default) as either a partnership or a disregarded entity depends (in whole, in case of domestic entities, or in substantial part, in case of foreign entities) on whether the entity has one or more than one “member” or “owner.”

Applying these regulatory rules to our first illustrative situation, if Sliver Shareholder is recognized as a “member” or “owner” of Y, Y will have two members (Sliver Shareholder and X) upon its conversion to an LLC, which will cause Y to be classified as a partnership by default (and will prohibit Y from electing to be treated as a disregarded entity of X). If Sliver Shareholder can be disregarded as a “member” or “owner” of Y, Y will have only one “member” or “owner” (X) upon its conversion to an LLC, which will cause Y to be classified as a disregarded entity of X by default — the desired entity classification.

So, it seems that the key to addressing the overall issue rests in the definition of the term “member” or “owner” as it is used in the check-the-box regulations. Unfortunately, those regulations do not define “member” or “owner.” The preamble to the check-the-box regulations states (rather unhelpfully) that the “determination of whether an organization has more than one owner is based on all the facts and circumstances.”\textsuperscript{19} There appears to be no other regulatory guidance.

**Published Administrative Guidance**

Moving from regulatory guidance into other administrative guidance, Rev. Rul. 2004-77\textsuperscript{20} provides a bit more guidance on what it means to be a “member” or “owner” under the check-the-box regulations.

Assume the following facts. P and Y are domestic LLCs that have not made entity classification elections, and X is a “per se” corporation. X wholly owns Y, and X and Y equally own P. For purposes of classifying P as an entity under the check-the-box regulations, how many “members” does P have — one or two?

Note that P has two members under state law (i.e., P has two local-law members) — X and Y, Y, though, is classified by default as a disregarded entity of X for federal tax purposes. Rev. Rul. 2004-77 reasons that, since Y is disregarded as an entity separate from X for federal tax purposes, P should be treated as having only one “member” or “owner” under the check-the-box regulations. This conclusion seems to be a natural extension of the following two principles expressly mentioned in the check-the-box regulations: (i) “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”; and (ii) “An entity formed under local law is not always recognized as a separate entity for federal tax purposes.”\textsuperscript{21} Thus, the following principle can be taken from Rev. Rul. 2004-77: Federal tax law controls whether something constitutes a “member” or “owner” for federal tax purposes. This revenue ruling and, accordingly, this principle have been applied in the corporation-shareholder context as well.\textsuperscript{22}

However, such a principle does not mean that non-tax law is irrelevant in this context. It actually has a large role to play. Non-tax law creates bundles of rights and obligations. Those rights and obligations are then subjected to federal tax pursuant to federal tax law.\textsuperscript{23} In the context of classifying foreign entities by default, the check-the-box regulations echo this approach. They direct the practitioner to “the statute or law pursuant to which the entity is organized” and, in some cases, the “organizational documents” (but not indemnity agreements from other persons that otherwise enforceable under non-tax law) to determine whether a “member” or “owner” has limited liability for the debts of the foreign entity.\textsuperscript{24} So, in a sense, the practitioner should start with non-tax law to define the relevant economic bundle of rights and obligations. The practitioner then should apply the Code to that economic bundle to determine federal tax consequences.

The principle that federal tax law controls the determination of whether some economic bundle of rights and obligations constitutes a “member” or “owner” is not too surprising. It also is not too helpful, at least for purposes of determining whether Sliver Shareholder may be disregarded as a “member” or “owner” of Y, since the Code, regulations, and official administrative guidance discussed above offers no real clues to what it means to be a “member” or “owner.”

\textsuperscript{18} Regs. §301.7701-3(b)(2).
\textsuperscript{19} See T.D. 8697 (12/17/96).
\textsuperscript{20} 2004-2 C.B. 119.
\textsuperscript{21} See Regs. §301.7701-1(a)(1), (3).
\textsuperscript{22} See, e.g., PLR 200513001 (ruling that a limited partnership was not (and its ultimate owner was) treated as a shareholder of an S corporation since the limited partnership was disregarded as separate from its ultimate owner).
\textsuperscript{23} See Morgan v. Comr., 309 U.S. 78 (1940) (“State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed . . . . [Federal law must prevail no matter what name is given to the interest or right by state law.”); Craft Est. v. Comr., 68 T.C. 249 (1977), aff’d, 608 F.2d 240 (5th Cir. 1979); INI, Inc. v. Comr., 69 T.C.M. 2113 (1995).
\textsuperscript{24} Regs. §301.7701-3(b)(2)(ii).
Unofficial Administrative Guidance

Moving from official, published Service guidance to unofficial Service guidance, there appears to be a few interpretational clues.

Assume the following fact scenario. P is a domestic LLC that has not made an entity classification election. X and Y are domestic, unrelated “per se” corporations. X and Y own all the interests of P. For purposes of classifying P under the check-the-box regulations, how many “members” or “owners” does P have — one or two?

Due to Rev. Rul. 2004-77, we know that federal tax law controls this inquiry. So, since X and Y are “per se” corporations pursuant to federal tax law (i.e., the check-the-box regulations), P should be treated as having two “members.” Thus, P generally should be classified as a partnership by default.25

However, in this structure, is there any set of circumstances under which P would be treated as having only one “member” or “owner” under the check-the-box regulations?

Yes. The Service, without citation to anything other than the check-the-box regulations, ruled privately that, if Y has no rights to distributions, no share of profits and losses, no other economic interest, and very limited management rights, Y is not considered a “member” under the check-the-box regulations despite Y being (i) a “per se” corporation for federal tax purposes and (ii) a member of P for state-law purposes.26

So, why is Y inserted as a member of P in the first place? A lender has provided funds to P so that it can be used for some activity controlled by X, and the lender wants to make sure that X does not cause P to compromise the lender’s preferred position regarding repayment. The lender protects its interests via Y. Neither the lender nor X owns or apparently controls Y, but the lender has a representative on the board of Y. The operating agreement of P provides that Y’s approval is required for P to file for bankruptcy, dissolve or liquidate, amend P’s certificate of formation, or enter into a borrowing in a manner other than contemplated upon P’s formation. Most importantly, Y cannot give such approval without unanimous board consent, which effectively provides the lender with veto power over such approval.

Another reason Y could be inserted as a member of P in the manner described above is in the context of tax-deferred like-kind exchanges under §1031. If P is acting as an intermediary in a deferred like-kind exchange under §1031, P may hold temporarily the title to property (or proceeds from the sale of property). X placing P into bankruptcy (or otherwise diverting funds held by P to X) during a deferred like-kind exchange likely would defeat the intended §1031 deferral for the taxpayers using P as an intermediary.27 Y being a member of P in this manner helps reduce this risk for the taxpayers.

Yet another reason Y could be inserted as a local-law member of P in the manner described above is to permit X (through P) to conduct business in a particular foreign country. In certain foreign jurisdictions, for example, a person cannot conduct business within the foreign jurisdiction without natural or corporate citizens of that jurisdiction having record ownership of a certain percentage of the business. In such a case, beneficial ownership is retained by the original owners of the business. Although there appears to be no specific guidance available, there seems to be no reason why the Service would not rule similarly to the way it ruled in a domestic context in PLR 200201024. In this foreign context, Y would have no economic interest and no (or very limited) management rights. Therefore, Y presumably would not be treated as a “member” or “owner” of P, which would permit P to elect to be treated as a disregarded entity (i.e., a branch) of X.

Recall that PLR 200201024 ruled that Y is not a “member” or “owner” of P for purposes of classifying P as an entity for federal tax purposes, and such ruling did not appear to rely upon anything other than general citations to the check-the-box regulations. Thus, the ability to use this private letter ruling to help one analyze a Silver Investor issue outside the specific facts of the ruling is very limited. However, two other private letter rulings that address the same issue as in PLR 200201024 in scenarios insignificantly different than the scenario addressed in PLR 200201024 (and that come to the same conclusion) appear to be more helpful. In PLRs 199911033 and 199914006, the Service cited not only the check-the-box regulations but also somewhat discussed (and apparently relied upon) fundamental tax authority with which practitioners have a large body of subsequent authority to work — Comr. v. Tower,28 Comr. v. Culbertson,29 and Luna v. Comr.30 PLR 199911033 contains the following relevant discussion:

Since LLC is a domestic eligible entity and you have represented that it will not file an election to be treated as a corporation, its federal tax classification depends upon the num-

25 Regs. §301.7701-3(b).
26 See PLR 200201024.
28 327 U.S. 280 (1946).
29 337 U.S. 733 (1949).
ber of members of LLC. The cases of Commissioner v. Tower, 327 U.S. 280 (1946) and Commissioner v. Culbertson, 337 U.S. 733 (1949), provide general principles regarding the determination of whether individuals have joined together as partners in a partnership. The primary inquiry is whether the parties had the intent to join together to operate a business and share in its profits and losses. The inquiry is essentially factual and all relevant facts and circumstances must be examined. Furthermore, it is federal, not state, law that controls for income tax purposes, regardless of how the parties are treated under state law.

In Herbert M. Luna, 42 T.C. 1067, 1077 (1964), the court stated that the following factors should be considered in determining whether the parties intended to be a partnership: (1) the agreement of the parties and their conduct in executing its terms; (2) whether business was conducted in the joint names of the parties; (3) whether the parties filed Federal partnership returns or otherwise represented to the Service or to persons with whom they dealt that they were joint venturers; (4) whether separate books of account were maintained for the venture; (5) the contributions, if any, which each party has made to the venture; (6) whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; (7) the parties’ control over income and capital and the right of each to make withdrawals; and (8) whether the parties exercised mutual control over and assumed mutual responsibility for the enterprise.

In this case, the members of LLC have not come together to form a partnership for federal tax purposes because, as evidenced by the LLC agreement, Trust and Member2 did not enter into the Agreement to operate a business and share profits and losses. Member2 is a member of LLC for the sole limited purpose of preventing Trust from placing LLC into bankruptcy on its own volition. Member2 has no interest in LLC’s profits or losses and neither manages the enterprise nor has any management rights other than those limited rights described above. Thus, for federal tax purposes LLC will not be treated as a partnership between Trust and Member2 but rather as being owned solely by Trust. Because Trust is the sole owner of LLC and LLC will not elect to be treated as a corporation for federal tax purposes, LLC will be disregarded as an entity separate from Trust.

PLR 199914006 contains a substantially similar discussion.

So, what principle can we draw from the preceding discussion of authority in these private letter rulings? It seems that the Service is indicating that it is appropriate for practitioners to look to the large body of traditional tax authority that defines what it means to be a “partner” in attempting to define “member” or “owner” under the check-the-box regulations. Also, if the Service applies the traditional authority that defines what it means to be a partner in a factual context involving an LLC and its local-law members, it seems it would be a short leap of logic to the conclusion that the Service would apply the traditional authority that defines what it means to be a shareholder in a factual context involving an entity capable of qualifying as a corporation and its local-law equity holders. This approach seems consistent with the fact that the Code definitions of “partner” and “shareholder” are based generally on the existence of a “member,” and those definitions have been in the Code for decades (existing well before the issuance of the check-the-box regulations in late 1996).31

There is a final piece of administrative guidance regarding what it means to be a “member” or “owner” under the check-the-box regulations.

Assume the following facts. A taxpayer (“Son”) was a member of an LLC. The LLC had no organizational documents. Son claims that his father (“Father”) became a member of the LLC and, therefore, the LLC is a partnership for federal tax purposes, not a disregarded entity of Son. Father says he invested money into the LLC but had no knowledge of being a member of the LLC and understood Son to be the sole owner of the LLC. Son reported all tax items from the LLC on his personal tax return. Under these facts, the Service concluded, in CCA 200501001, that it was unable to determine whether LLC was a single-member or multi-member entity for federal tax purposes. Of particular interest is the following discussion:

Issue 2: Does the fact that Son originally indicated that Father was a member affect the determination of whether LLC is a single- or multi-member entity?

31 See §§761(b), 7701(a).
A taxpayer’s intent (or lack thereof) to form a partnership as expressed in reporting of income and representing the status of an LLC to the Service is relevant to the question of whether there is a partnership. See Commissioner v. Culbertson, 337 U.S. 733, 742–743 (1949). Given the conflicting evidence of intent here, however, Son’s representations alone are not determinative of the entity’s status as a disregarded entity or a partnership.

Issue 3: How is it determined how many members an LLC has for federal tax purposes?

Whether an LLC is a single or multi-member LLC depends on how many separate entities (including individuals) that are recognized for federal tax purposes are owners (again for federal tax purposes) of the entity. Ownership generally involves an analysis of who has the benefits and burdens and control of the entity. See, e.g., Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-1238 (1981). Thus, the determination as to whether there is more than one owner of an LLC is dependent on the facts and circumstances of each case.

So, what principles can we draw from the preceding discussion of authority in this chief counsel advice?

First, it seems that the Service is indicating that it is appropriate, in determining whether something is a “member” or “owner” under the check-the-box regulations, to use not only authority directly related to what it means to be a “partner” and “shareholder” but also the general authority on tax ownership of assets (as applied to interests in entities). Directly in response to the question of how to determine the number of “members” an entity has for federal tax purposes, the CCA replies that one must determine who are the owners of the entity, and “[o]wnership generally involves an analysis of who has the benefits and burdens and control of the entity. See, e.g., Grodt & McKay Realty, Inc. v. Commissioner.” Thus, the general “substantial benefits and burdens test” addressed in Grodt seems relevant.

Second, it also seems that the Service is indicating that the analysis of what constitutes a “member” under the check-the-box regulations should not vary based on whether the relevant state-law member and state-law entity are a partner and a partnership, a shareholder and a corporation, or some other type of equity owner and entity. The general “substantial benefits and burdens test” has been applied to determine ownership of all types of assets, including partnership interests, stock, and other local-law equity interests. What also seems to support this view are the facts that (i) the Code definitions of “partner” and “shareholder” both use “member” and (ii) the check-the-box regulations classify a domestic business entity (other than a “per se” corporation) solely by reference to the number of members it has (no other factors related to partner or shareholder status are used).

Applying Authority to First Illustrative Situation

So, now let’s go back to our first illustrative situation. X and Y want to disregard the existence of Sliver Shareholder as a “member” of Y under the check-the-box regulations in order to reach the conclusion that, immediately after the conversion of Y to an LLC, Y liquidated into X but remains a disregarded entity of X (rather than a partnership between X and Sliver Shareholder). Is it appropriate for X and Y to take this position?

Based on the discussion of the authorities, above, that interpret what it means to be a “member” or “owner” under the check-the-box regulations, it seems that one must look to the traditional authorities relating to what constitutes a partner in a partnership and a shareholder in a corporation to answer the question.

Pursuant to authorities in the corporate context, the general hallmarks of a shareholder of a corporation have been identified as being the following: (i) rights to dividends, (ii) rights to liquidation proceeds, (iii) rights to vote, (iv) rights to dispose of the interest in the corporation and keep the proceeds, if any, (v) treatment as a shareholder in tax returns and organizational documents, and (vi) holding out to the public as a shareholder.

Pursuant to authorities in the partnership context, the general hallmarks of a partner of a partnership have been identified as being the following: (i) rights to current distributions, (ii) rights to liquidating distributions, (iii) management rights, (iv) rights to dispose of the interest in the partnership and keep the proceeds, if any, (v) treatment as a partner in tax returns and organizational documents, and (vi) holding out to the public as a partner.

What is readily apparent from the preceding two paragraphs is that the general hallmarks of share-

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32 See, e.g., Paulsen v. Comr., 469 U.S. 131 (1985); Himmel v. Comr., 338 F.2d 815 (2d Cir. 1964); U.S. v. Title Guarantee & Trust Co., 133 F.2d 990 (6th Cir. 1943); Dunne v. Comr., 95 T.C.M. 1236 (2008).

33 See, e.g., Luna v. Comr., 42 T.C. 1067 (1964); Regs. §1.704-1(e)(2).
holder status and partner status are the same. Some practitioners might argue that such a statement is inaccurate, because the partnership authorities also separately focus on whether a person is allocated profits and allocated losses and the shareholder authorities do not separately do this. In my view, those hallmarks should be viewed as subsumed within the partner hallmarks of (i) rights to current distributions, (ii) rights to liquidating distributions, and (iii) possibly, treatment as a partner in tax returns. Allocations of profit and loss generally affect a partner’s right to current and/or liquidating distributions. Also, there would seem to be no clearer example of the hallmark of being treated as a partner in tax returns than including a distributive share of partnership profit or loss in a person’s federal tax return. So, it seems that the partnership authorities’ separate focus on whether a person is allocated profits and allocated losses is a distinction without a difference.

The partnership authorities also make much out of another aspect in which the hallmarks of partner and shareholder status apparently differ. Section 704(e)(1) affirmatively provides that a person “shall be recognized as a partner” in a partnership if that person owns a capital interest in such partnership and capital is a material income-producing factor of such partnership. The regulations issued under §704(e) define a “capital interest” as “an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon the liquidation of the partnership.” So, this §704(e)(1) test should be viewed, at the least, as part of the hallmark of the right to liquidating distributions, since to own a capital interest means that an investor has a right to liquidating distributions. The §704(e)(1) test seems not to create separate hallmarks but seems to address which hallmarks — rights to liquidating distributions — may be more important than others in certain partner analyses.

So, overall, there appears to be little, if any, difference between the general hallmarks of shareholder status and the general hallmarks of partner status. Now, the real effort comes in determining which hallmarks are the most important (or what combination of hallmarks is conclusive) in determining shareholder or partner status. This short article is not the place to try to provide a detailed explication. In my experience, the continuum of importance seems to be as follows (from most to least important): (i) the economic-based factors (rights to dividends/current distributions, rights to liquidation proceeds/liquidating distributions, and rights to dispose of the interest and keep the consideration, if any), (ii) rights to vote/manage, and (iii) the remaining non-economic-based factors (treatment in tax returns and organizational documents and holding out publicly) as a shareholder or partner.

Sliver Shareholder’s .00001% interest entitles him to .00001% of any dividends from Y and .00001% of any liquidation proceeds. Sliver Shareholder technically does have voting rights but their small size renders them virtually useless. We do not know how Sliver Shareholder has treated himself (i) on his tax returns with respect to his interest in Y, or (ii) in public forums (e.g., describing himself as a shareholder in loan applications). Sliver Shareholder is listed on Y’s corporate documents as a shareholder. In theory, Sliver Shareholder could sell his interest to anyone and keep the paltry amount of proceeds such sale could produce. So, based on the authorities discussed above, it seems that Sliver Shareholder meets the definition of a “shareholder” of a corporation and, therefore, the definition of a “member” or “owner” of Y under the check-the-box regulations.

However, what has not been discussed yet that seems important to the analysis is how substantial must such hallmarks of “member” status be. In other words, is there a minimum percentage threshold that Sliver Shareholder needs in his rights to dividends, liquidation proceeds, and disposition proceeds (and possibly voting rights) to ensure that such hallmarks are considered as existing for federal tax purposes? Is .00001% too small to be respected?

There appears to be no direct guidance on this issue. There are instances where small equity interests in entities have been disregarded for federal tax purposes, but they have been in situations where the insubstantial size is created or used primarily for federal tax purposes (either for a substantive tax advantage or for a procedural tax advantage). That is not the type of situation that this article addresses. The types of situations this article addresses involve, for example, former employees with employee stock compensation, the 25 heirs who inherited an equal 1/25th of grandpa’s two shares of Bigco, or the widow who refuses to give up her late husband’s shares he bought 30 years ago with their wedding gift money. These circumstances in which Sliver Investors arise are not tax-driven.

In these contexts, there appears to be neither case law nor administrative guidance that concludes that a partner or shareholder should be disregarded for fed-

34 See, e.g.,Regs. §1.704-1(b)(2)(ii), (iv) (economic effect tests and capital account maintenance rules).
35 Regs. §1.704-1(c)(1)(v).
36 See Regs. §1.704-1(e)(1)(v).
37 See, e.g., Regs. §1.701-2(d), Ex. 7 (substantive tax advantage); §6226(c) (a procedural tax advantage regarding the deposit required for judicial review of final partnership administrative adjustments).
eral tax purposes due solely to its miniscule interest in the partnership or corporation.\textsuperscript{38} So, it seems that the size of such hallmarks should not be relevant in determining whether such hallmarks exist in a shareholder or partner analysis. This seems to make sense. If the size of such hallmarks were relevant, for example, owners of stock in publicly traded corporations or owners of units in publicly traded partnerships (that are still treated as partnerships under the §7704 exceptions) would be subject to being disregarded as “members” or “owners” of such corporations or publicly traded partnerships.

Some practitioners might argue that some recent guidance does exist regarding minimum thresholds. Lately, the Service provided that it will respect the allocation of §45 renewable electricity production credits produced by a “wind farm” partnership if, among other requirements, the developer-partner has “a minimum one percent interest in each material item of partnership income, gain, loss, deduction, and credit at all times during the existence” of the partnership.\textsuperscript{39} The revenue procedure goes on to state that, if such requirements are not met, the Service will “closely scrutinize” the entity as a partnership and its investors as partners. This 1% safe harbor seems like a resurrection of the old ruling guidance under the “Kintner” classification regulations, which generally required (in order to classify a limited partnership as a partnership for federal tax purposes) the combined interests of all general partners of a limited partnership in each material item of partnership income, gain, loss, deduction, or credit to equal at least 1% of each such item at all times during the existence of the partnership.\textsuperscript{40} However, the current and the predecessor 1% safe harbors are only safe harbors — not interpretations of substantive law. The Service emphasized this point two months after Rev. Proc. 2007-65 was issued. Announcement 2007-112 retroactively amended Rev. Proc. 2007-65 to state: “The requirements set forth in this revenue procedure that must be satisfied in order to qualify for [safe-harbor treatment] are not intended to provide substantive rules and are not to be used as audit guidelines.” So, at the most, this guidance seems to be a conservative estimate of the boundary line (if there is one at all). It seems to have nothing to do with providing a substantive interpretation of tax law, such as what are the precise boundary lines of “member” or “owner” status under the check-the-box regulations.

**Alternative Structures and Resulting Issues**

If it is inappropriate for X and Y to take the position that Sliver Shareholder is not a “member” or “owner” of Y under the check-the-box regulations, what alternatives are there? There are several, but each of these alternatives require more public exposure and due diligence time and effort than simply taking a position on tax returns that Sliver Shareholder is not a “member” or “owner” of Y for federal tax purposes. In short, the alternatives require X and Y to spend an amount of time and money that is grossly disproportionate to the size of Sliver Shareholder’s interest in Y.

First, Y might consider redeeming Sliver Shareholder. Second, X might consider purchasing Sliver Shareholder’s interest in Y. Third, Y might consider doing a reverse stock split. For example, Y announces that it will issue a new share of Y stock for every 10 shares of old Y stock and Y will not issue fractional shares. Thus, if Sliver Shareholder’s .0001% interest represents only 2 shares of old Y stock, Sliver Shareholder will be cashed out in the reverse stock split. Fourth, X and Y might consider doing an upstream “squeeze-out” merger. For example, X contributes its interest in Y to a new subsidiary corporation (Newco) in exchange for all of Newco’s stock. Y then merges up into Newco, which would leave Sliver Shareholder with a right to a cash payment for its former interest in Y and associated state-law appraisal rights. Fifth, X and Y might consider doing a brother-sister “squeeze-out” merger. For example, X forms a new subsidiary corporation (Newco). Y then merges across into Newco, which would leave Sliver Shareholder with a right to a cash payment for its former interest in Y and associated state-law appraisal rights.

In addition to the public exposure and due diligence time and effort, all of these alternatives involve at least some notice to Sliver Shareholder. However, recall that Sliver Shareholder may be very difficult to find (or may not want to be found). If the entity’s internal documents do not suffice, Google can be a surprisingly powerful and cost-effective way to find people. A private investigator also might do the trick. Also, sufficient notice can be given, in certain cases, through newspapers with a circulation territory that includes the relevant person’s last known address.

**What Should Be the Law?**

What this discussion highlights, though, is that, if Sliver Shareholder cannot simply be disregarded as a
“member” or “owner” under the check-the-box regulations, X and Y must expend considerable amounts of time and money getting to the business and tax result that they want. This begs the question whether there should be a minimum threshold that Sliver Investor needs in its hallmarks of shareholder or partner status to have those hallmarks respected for purposes of determining whether it is a “member” or “owner” under the check-the-box regulations.

The former ruling guidance under the old “Kintner” classification regulations and the “wind farm” safe-harbor guidance (both described above) contain minimum 1% thresholds for partner status. However, as discussed, these are not substantive interpretations of law. If a minimum threshold were formulated, it seems that it may need to be a floating threshold to take account of the relative size of the entity and the number of its investors. For example, a .00001% interest in liquidation proceeds or distributions from a corporation or partnership that has assets worth $1 million may be viewed as less substantial than a similar percentage interest in an entity that has assets worth $1 billion. The Service has in the past used a variant of this sliding-scale approach in some of the guidance under the old “Kintner” classification regulations. Under that guidance, the previously described 1% minimum threshold that general partners of limited partnerships needed to meet could be lowered to a minimum of 0.2% if the total amount of capital contributions to the limited partnership exceeded certain thresholds. In other words, as the financial size of the limited partnership increased, the minimum required interest in the partnership that general partners had to own decreased (i.e., as capital contributions increased, the minimum threshold decreased).

So, one possible minimum threshold could be the lower of (i) 10% of the aggregate percentage interests of the smallest 10% of all members (to account for entities with large investor pools) and (ii) 0.1%. However, this minimum threshold could apply only after a reasonable attempt to notify the member that the relevant entity wished to disregard the member’s interest for federal tax purposes. So, a percentage interest below this threshold with respect to a relevant hallmark of partner or shareholder status would cause such hallmark to be disregarded in determining whether an investor constituted a “member” or “owner” under the check-the-box regulations. Such an approach, obviously, puts the focus on the economic-based hallmarks.

While permitting entities to do this might seem to be beneficial at first blush, the resulting tax issues under any type of minimum threshold seem to under-

mine any potential benefit from such an approach. First, how is a member that is disregarded under such an approach treated for federal tax purposes when the entity makes a pro rata distribution to all its local-law investors, including such disregarded member? Remember that the member would remain a member for all purposes other than federal tax purposes. The member would remain entitled to whatever economic and control rights local law and the controlling documents entitled the member to. Second, what should happen for federal tax purposes if the member increases its percentage interest above the minimum threshold? In such a case, for example, the relevant entity could be converted (in effectively an involuntary manner) from one type of entity (a disregarded entity) into another type (a partnership). Third, how would allocations of partnership income or loss that are still made to such a disregarded member pursuant to the controlling partnership agreement be recharacterized for federal tax purposes? Fourth, if a member that is disregarded under such an approach receives a distribution from a corporation, would the corporation not be required to notify the Service of such distribution via, for example, a Form 1099-DIV, since the member would not constitute a shareholder for federal tax purposes? The Service may not be too enamored with the prospect of losing such an effective compliance tool regarding the taxation of state-law dividends. These types of issues might make it seem that the adoption of a minimum threshold may do more harm than good for the interested entities and the Service.

OTHER ILLUSTRATIVE SLIVER INVESTOR SITUATIONS

The Publicly Traded Partnership and K-1’s

As a final note, the following are two other illustrative situations in which Sliver Investors can cause entity-level problems that are disproportionate to the size of their interest in the relevant entity.

PTP wishes not to have to issue a Schedule K-1 (Form 1065) (a “K-1”) to these infinitesimally small unitholders that have such small percentage interests in the PTP that their distributive share of any tax item is generally less than one cent.
of underlying flow-through investment vehicles. May it appropriately do this by taking the position that these unitholders are disregarded for federal tax purposes due to their small size?

Before answering the question, let us explore briefly what is at stake. In general, a partnership required to file a return for a taxable year must furnish a K-1 to every person who was a partner (or who held an interest in such partnership as a nominee for another person) at any time during the taxable year. Generally, the K-1 must be furnished on or before the day on which the partnership return for that taxable year is required to be filed (determined with regard to extensions).

Section 6722 imposes a penalty on any person that (i) fails to furnish a K-1 in a timely manner, (ii) fails to furnish a K-1 to the person required to receive such schedule, (iii) fails to include all required information on the K-1, or (iv) includes incorrect information on a K-1 (each, a “failure”). Absent intentional disregard, the penalty is $50 for each K-1 with respect to which a failure occurs. Absent intentional disregard, the total penalty imposed on a person for all such failures during any calendar year cannot exceed $100,000. If intentional disregard of the requirements to furnish a K-1 is involved (which seems likely in this situation), the $50 penalty is increased to the greater of (i) $100 or (ii) 10% of the aggregate amount of the items required to be reported correctly on the K-1. Also, the $100,000 ceiling does not apply to $6722 penalties due to intentional disregard. However, a $6722 penalty will not be imposed if the relevant person can establish that the failures that generated the penalty are due to reasonable cause and not to willful neglect.

So, may PTP appropriately take the position that it need not issue K-1’s to each of its infinitesimally small unitholders and avoid K-1-related penalties under §6722? Like Sliver Shareholder in the first illustrative situation, it does not appear that the current body of authority would permit PTP to do this.

The C Corporation Wishing to Convert to an S Corporation

Another situation in which a Sliver Investor can cause problems disproportionate to the size of its interest is as follows.

X is a domestic C corporation. X has several individual U.S. shareholders that have an aggregate interest in X of 99.9999%. P, a domestic partnership, owns the remaining interests in X — a .00001% interest. X wants to convert to an S corporation in order to eliminate the entity-level tax imposed on its earnings as a C corporation. In order for X to convert to an S corporation, all shareholders must be permissible shareholders of an S corporation, which include U.S. individuals but do not include partnerships. Also, to elect to be an S corporation, X must acquire the consent of all shareholders.

X might prefer not to contact P about this transaction for a multitude of reasons, among them being the fear that P will delay the conversion or will demand an unreasonable amount of money from X to be redeemed from X before the conversion. Alternatively, X might be willing but not able to contact P due to (i) X not having current contact information for P and its partners or (ii) P and its partners actively resisting contact due to a fear that it may lead to their discovery by various law enforcement authorities.

So, X simply wants to convert to an S corporation without having to deal with P. May it appropriately do so by taking the position that P is disregarded for federal tax purposes due to the extremely small size of its interest in X? Note that, if P is not disregarded, X would be ineligible to become an S corporation due to P being an ineligible shareholder — a partnership. Unfortunately, similar to the first illustrative situation and the PTP situation described above, the current body of authority does not appear to permit X to disregard the existence of P due to its extremely small percentage interest in X. So, X likely is going to have to deal with P before it can convert.

CONCLUSION

All types of entities are susceptible to Sliver Investor tax problems. Entities can plan around the possibility of these problems when the interests are issued to such investors by, for example, inserting fixed buyback provisions in equity purchase agreements. However, if those types of proactive measures are not put in place at the outset, the costs of dealing with such a Sliver Investor in the future likely will be grossly disproportionate to the investor’s interest in the entity. So, it should come as no surprise that applying federal tax law to disregard a Sliver Investor for tax purposes (and thereby eliminating the tax problem for the entity) would be an enticing approach to consider, since it could avoid all such disproportionate costs.

43 §6031(b), (e); Temp. Regs. §1.6031(b)-1T(a).
44 §6031(b), (e); Temp. Regs. §1.6031(b)-1T(b).
45 §§6722(a), 6722(b), 6724(d)(2)(A), 6724(d)(4); Regs. §301.6722-1(d)(2)(i).
46 §6722(a); Regs. §301.6722-1(a)(1).
47 Id.
48 §6722(c)(1)(A).
49 §6722(c)(2).
50 §6724(a); Regs. §301.6724-1.
51 See §1361(b)(1).
52 See §1362(a).
Unfortunately, the current body of federal tax authority does not seem to provide a basis for entities to disregard Sliver Investors. If future authority might permit entities to do so, a considerable amount of thought and effort would be required to provide sufficient guidance to address the various additional tax issues that inevitably would arise from such an approach.