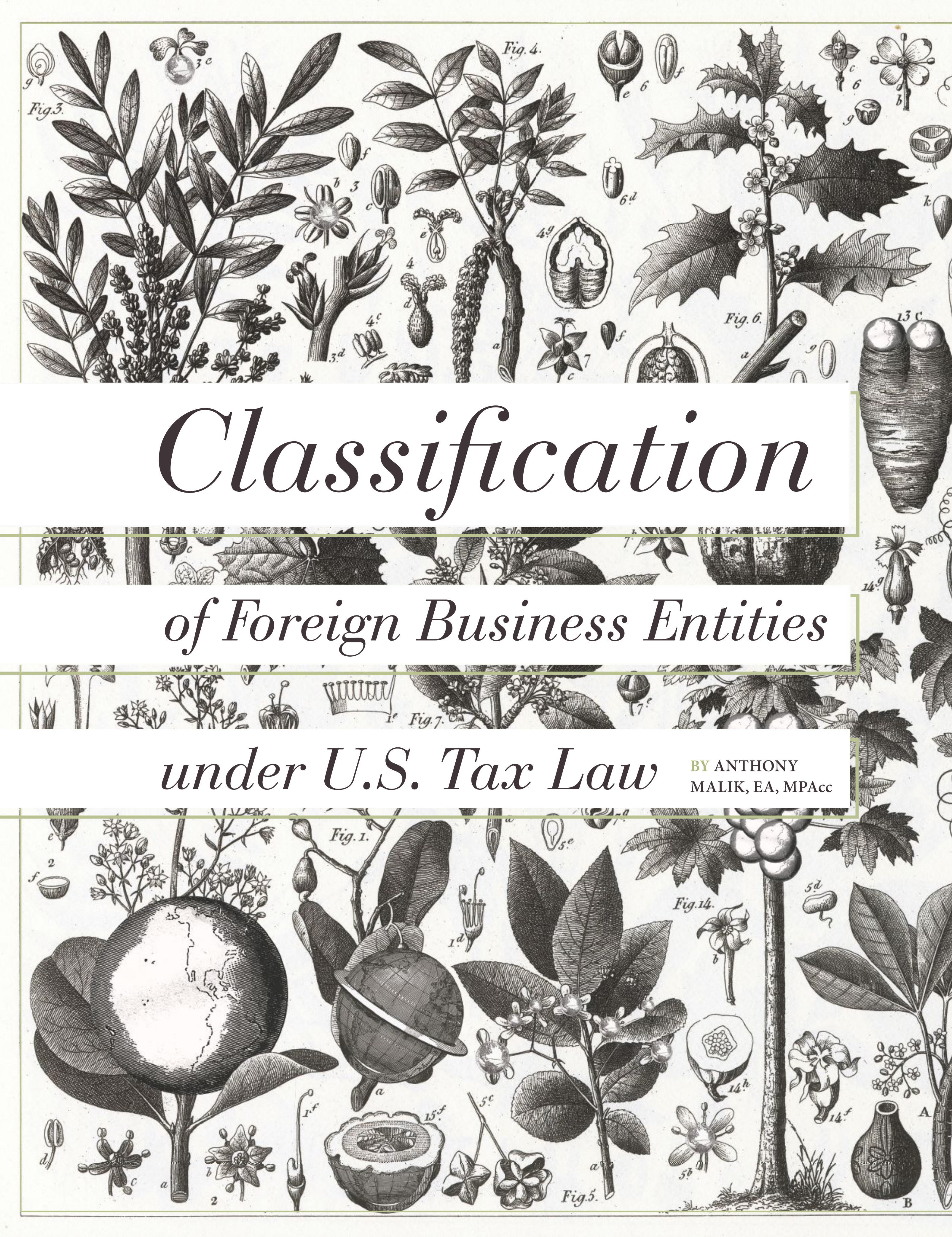

Classification

of Foreign Business Entities under U.S. Tax Law

BY ANTHONY MALIK, EA, MPAcc

An elementary question in business international taxation involves ascertaining the classification of foreign entities for U.S. tax purposes. This question emerges whenever a foreign business pursues U.S. economic activity or when a U.S. person establishes a business outside the U.S. While foreign entities enjoy definite classification under the laws of their respective countries of organization, their classification under U.S. tax law may be ambiguous. Since the U.S. taxation of any business entity—foreign or domestic—depends on its classification, this ambiguity places tax practitioners at an impasse. In the ensuing sections, this article will present an overview of the U.S. tax rules for foreign entity classification.

Historically, the classification of many foreign entities often proved problematic. This was owed to the purely factual classification system under prior law whereby foreign entities were classified based on their predominant character. In practice, applying the factual classification regime was difficult since the idiosyncratic features of foreign entities did not line up conveniently with those of U.S. chartered entities. Indeed, the large variety of entity types in the world, designed to operate in legal and economic environments vastly different from those of U.S. environments, often led to disputes over their classification for U.S. tax purposes.

Luckily for tax practitioners, in 1997 the factual classification regime was largely replaced by an elective classification regime.[1] Under this new regime, foreign eligible entities (discussed later) are able to definitively elect their federal tax classification by checking a box on Form 8832, Entity Classification Election, thereby eliminating much uncertainty from the

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international tax infrastructure. It should be mentioned that in many cases, in addition to classification changes, check-the-box (CTB) elections for foreign eligible entities (FEEs) also trigger restructuring transactions under U.S. tax law.[2] However, this article will limit itself only to the question of entity classification and will not delve into the transactional impact of cross-border CTB elections.

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Per Se Corporations – A Question of Axioms

Before delving into foreign entity classification, it will be helpful to briefly consider domestic entity classification, a subject that most tax practitioners are versed in. Remember that sole proprietorships and corporations generally cannot change their tax treatment by filing Form 8832.[3] In this respect, the law clearly defines corporations in a domestic context.[4]

Now bridging over to foreign entities, something that will undoubtedly be new for many tax practitioners is that the law also specifically classifies certain foreign entities as corporations for U.S. tax purposes.[5] This list exposes tax practitioners to colorful terms such as Sociedad Anonima, Public Limited Company, Aktiengesellschaft, and Kabushiki Kaisha among others. Extending the elective classification limitations of domestic corporations to foreign corporations, it becomes clear that these specifically classified foreign corporations (i.e., per se corporations) cannot opt for elective classification.

It should be mentioned that while it is always a relief to find clear guidance in the law, the per se corporation list is generally limited to publicly traded type entities. Thus the list itself provides little value unless the tax practitioner is employed by either the tax department of a multinational company or a giant professional services firm. As the discussion ahead will reveal, most tax practitioners will have to exercise some professional judgment in ascertaining a given foreign entity's classification.

Default Classification – A Question of Facts

As is often the case with regime changes, the current classification regime retained certain elements of the old factual classification regime. Specifically, foreign businesses that are not per se corporations automatically default to corporate, partnership or trust status based on an attenuated factual classification regime.[6] Under the current default rules, a foreign business is classified as a:

- Partnership if it has two or more members and at least one member does not have limited liability[7]
- Corporation if all members have limited liability[8]
- Disregarded entity if it has a single member-owner without limited liability[9]

Notice that a foreign entity's absence from the per se corporation list does not necessarily bar its corporate status. The reality is that many foreign entities, even ostensibly non-corporate ones, will default to corporate status à la the aforementioned legal standard. Along these lines, it is critical to understand that the default U.S. rules operate independently of the classification of the foreign entities in their countries of organization. In other words, cross-border entity classification mismatches are not uncommon. A foreign corporation may default to partnership or disregarded entity status[10] while a foreign partnership may default to corporate status[11] under U.S. standards. Since entity hybridization opens the window to a world of international tax planning, it acquires increased significance in the elective classification context discussed next.

Elective Classification – A Question of Choice

The CTB regime is designed to complement the underlying default entity classification regime. Since it is possible for the default rules to apply dubiously to some foreign entities, a CTB election minimizes the possibility of disputes with respect to foreign entity classification. Clearly, a boon of the elective classification system is that it introduces stability to the regulatory framework beyond what the default classification system alone can deliver. While there is no unqualified election for all foreign entities, FEEs that establish their characters as separate entities (i.e., entities not disregarded as separate from their owners) qualify to choose their own classification.[12]

FEEs are business entities that are not otherwise classified as corporations under the Tax Code.[13] The law stipulates that a FEE with at least two members can elect to be classified as either a corporation or a partnership while

an entity with a single owner can elect to be classified as either a corporation or a disregarded entity.[14] At this juncture, it behooves us to pay heed to a couple of things. Firstly, note the radical flexibility extended to FEEs. Relying on this legal provision, a FEE can elect corporate status even if its members have unlimited liability. A given FEE can also elect partnership status even if all its members have limited liability. Secondly, note that while we do not ordinarily think of FEEs in the context of default classification, those entities are de facto FEEs, i.e., eligible to elect their own classification. Thus a default foreign partnership can elect corporate status while a default foreign corporation can elect partnership or disregarded entity status.

The point is that the CTB elections offer many foreign businesses the freedom to choose their tax outcomes. This plays a monumental role, both in terms of international tax planning and compliance. While not the subject of this piece, it is worthwhile to reiterate that much innovative international tax planning is driven by strategic cross-border CTB elections as the differing jurisdictional classifications of cross-border businesses create opportunities for tax arbitrage.

It is also imperative for tax advisors to be mindful of the appurtenant procedural complexities when navigating foreign businesses through the CTB elective classification regime. An incorrectly prepared, or untimely filed, Form 8832 can result in a rejection of the desired entity classification election by the IRS. Moreover, the tax timing for various deemed transactions resulting from CTB elections must also be deliberated upon before filing Form 8832. Unless procedural due diligence is exercised, the multinational business may unwittingly end up with adverse U.S. tax consequences.

Business Foundations – A Question of Trust

Foreign legal constructs such as foundations and establishments are generally treated as foreign trusts for U.S. tax purposes.[15] An entity properly classified as a trust is not a business entity for tax purposes. However, such foreign trusts, when organized to operate a business, are treated as business entities rather than as trusts.[16] "These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code... The fact that any organization is technically cast in the trust form… will not change the real character of the organization if the organization is more properly classified as a business entity."[17]

The characterization of foreign business trusts as foreign business entities is critical for purposes of our discussion since it is this characterization that affords the trusts elective classification. This is because the entity classification regulations articulate that only "business entities" can elect their classification.[18] Keeping with this, while under the default rules foreign business trusts with a single beneficiary are treated as disregarded entities and those with two or more beneficiaries are treated as partnerships, they are extended the flexibility to file an election to be treated as foreign corporations for U.S. tax purposes.

Conclusion

Ascertaining the classification of foreign business entities under U.S. tax law is typically the first step in business international tax advisory. While foreign businesses enjoy definite classification in their respective countries of organization, their classification for U.S. tax purposes is not necessarily self-evident. Obvious enough, the entire gamut of tax planning and compliance services rely on a given foreign entity's classification. As such, any tax practitioner intending to serve a cross-border business must, at a very minimum, develop an understanding of the entity classification rules as applicable to foreign businesses. **EA**

About the Author

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ENDNOTES

1 Regulations promulgated under IRC Sec. 7701.
2 CTB elections for newly created entities may not necessarily implicate taxable transactions under the Tax Code. However, depending on the facts, CTB elections for existing entities trigger a variety of reorganization transactions such as business unit liquidations, intercompany asset transfers, subsidiary drop-downs etc. that may yield immediate tax consequences to the multinational company. This is an extremely complex area of tax practice and requires a high level of expertise.
3 Treas. Reg. Sec. 301.7701-3(a).
4 Treas. Reg. Sec. 301.7701-2(b)(1)-(7).
5 Treas. Reg. Sec. 301.7701-2(b)(8).
6 The prior factual classification regime prescribed a multifactor assessment checklist based on an old Supreme Court Case (*Morrissey, T.A. v. Commissioner* (1935, S. Ct.)).
7 Treas. Reg. Sec. 301.7701-3(b)(2)(i).
8 Id.
9 Id.
10 Such entities are referred to as "hybrid entities" or simply "hybrids" in practice.
11 Such entities are referred to as "reverse hybrid entities" or simply "reverse hybrids" in practice.
12 Treas. Reg. Sec. 301.7701-1(a)(1).
13 Treas. Reg. Sec. 301.7701-3(a).
14 Id.
15 Treas. Reg. Sec. 301.7701-2(a).
16 Treas. Reg. Sec. 301.7701-4(b).
17 Id.
18 Treas. Reg. Sec. 301.7701-3(a).