

A planning tool

Kent D Lawson, Inna Merzheritsky, and Ferdinand M Santos consider US income and estate planning for multinational families, structuring with foreign entities, and defining relevance before “checking the box”

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A check-the-box election is a simple two page form (see Form 8832 Entity Classification Election). However, it is one of the most powerful US tax planning tools for multinational families. It can change the US tax classification of a foreign corporation into a partnership or disregarded entity. The basic procedure for making the election is straight forward. However, practitioners should be cautious. The election can unleash corporate tax consequences that can either benefit or harm a client. Often the nuances of the relevance rules are overlooked and an election may not have its intended effect. The IRS has recently relaxed the procedures for making late elections. However, new legislative proposals may greatly curtail the use of the election.

Planning for multinational families

A check-the-box election is often used in pre-arrival planning before a nonresident moves to the US. If the election is made before the owner becomes a US 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 US 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 US heirs from punitive US tax rules intended to prevent income tax from being deferred in foreign corporations.¹ A basis step-up can depend upon the corporate tax rules, US basis rules for nonresidents, and the check-the-box relevance rules. These rules are discussed in separate sections below.

Check-the-box basics

An entity can be classified as a trust, a corporation, a partnership, or a disregarded entity for US tax purposes.² If no check-the-box election is made, the US 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 US tax purposes if all its members have limited liability.

If a foreign entity is neither a trust for US 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 US tax purposes. It does not affect the status of the entity for foreign tax purposes or other legal purposes. Thus, the election is a US 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.

Subsequent change to an entity's classification from a corporation to a

pass-through entity triggers a deemed liquidation of the corporation (Regulation section 301.7701-3(g) (1) and (2)).

Corporate tax rules

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 percent 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. The first transaction is a deemed sale by the liquidating company of all its assets at fair market value. The second is a deemed exchange by the shareholders of their stock in the company in exchange for the corporation's assets at fair market value (Code sections 331 through 334).

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.’

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

A principle of US tax law is that basis is created when tax is paid. In the case of nonresident shareholders and a foreign corporation, this principle is often violated. No US tax would be paid unless the company had US assets.

Practitioners seeking a basis step-up are left to analogize to other types of foreign transactions where basis is created even

though no US 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 US acquirer to treat the acquisition of a foreign company as an asset acquisition.

Relevance rules

Frequently, with check-the-box planning, US 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. As a result, 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 dates:

- When its classification affects the liability of any person for US federal tax or information purposes or,
- When the entity makes a check-the-box election (Regulation section 301.7701-3(d)).

The Treasury Regulations give two examples of when the classification of a foreign entity affects the liability of any person for US federal tax or information purposes. In the first example, US 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.

In the second example, the classification of a foreign entity affects the type of disclosure form required to be filed by US 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.

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 US company that pays dividends, or US 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 US 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.

New procedure for allowing relief for late elections

On 3 September 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 in a timely manner
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) has 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 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 US tax purposes only if:

- its owner is created or organized in the same country in which the foreign eligible entity is organized, or
- except in the case of tax avoidance, a first-tier foreign eligible entity is wholly owned by a US person.

These changes are proposed in "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (Green Book), released by the US Treasury Department on 11 May 2009. The proposed legislation could greatly curtail the use of check-the-box elections for multinational families. Practitioners should be alert for future changes in the rules. ■

¹ See Code sections 951 to 959, relating to Controlled Foreign Corporations and 1291 to 1298, relating to Passive Foreign Investment Companies. All Code section references herein are to the US Internal Revenue Code of 1986, as amended. All Regulations sections references are to the US Treasury Regulations promulgated there under.

² Regulations sections 301.7701-1 through 301.7701-7 contain entity classification rules for federal tax purposes.