

Shore to Shore

June 1998

Check the Box Rules – Part I

Clearing a Path Through the Paperwork, Mark Merric Looks at the “Check the Box” Regulations and Foreign Entity Pitfalls.

On January 1, 1997, new tax regulations were issued by the US Treasury Department for determining how an entity, including a foreign entity, is classified for US tax purposes. In 'certain situations' these regulations allow the owner(s) of a newly created entity to 'check the box' and thereby make an election whether the entity will be classified for US tax purposes as a trust, corporation, partnership, or non-entity.

The US tax classification of an entity determines how a US owner will be taxed on the income or loss of the entity. For domestic US entities, the new rules are relatively straightforward. However, for foreign entities, there are several key pitfalls to avoid. Generally, a US taxpayer's purpose when creating a limited liability company is to be taxed under partnership taxation. Unfortunately, due to the foreign entity's failure to 'check the box', the US owner may be unpleasantly surprised. This article discusses the new regulations and several of the pitfalls in foreign entity planning. The

first part of the article discusses the mechanics of how the new regulations work; the second looks at pitfalls and opportunities as applied to foreign entities.

Avoiding the check-mate

To the unwary tax advisor, the 'check the box' regulations may create potential problems for the following reasons:

- the default foreign entity when a taxpayer does not 'check the box' is a corporation;
- the definition of what is 'limited liability' under the foreign entity default rule is unclear;
- single member entities may only be classified as a corporation or a sole proprietorship (i.e. non-entity).

Based on the flow chart detailed at the end of this article, there is up to a five step process for determining how an entity is classified under the 'check the box' regulations. For trusts only, one step may be required to determine its tax classification.

However, for a new foreign entity that did not 'check the box' all five steps are required.

It should be noted that even though the 'check the box' regulations imply that the taxpayer may choose how an entity is taxed, this choice only applies to certain entities. An entity that is required to be classified as a trust or required to be classified as a corporation may not elect to check the box under the new regulations. Therefore, the ability to choose exactly how an entity is taxed usually only applies to partnerships and limited liability companies.

It should be noted that the default rule for a US entity is to be classified as a partnership. However, for a foreign entity, it is the exact opposite. The default is a foreign corporation

The five-step process

In regard to the following five step process, please refer to the flowchart. Example:

Assume two US taxpayers create an Isle of Man limited liability company ('IOM LLC'), and the IOM LLC does not 'check the box.' The US members created the IOM LLC to hold a new operating business. It is projected that the operating business will have significant losses for the first couple of years. What will be the tax classification of the IOM LLC?

STEP 1: As with the old Morrisey Regulations, the first step in determining the tax classification of an entity is to determine whether it is an 'ordinary trust' or a business entity. An ordinary trust under Treasury Regulation §301.7701-4(a) is classified as a

trust for tax purposes, and the entity may not 'check the box' and make, an election to have it taxed as some other form of entity. An 'ordinary trust' is a trust arrangement created either by a will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts, and there are not any associates in a joint enterprise for the conduct of business for profit.¹ A trust that is really an operating business, the so called Massachusetts Business Trust or many of the foreign mutual funds organized under trust agreements in Jersey, Channel Islands, are classified as business entities. As noted above, an ordinary trust may not 'check the box.' It is taxed as a trust. Under our facts, we are not dealing with a trust, so we proceed to the right along the business entity side (i.e. right hand side) of the flow chart.

STEP 2: Once it has been determined that the IOM LLC is a business entity, the next step is to determine whether it is required to be classified as a corporation. In a few situations, an entity will be required to be classified as a corporation. The three most common scenarios: (1) it is incorporated under local law; (2) it is listed as a foreign corporation²; or (3) it is a publicly traded partnership.'

For US purposes, it is easy to deduce whether an entity was incorporated under state law. For foreign purposes, many jurisdictions do not use the word 'incorporated' to designate that an entity is a corporation. For example, Barbados uses the term 'Limited Company'. However, Barbados's statute reads like a US state incorporation statute. Under the first of the aforementioned three tests, it is uncertain that a Barbados Limited Company would be classified a corporation for US tax purposes.

To avoid such ambiguities, the Internal

Revenue Service developed the second test which is a list of these so-called foreign corporations that are automatically classified as a corporation for US tax purposes.⁴ The Barbados Limited Company is mentioned in this list, and therefore, it is automatically classified as a corporation for US tax purposes. On the other hand, in regard to the 10M LLC, it is not an entity incorporated under local law, it is not mentioned on the automatic foreign corporation list, and it is not a publicly traded partnership. Therefore, the TOM LLC is classified as a other business entity on the flow-chart and the IOM LLC has the option to 'check the box.'

STEP 3: If the entity is not required to be classified as a trust or a corporation, the entity may make an election to be taxed as a certain form of entity; otherwise, the default rules apply. If the entity has only one member, the entity may elect to be taxed either as a sole proprietorship, or an association taxable as a corporation. See right side of the flow chart. If the entity has two members or more, the entity may elect to be taxed either as a partnership or an association taxable as a corporation. Please note, an entity with only one member may never elect to be taxed as a partnership. Under our facts, the IOM LLC did not make an election to 'check the box.' Therefore, the default rules apply.

The default rules are different depending on whether the entity was in existence prior to January 1, 1997, the effective date of the 'check the box' regulations, or the entity was created after January 1, 1997. If the entity was in existence prior to January 1, 1997, the default entity is whatever the entity claimed on its US tax return immediately prior to January 1, 1997. However, if (i) a foreign entity that has never filed a previous tax return and (ii) during previous years the foreign entity's tax classification would

affect the liability of any person for US federal tax or information purposes, then the foreign entity's tax classification is determined under the old §301.7701 regulations. Under our facts, the IOM LLC was formed in 1997; therefore, the new entity default rules apply.

STEP 4: For an entity formed after January 1, 1997, the default entity depends on whether the entity is a domestic or a foreign entity. The default entity for a US entity is either a partnership or sole proprietorship, depending on the number of members. If a US entity has only one member, the default entity is a sole proprietorship. If a US entity has two or more members, the default entity is a partnership. The default entity for a foreign entity depends on whether the foreign entity has limited liability. Therefore, for a foreign entity, an additional step must be analyzed before the default rules apply.

STEP 5: From the local law, the tax advisor must determine whether any member of the entity is liable, by virtue of being a member. 'A member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such.'⁵

If any member, by virtue of being an owner, is liable for all or any portion of the foreign entity's debts, the foreign entity does not have limited liability. If a foreign entity does not have limited liability the default entity classification is either sole proprietorship or a partnership depending on the number of members. If a foreign entity does have limited liability the default entity is an association taxable as a corporation. It should be noted that the default rule for a US entity is to be classified as a

partnership. However, for a foreign entity, it is the exact opposite. The default is a foreign corporation. Under our facts, the IOM LLC has limited liability; therefore, under the foreign new entity default rules, the TOM LLC is classified as a corporation. Unfortunately, this is the exact opposite of what the persons who created the IOM LLC intended.

While the new 'check the box' regulations allow owner (s) in 'certain situations' to elect whether a newly created entity will be classified as a corporation or a partnership for US tax purposes, these regulations also create new pitfalls. Part I of this Article analyzed the mechanics of the 'check the box' regulations using the IOM LLC example. Part II of this Article will detail how these regulations apply to several foreign entities, some of the pitfalls of the 'check the box'

regulations, and some of the opportunities of the 'check the box' regulations.

Endnotes:

- 1 Treasury Regulation §301.7701-4(a)
- 2 Treasury Regulation §301.7701-2(b) (8)
- 3 Under IRC §7764(a), a publicly traded partnership is classified as a corporation for US tax purposes. A publicly traded partnership is any partnership if interests in such partnership are traded on an established securities market, or such interests are readily traded on a secondary market. IRC §7704(b)
- 4 Treasury Regulation §301.7701-2(b)(8)
- 5 Treasury Regulation §301.7701-(b) (2)(C)(ii).

Check the Box Flow Chart

