

THINK LOCALLY, ACT GLOBALLY:

*U.S. Income and Estate Planning for Multinational Families,
Planning with Foreign Entities, and Check-the-Box Elections*



Executive Brief

- *Global companies and multinational families must deal with a number of subtleties in the U.S. tax code to minimize their exposure.*
- *The “check-the-box” regulations, which allow the company or family to select what type of tax entity it should be considered, can carry significant tax consequences and should be considered carefully.*
- *Current and proposed legislation may impact the use and applicability of these regulations going forward.*

FOCUS ON A FORM: *Plain, Simple, Powerful*

A check-the-box election is a simple two page form,¹ but it is one of the most powerful U.S. tax planning tools for multinational families. It can change the U.S. tax classification of a foreign corporation into a partnership or disregarded entity.

The basic procedure for making the election is straightforward. However, practitioners should be cautious, since the election can unleash corporate tax consequences that can either benefit or harm a client. Moreover, the nuances of the relevance rules are often overlooked and an election may not have its intended effect. The IRS has recently relaxed the procedures for making late elections. Nevertheless, new legislative proposals may greatly curtail the use of the election at all.

“ . . . the election can unleash corporate tax consequences that can either benefit or harm a client.”

PLANNING FOR MULTINATIONAL FAMILIES: *Staying Ahead of the Curve*

A check-the-box election is often used in pre-arrival planning before a nonresident moves to the U.S. If the election is made before the owner becomes a U.S. tax resident, the basis of the company’s assets may be stepped up to fair market value. When the assets are later sold, the stepped-up basis will offset the gain on the transaction and reduce the income taxes owed.

A check-the-box election is also often used at the time a nonresident passes away if there are U.S. heirs. Because the election can be made retroactively up to 75 days, it can be made effective prior to the date of death. The election can trigger a taxable transaction to the nonresident decedent. As a result, the heirs may get the benefit of a basis step-up in the corporation’s assets. Often the election is made to protect U.S. heirs from punitive U.S. tax rules intended to prevent income tax from being deferred in foreign corporations.² A basis step-up depends upon the corporate tax rules, the U.S. basis rules for nonresidents, and the check-the-box relevance rules, discussed in separate sections below.

“Often the election is made to protect U.S. heirs from punitive U.S. tax rules . . .”

CHECK THE BOX

CHECK-THE-BOX BASICS: *Selecting the Correct Classification*

An entity can be classified as a trust, a corporation, a partnership, or a disregarded entity for U.S. tax purposes.³ If no check-the-box election is made, the U.S. tax law has its own default classification system that looks largely to the characteristics of a foreign entity under local law. For example, any foreign business entity is classified as a corporation for U.S. tax purposes if all its members have limited liability.

If a foreign entity is neither a trust for U.S. tax purposes nor on a list of *per se* corporations, it can file a check-the-box election with the IRS to be treated as a corporation or a pass-through entity. If pass-through treatment is elected, the entity is classified as a disregarded entity if it has only one owner. If it has two or more owners, it is classified as a partnership. The election affects the classification of the entity only for U.S. tax purposes. It does not affect the status of the entity for foreign tax purposes or other legal purposes. Thus, the election is a U.S. tax fiction.

An election for a newly formed corporation must be made within 75 days in order to choose the corporation's initial classification. An election can be made retroactive up to 75 days. As discussed below in a separate section, there are new procedures that allow for relief for late elections.

It is important to note that subsequent change to an entity's classification from a corporation to a pass-through entity triggers a deemed liquidation of the corporation.⁴

CORPORATE TAX RULES: *Relationships Make a Difference*

The tax consequences of a corporate liquidation depend on whether or not the liquidation is a parent or a subsidiary liquidation. The deemed liquidation of an 80%-or-more-owned subsidiary into its parent corporation is generally a tax-free transaction and no basis step-up occurs.

In contrast, a subsidiary liquidation results in two taxable transactions. First, a deemed sale by the liquidating company of all its assets at fair market value. Second, a deemed exchange by the shareholders of their stock in the company in exchange for the corporation's assets at fair market value.⁵

The recognition of gain on the second transaction causes the basis step-up if the Internal Revenue Code is read literally. Code section 334(a) reads:

If property is received in a distribution in complete liquidation, and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

“The election affects the classification of the entity only for U.S. tax purposes . . . not . . . for foreign tax purposes or other legal purposes.”

“. . . a subsidiary liquidation results in two taxable transactions.”

“No U.S. tax would be paid unless the company has U.S. assets.”

75 DAYS

However, there is no legal authority that expressly states whether or not this rule applies when a foreign corporation is liquidated and the owners are nonresidents.

BASIS RULES FOR NONRESIDENTS: *Tax or No Tax?*

A principle of U.S. tax law is that basis is created when tax is paid. In the case of nonresident shareholders and foreign corporations, this principle is often violated. No U.S. tax would be paid unless the company has U.S. assets.

Practitioners seeking a basis step-up are left to analogize to other types of foreign transactions where basis is created even though no U.S. tax is paid. For example, see *Simmonds Precision Products*, 75 TC 103, (1980) which concerns the contribution of appreciated assets by a nonresident to a foreign corporation. See also AM 2007-0006 which concerns the effects of a section 338(g) election by a U.S. acquirer to treat the acquisition of a foreign company as an asset acquisition.

RELEVANCE RULES: *Avoiding a Potential Risk*

Frequently, with check-the-box planning, U.S. tax advisors overlook the importance of the relevance rules. A check-the-box election for an entity that has not previously been relevant has the same effect as an initial election for a newly formed entity. The election affects the status of the entity, but no liquidation and tax basis step-up occurs. Thus, otherwise good tax planning can go awry.

Whether or not the election is a change in classification depends on whether the corporation's classification was relevant prior to the making of the election.

A foreign corporation's classification is relevant for federal tax purposes on the earlier of the date:

When its classification affects the liability of any person for U.S. federal tax or information purposes, or when the entity makes a check-the-box election.⁶

The Treasury Regulations give two examples of when the classification of a foreign entity affects the liability of any person for U.S. federal tax or information purposes. In the first example, U.S. source income was paid to a foreign entity and the amount of withholding tax and the required reporting depends upon whether or not the foreign entity is classified as a partnership or as a corporation. Thus, the classification might affect the type of documentation the withholding agent must receive from the entity or the type of tax or information return to file.

“ . . . otherwise good tax planning can go awry.”

“ . . . the classification might affect the type of documentation the withholding agent must receive . . . ”

In the second example, the classification of a foreign entity affects the type of disclosure form required to be filed by U.S. residents to report interest in foreign companies. If the entity is a corporation, the disclosure has to be made to Form 5471. If the entity is a partnership, reporting would instead be required on Form 8865.

RELEVANCE

A fairly simple and more certain way of creating relevance is to have the foreign corporation make an investment that is subject to withholding tax. Buying stock in a U.S. company that pays dividends or U.S. government or corporate bonds that pay interest should solve the problem. The account should be set up with a financial institution as a nonresident account by filing Form W-BEN so that tax is withheld on the dividends and interest. Other types of U.S. source interest may not trigger a tax liability so careful planning is required. In cases where relevance is in doubt, an actual liquidation under foreign law may be preferable.

“The new rule relaxes previous requirements for relief.”

SIDEBAR: *The Relevance of Relevance*

Relevance, in the world of accounting, is one of the two primary qualities that make accounting information useful for decision making. As detailed in the Financial Accounting Standards Board’s Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information,” reliability is the other quality. Together, relevance and reliability drive the usefulness of the financial information. “Useful” in these applications means that the information can be relied upon to make decisions. If information is relevant, therefore, it can be relied upon either to provide feedback on a past decision or to be predictive about a future decision. To be so effective, then, the relevant information must also be timely; that is, more current information is considered more relevant than older information. Reliability relates to the faithfulness of the information, so it should be both neutral and verifiable. Both qualities are also subject to constraints of cost and materiality, that the incremental cost to marginally improve either quality may not be justified nor may be significant enough to affect the decision.

“In cases where the new rules do not apply, the IRS may grant relief . . .”

RELIEF FOR LATE ELECTIONS: *More Time, More Flexibility*

On September 3, 2009 the IRS issued Revenue Procedure 2009-41, which allows an election to be made retroactive three years and 75 days for both initial classification elections and changes in classification elections. The requirements for relief are:

- (1) The entity failed to obtain its requested classification solely because Form 8832 was not filed timely;

(2) The entity (a) has not filed a federal tax or information return for the first year for which the election was intended because the due date has not passed for such return or (b) timely filed all required federal tax returns and information returns consistent with its requested classification for all the years the entity intended the requested classification to be effective;

(3) The entity has reasonable cause for its failure to timely make the entity classification election.

“The proposed legislation could greatly curtail the use of check-the-box elections for multinational families.”

The new rule relaxes previous requirements for relief. In cases where the new rules do not apply, the IRS may grant relief for late elections in the form of a private letter ruling under Code section 9100.

NEW LEGISLATIVE PROPOSALS

The Obama administration’s current proposal would allow a foreign eligible entity with a single owner to be treated as disregarded for U.S. tax purposes only if:

(i) its owner is created or organized in the same country in which the foreign eligible entity is organized, or

(ii) except in the case of tax avoidance, a first-tier foreign eligible entity is wholly owned by a U.S. person.

These changes are proposed in “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals” (Green Book) released by the U.S. Treasury Department on May 11, 2009. Proposed legislation could greatly curtail the use of check-the-box elections for multinational families.

As these proposals are currently under consideration, practitioners should be alert for future changes in the rules. Meanwhile, the effective and judicious application of the current rules depends upon making timely and nimble decisions based upon sound information.

1] Form 8832, “Entity Classification Election.”

2] Code §§951-959. All Code section references herein are to the U.S. Internal Revenue Code of 1986, as amended.

All Regulations section references are to the U.S. Treasury Regulations promulgated thereunder.

3] Regulation §§301.7701-1 to 301.7701-7 contain entity classification rules for federal tax purposes.

4] Regulation §§301.7701-3(g)(1) & (2).

5] Code §§331-334.

6] Regulation §301.7701-3(d).

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