Shore to Shore

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Check the Box Rules – Part II

By Mark Merric

In a follow-up to his last article on the check the box regulations, Mark Merric discusses some of the pitfalls of the regulations as applied to foreign entities

In the case of a partnership or a limited liability company (LLC), the check the box regulations allow the client to choose how such entity will be taxed for US tax purposes among the following alternatives:

1. A partnership or LLC that is owned by two or more persons may elect to be taxed either as a corporation or a partnership;

2. A LLC that is wholly owned by one person may elect to be taxed either as a corporation or a disregarded entity (i.e. as if the entity does not exist). It is assumed that under state law a partnership requires two or more persons, and therefore, a partnership may not elect to be taxed as a disregarded entity.

On the other hand, trusts and corporations may not make any election under the check the box regulations.

In the event that an election is not made for an entity created on or after the date of enactment of the check the box regulations, January 1, 1997, the following default rules apply depending on whether the entity is a domestic[1] or foreign entity.

Domestic Entity Default Rules:

1. If a domestic partnership or LLC has two or more members, the partnership or LLC will be classified as a partnership for US tax purposes;

2. If a domestic LLC is wholly owned by one person (ie, a one member LLC), the LLC will be taxed as a disregarded entity.

Foreign Entity Default Rules:

The foreign entity default rules have an additional 'limited liability' step to determine how the entity will be classified under the default rules. A member of a foreign entity has limited liability if the member has no personal liability for the debts or claims against the entity by reason of being a member. A member has personal liability if the creditors may seek personal satisfaction of all or any portion of the debts or claims of the entity by virtue of being a member.[2] For purposes of the foreign default rules, a member cannot alter personal liability by making an agreement under which another person assumes a member's liability by virtue of being a member.[3]

In the case of a partnership, generally, at least one partner, the general partner, will not have limited liability, because the general partner will be liable for the debts and obligations of the partnership by virtue of being a general partner. Therefore, this `limited liability' step will not apply to a foreign partnership. On the other hand, the 'limited liability step' usually will apply to a foreign LLC. Based on this analysis, the following list details the foreign entity default rules:

1. If all of the members of a foreign LLC have limited liability, it is classified as a corporation for US tax purposes.' It does not matter whether the foreign LLC has one or two members, the foreign LLC will still be classified as a corporation.

2. If any member of a foreign LLC does not have limited liability, it is classified as a partnership.

A foreign partnership will be classified as a partnership for US tax purposes.[5]

Please note that in regard to a foreign LLC, this is the exact opposite rule that would be applied if the LLC was a domestic LLC. If the LLC was a domestic entity with two members, the LLC would be classified as a partnership. If the LLC was a domestic entity with one member (i.e. wholly owned by one person), the LLC would be classified as a disregarded entity.

Potential Pitfalls

This paradox, which results in the exact opposite tax classification for a foreign LLC under the default rules, creates the following foreign entity pitfalls:

In addition to the many opportunities created under the check the box regulations that will be discussed in the follow-up to this article, to the unwary tax advisor, the `check•the box' regulations may create potential problems in regard to foreign LLCs for the following reasons:

1. the default foreign entity when a taxpayer does not check the box for a foreign LLC with two or more members is a corporation;

2. the default foreign entity when a taxpayer does not check the box for a foreign LLC with only one member (ie, a wholly owned foreign LLC) is a corporation; and

3. the definition of what is 'limited liability' in the case of certain foreign entities is uncertain, and therefore, the application of the default rules may result in the foreign entity being classified different from the client's intentions.

The Two Member LLC Pitfall:

The magnitude of the first potential pitfall is illustrated by the following example. Let us say your client invests $2M for a 50 per cent ownership interest in a newly formed foreign LLC. The other 50 per cent is owned by another US investor, your client's friend. The members of the foreign LLC do not make an election under the check the box regulations.

The foreign LLC invests in securities throughout the world, some of which are US securities. The foreign LLC recognizes net capital gains of approximately $1M, of which your client's share is $500,000. Also, the foreign LLC received $100,000 in dividend income from US sources and $200,000 from foreign sources.

Unfortunately, toward the end of the year, when the fair market value of the foreign LLC was $6M, your client passes away. Your client's estate sells its interest in the foreign LLC under the terms of a buy-sell agreement to the remaining member for its respective fair market value, $3M. Your client and the estate are in the top marginal tax bracket. What are the different tax consequences if the foreign LLC is taxed as a partnership as opposed to a corporation?

If the foreign LLCI made an election under the check the box regulations to be classified as a partnership for tax purposes, which it did not, the tax consequences are relatively simple.

Through the foreign LLC, your client would be allocated capital gain of $500,000 and ordinary income of $150,000. The income tax attributable to the $650,000 of income in the foreign LLC would be $159,400.[6] At the death of your client, his estate would receive a step up in basis in the foreign LLC of $350,000[7] under Section 1014 of the Internal Revenue Code (`IRC'). Due to the step up of basis, the estate would not incur any income tax from the sale of the foreign LLC interest to the remaining LLC member. Therefore, if the election to be taxed as a partnership under the check the box regulations had been made, the total tax consequences to both your client and his estate would have been income tax in the amount of $159,400.

Unfortunately, your client did not make an election for the foreign LLC to be taxed as a partnership under the check the box regulations, and therefore, the foreign LLC is classified as a 'foreign' corporation under the foreign default rules. Further, the foreign corporation will also be classified as a controlled foreign corporation (`CFC') for tax US tax purposes.[8] A CFC has the following negative tax consequences:

1. All capital gain is converted to ordinary income;

2. There is no step up of basis on the death of a shareholder under IRC §1014;

3. A true double tax will be incurred on any US dividend income;

4. And any capital loss incurred by the CFC will be suspended in time until the CFC is liquidated.

If the foreign LLC is classified as a foreign corporation for US tax purposes, the CFC will pay income tax of $22,250 on its US source dividend income. Your client will pay income tax individually of $257,400,[9] and your client's estate will pay income tax on the sale of the LLC interest in the amount of $70,000.[10] The result of all of the aforementioned negative tax implications is that your client and the estate will pay $327,400[11] in income tax, as opposed to $159,400 which would have been the tax if the foreign LLC was classified as a partnership. In other words, the cost of failing to check the box in this one year example was approximately $168,000.

The Single Member LLC Pitfall:

A second pitfall occurs in the case of a foreign LLC if the client does not check the box when the client wishes the entity to be classified as a disregarded entity for tax purposes. This is because the default entity for a foreign single member entity is a corporation.

This potential pitfall is particularly acute in the case of an asset protection trust where a wholly owned foreign LLC has been added as an additional layer of insulation from the claims of a creditor.[12]

As noted above, if the trustees of the asset protection trust do not check the box and make the election for the foreign LLC to be classified as a disregarded entity, the foreign LLC will be classified as a corporation. Also, such a foreign corporation will also be classified as a CFC, and therefore, it will have the same negative tax consequences as noted above. The negative tax aspects of a CFC are particularly troublesome in the case of an asset protection trust structure, because the foreign LLC is only created for the limited period of the legal crisis. At the end of the legal crisis, the foreign LLC will be liquidated and the assets owned by the foreign LLC will be titled in the name of the asset protection trust.

At the time of liquidation, any appreciation in the fair market value of the CFC from the time it was created will be recognized as ordinary income. On the other hand, if the foreign LLC had checked the box to be classified as a disregarded entity, only for tax purposes the entire entity would be disregarded, no corporate information return or income tax returns would be required to be filed, and all of the negative tax consequences of a CFC would be avoided.

The 'Limited Liability' Pitfall

A third pitfall occurs when the client fails to check the box and there is uncertainty how the foreign entity will be classified under the foreign default rules, because the definition of the term 'limited liability' is ambiguous. A client may create an entity known as a company limited by guarantee or a 'hybrid company-[la] and want such entity to be classified as a corporation for tax purposes. For example, if the company limited by guarantee or the hybrid company will be conducting an operating business that buys goods abroad and sells them abroad, a true tax deferral may be obtained if the corporation is classified as a CFC."

In the past couple of years, in the jurisdictions of the Isle of Man, Ireland, Gibraltar, and the Turks & Caicos, companies limited by guarantee and the hybrid company have gained renewed interest. A company limited by guarantee is a company whose members pursuant to the organizational document of the company,[13] agree to contribute a 'guarantee amount' in the event the company is liquidated and the assets of the company are insufficient to pay its debts and obligations.

Typically, a hybrid company is a company that has two classes of shareholders: (1) voting shareholders who own shares of stock, and (2) guarantee members who own a membership interest and agree to pay a 'guarantee amount.' Usually, under either the company limited by guarantee or the hybrid company, the guarantee amount that each member would be obligated to pay in the event the company is liquidated and the assets of the company are insufficient to pay the company's debts is a nominal amount, approximately $15.

Under the organization documents of either a company limited by guarantee or the hybrid company, the guarantee members to the extent of the 'guarantee amount' are partially liable for a debt of the company by virtue of being a member. However, $15 is an insignificant amount. If the literal language of the check the box regulations are applied, the company limited by guarantee or the hybrid company will be taxed as a partnership for US tax purposes. Query: Would the same result occur if a LLC had a member who did not contribute the full amount of his required capital contribution, or if an LLC's operating agreement contained an obligation to restore a negative capital account?[16]

On the other hand, if the literal language of the regulation is not followed, what is the de minimus amount? Is it $10, $100, or $1,000? The uncertainty of what exactly is the definition of 'limited liability' under the check the box regulations creates this additional pitfall for foreign entities. A pitfall that may be easily avoided by checking the box, rather than relying on the default rules.

Conclusions to be made

While the check the box regulations provide opportunities, these regulations also create some pitfalls, particularly in regard to foreign entities.

In the absence of checking the box, the default entity for a foreign LLC is that it will be classified as a corporation. This is probably the exact opposite of what a US taxpayer creating a foreign LLC would expect. Also, in regard to asset protection trust structures that wholly own a foreign LLC, the same foreign LLC pitfall presents itself (ie, the foreign LLC will be classified as a CFC), unless the trustees of the asset protection trust check the box to classify the foreign LLC as a disregarded entity.

Finally, many jurisdictions have entities that do not exist in the US such as companies limited by guarantee and hybrid companies. Uncertainty of exactly what the term 'limited liability' means creates further problems where the taxpayer may have thought a company limited by guarantee or the hybrid company would be classified as a corporation when in fact it may be classified as a partnership. It should be noted that all of the aforementioned foreign entity pitfalls may easily be avoided by checking the box. However, failure to check the box and let the foreign default rules apply may result in any of the aforementioned pitfalls.

Reference

1 A .'domestic' partnership or LL.0 is a partnership or[t] LLC created or organized in the United States or under the law of the United States or of any State. IRC §7701 (a) (4).

2 Treas. Reg. §30.1.7701-3(b) (2) (ii).

3 Treas. Rig: §301.7701-3(b) (2) (ii).

4 Treas. Reg. §301.7701,3(h)(2) (i)(B).

5 Treas. Reg,§301.7701-3 (b) (2) (i) (A).

6 The capital gain of $500,000 would be taxed at a rate of 20 per cent and the dividend income Of $150,000 would be taxed at the rate of 39.6 per cent for a total income tax of $159,400.

7 Your client invested $2,000,000. lie was then allocated capital gain and ordinary income in the amount of $650,000, raising Isis basis in the foreign LLC to $2,650,000. The fair market value of the foreign LLC is $6,000,000, and your client's share is $3,000,000. Therefore, the unrealised appreciation and step up of basis under IRC §1014 is $350,000.

8 If more than 50 per cent of the voting power or the value of a foreign corporation is owned by US shareholders who own at least 10 per cent of the foreign corporation, the corporation is classified as a CFC. IRC §957(a), §951 (a) , and §951(b).

9 $650,000 of income passed through from the CFC multiplied by the ordinary income tax rate of 30.6 per cent.

10 $350,000 unrealised appreciation multiplied by the capital gain rate of 20 per cent.

11 ($650,000 of income x 39.6% = $257,400. Plus, capital gain tax of $70,000 by the estate ($350,000 x 20%)).

12 A wholly owned foreign LLC may be added to an asset protection trust structure so that it will make it very difficult for a US court to obtain jurisdiction over the foreign LLC and its assets. if the foreign LLC's managers and members are offshore, a US judge should not have any personal jurisdiction over the foreign LLC. If the foreign LLC has no US assets, a US judge should not

have any subject matter (in rem) jurisdiction over the property owned by the foreign LLC.

[13] The term hybrid company must be distinguished from the term hybrid arrangement. A hybrid company is a company created by statute under the laws of Isle of Man, Ireland, Gibraltar, or the Turks & Caicos. A hybrid arrangement is a term used when a US taxpayer owns an entity that is taxed as a corporation abroad, but as a partnership or disregarded entity in the US The Internal Revenue Service has brought some of these hybrid arrangements under scrutiny its Notice 9&11 The concept of hybrid arrangements will be discussed in detail in the follow-up to this article.

[14] It should be noted that in the case of an operating company many of the disadvantages of a CFC that were previously discussed do not apply. The generation of capital gains is not is material factor. Therefore, the conversion of capital gains into ordinary income is not an issue. If the CFC is owned by a domestic 'entity, the step of basis is not an issue, and since the CFC is not investing its US securities, there is no double tax 'skier.

[15] The organizational document is typically referred to as a memorandum of association.

[16] If The determination of whether limited liability exists is to be made solely from the statute or law pursuant to which the entity is organized, except when the underlying statute or law allows the entity to specify in its organizational document whether the members will have limited liability. Treas. Reg. §301.7701-3(b) (ii). Query: Is a negative capital restoration provision in an operating agreement considered part of the organizational document under the statute that created it?