taxnotes®

Volume 161, Number 7 ■ November 12, 2018

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Reprinted from *Tax Notes*, November 12, 2018, p. 825

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In this article, McCormick explores methods for determining how to classify international holdings, options for altering the default classification of an entity, the implications of various classification types, and things to consider when a choice of entity classification is possible.

A growing number of U.S. individuals with international holdings — along with the IRS's increased emphasis on tax requirements associated with those holdings — has led to an expanded focus on international interests by U.S. tax advisers. These holdings are frequently maintained in structures that are — pardon the pun — foreign to U.S. advisers. As would be expected, foreign jurisdictions maintain entity structures that typically do not match U.S. options for entities. A threshold consideration that sometimes is inadequately explored is how a foreign structure should be classified under U.S. tax rules. U.S. practitioners often simply defer to foreign classification without fully exploring details that could dictate alternative U.S. results. The classification of foreign entities is important in many contexts, including the taxation of the interests and the reporting requirements associated with these interests. This article explores methods for determining how to classify international holdings, options for altering the default classification of an entity, the implications of various classification types, and things to consider when a choice of entity classification is possible.

## Existence of a Foreign Entity

It is vital to emphasize at the outset that classification of an organization in its home jurisdiction does not dictate its treatment in the United States. Reg. section 301.7701-3(a) provides that Internal Revenue Code provisions, rather than home country classifications, are dispositive for determining how an organization is treated for federal tax purposes. Circumstances can thus arise in which, for example, a structure designated as a trust under the rules of its home jurisdiction is treated as something entirely different (a foreign corporation, for example) under U.S. rules. Cognizance of this possibility is critical.

The first determination usually required is whether an organization exists — that is, whether an entity separate from its owners exists for tax purposes. An entity is defined under reg. section 1.1471-1(b)(39) simply as any non-individual taxpayer. As noted, determining whether an entity exists in the organization's home jurisdiction does not dictate whether an entity exists under U.S. law. Specific factors are evaluated to determine whether an undertaking by multiple parties is properly classified as an organization (that is, a partnership).[1] When an entity is found to exist, it is normally classified under the regulations as either a trust or a business entity.

## Is It a Trust?

Reg. section 301.7701-4(a) states that for purposes of the code, a trust is an arrangement "whereby trustees take title to property for the

[1] *See Holdner v. Commissioner*, T.C. Memo. 2010-175.

purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts." Importantly, the definition further indicates that trusts "vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit."

Whether a foreign structure will constitute a trust based on these standards is inherently fact-specific. Reg. section 301.7701-4(b) provides that nominally setting up an organization in trust form will not change the structure's real character if the organization is more appropriately classified (and taxed) as a business entity. Awareness that a trust can be recast under the tax code is crucial when evaluating foreign trust structures. For trust classification, emphasis is placed on whether the arrangement is made to protect or preserve property for beneficiaries, and whether the beneficiaries share in the ability to discharge responsibilities. Business trusts and commercial trusts, as two examples, are not typically classified as trusts under the code, but instead are more often treated as business entities.

When a foreign structure is treated as a trust for U.S. tax purposes, its taxation will be dictated by its status either as a grantor or nongrantor trust. Income and gains of a grantor trust are taxed to its grantor under section 671, while nongrantor trusts, conversely, are treated as entities separately taxable from their grantors. Importantly, several special U.S. tax rules apply to foreign nongrantor trusts, the most noteworthy of which is the "throwback" rule (under which U.S. beneficiaries are taxed on accumulated distributions in a manner that mirrors the taxation of passive foreign investment company distributions).

### Foreign Business Entities

If an organization exists but is not properly classified as a trust, it is likely to be properly designated as a business entity for U.S. tax purposes. A business entity is defined under reg. section 301.7701-2(a) as any entity recognized for federal tax purposes that is not classified as a trust or otherwise subject to special treatment. The three types of business entities are disregarded entities, partnerships, and associations taxable as corporations. When an entity has a single owner, it will be either a corporation or a disregarded entity; if multiple owners exist, it is either a corporation or a partnership.

Default rules for foreign entity classification are provided under the regulations (which were revised in 1996). The default classifications hinge on the limited liability of the organization's members or owner. A foreign entity is classified as a partnership if it has two or more members and at least one does not have limited liability. If the entity has a sole owner that does not have limited liability, it is a disregarded entity. (Foreign partnerships and foreign disregarded entities are often called flowthroughs because income and loss associated with them are treated as passing through to the entity's owners or members.) Conversely, if all owners maintain limited liability, the entity is classified as an association (taxable as a corporation). Contrary to many rules associated with entity classification, reg. section 301.7701-3(b)(2)(ii) provides that the existence of limited liability is dictated by the local law in the entity's place of formation.

Under the 1996 regulations, elections can normally be made to override the default classifications and dictate how a business entity will be classified for U.S. tax purposes. Reg. section 301.7701-3(a) provides that an entity with a single owner can normally elect to be taxed either as a disregarded entity or as a corporation, and an entity with multiple members can usually elect to be taxed either as a partnership or as a corporation. Importantly, the ability to elect treatment applies only to business entities. It does not allow, for example, a foreign trust to elect treatment as a business entity. The primary exception to this rule is for "per se" corporations — entities listed by country in reg. section 301.7701-2(b)(8) that are corporations by default and cannot elect alternate treatment.

To choose an initial classification, an entity makes an election within 75 days of the entity becoming "relevant" for U.S. tax purposes; an entity's classification is relevant under reg. section 301.7701-3(d)(1)(i) once its classification affects the liability of any person either for federal tax or information reporting purposes. For the entity, earning income effectively connected to a U.S.

trade or business typically will create a tax filing requirement under section 882(a) (making it relevant for federal tax purposes). However, relevance can exist before the entity earns U.S. income, or any income at all, based on information reporting requirements — for example, when a U.S. taxpayer maintains an interest in the entity sufficient to necessitate filing Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations" (if the entity is classified as a foreign corporation) or Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships" (in the case of a foreign partnership).

### Entity Classification Ramifications

Classification of a business entity significantly affects its U.S. tax treatment, both at the entity and shareholder level. For business entities, owners of foreign flowthroughs typically are directly responsible for income items of the entity. For entities classified as foreign corporations, separate entity status is respected, with the entity — rather than its owners — treated as the income recipient. Special rules, however, require current inclusion of specified income items for U.S. shareholders of foreign corporations, with the potential for current inclusion significantly expanded under the Tax Cuts and Jobs Act (P.L. 115-97).

Historically, the primary method for current inclusion has been subpart F, under which specified "movable" income items of controlled foreign corporations are included in the income of a U.S. shareholder in the year of receipt by the foreign corporation. A U.S. shareholder generally means a shareholder with a 10 percent or greater interest in the foreign corporation; a CFC exists if more than 50 percent of the corporation's voting power or value is held by U.S. shareholders (subject to applicable attribution rules).[2] Subpart F items include dividends, interest, royalties, rents, annuities, and net gains from property giving rise to either passive income or no income.[3] U.S. shareholders of CFCs also are normally required to file Form 5471 to reflect their interests (and disclose information regarding the entity).

The TCJA added section 951A, under which each shareholder of a CFC must include in current gross income its share of global intangible low-taxed income of the CFC. GILTI is statutorily defined as the excess of a shareholder's net CFC tested income over the shareholder's net deemed tangible income return. Functionally, GILTI creates a mandatory current inclusion of income exceeding a 10 percent rate of return for a foreign corporation's tangible business assets.

Other special rules besides GILTI and subpart F can apply to U.S.-based interest holders in foreign corporations, such as the rules applicable to PFICs, which are foreign corporations that meet either an asset test or income test, both of which focus on passive income.[4] Importantly, no 10 percent interest in a foreign corporation is required for the PFIC rules to apply, nor is any 50 percent aggregated level of U.S. ownership needed (unlike for purposes of subpart F and GILTI). PFIC holdings are subject to punitive tax ramifications under default PFIC rules. Specifically, holders are subject to tax under section 1291(a) on any excess distribution or disposition at the top marginal tax rates for individual taxpayers (taxed as ordinary income), plus interest amounts calculated based on the taxpayer's holding period. Special rules under section 1297(d) apply when a foreign corporation is classified both as a CFC and a PFIC. If this is the case, interests in a CFC are not treated as interests in a PFIC (and thus are not subject to the punitive PFIC ramifications).

### Which Type of Entity Classification Is Best?

The classification rules apply only if an entity is classified as a foreign corporation. When an entity is treated for U.S. tax purposes as a flowthrough (whether by election or by default), the CFC and PFIC rules are inapplicable. Importantly, however, this is because the CFC and PFIC rules are intended to deter deferral of income recognition. When an entity is treated as a flowthrough, no deferral option for its members or owner exists. Optimal classification of a foreign

[2] *See* sections 951(b) and 957(a).

[3] *See* section 951(c)(1).

[4] *See* section 1297.

business entity with U.S. shareholders is neither clear-cut nor universal and normally relies on many factors. For example, if a foreign corporation is not classified as a CFC based on its ownership, GILTI and subpart F implications are less relevant (contingent on anticipated prospective changes in levels of U.S. ownership). Classification determinations often require weighing the effect of reporting requirements and deferral availability of foreign corporation status (based on CFC classification) against the relative simplicity — but eschewal of deferral opportunities — of flowthrough treatment. (It is worth noting that some information reporting requirements — that is, Form 8865 for U.S. partners of foreign partnerships — may still apply to foreign flowthroughs.) How the foreign entity is treated in its home jurisdiction can be another vital consideration because it can introduce additional factors into the decision-making process. Of note, foreign corporations can elect flowthrough treatment in the United States, and foreign flowthroughs can elect to be treated as U.S. corporations. These entities, called hybrid entities (foreign corporations treated as domestic flowthroughs) and reverse hybrid entities (foreign flowthroughs treated as U.S. corporations), can present tax planning opportunities, subject to U.S. rules intended to curtail these opportunities. (An analysis of hybrid planning techniques and the rules associated with them are beyond the scope of this article.)

## Conclusion

In the context of foreign organizations, domestic advisers often assume U.S. classification will mirror the organization's classification in its home jurisdiction. This need not always be the case. U.S. classification of foreign organizations is based on the specific facts rather than foreign organizational nomenclature. Recognition of this fact is vital to avoid reporting failures associated with interests in these entities. Awareness of the ability to elect classification for foreign business entities is also critical, allowing for treatment of the foreign entity in the manner most advantageous under the relevant circumstances. ■