Tax Report #845

New York State Bar Association

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NYSBA

August 31, 1995

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: **Notice 95-14**

Dear Secretary Samuels and Commissioner Richardson:

I am pleased to enclose our report on Notice 95-14, the recent proposal to replace the existing four-factor entity classification system with an elective classification system. The principal authors of the report are Andrew N. Berg and William B. Brannan, Co-Chairs of our Committee on Partnerships, and Philip R. West, Co-Chair of our Committee on Foreign Activities of U.S. Taxpayers.

The report strongly supports the adoption of an elective classification system along the lines set forth in the Notice. Because of the importance of achieving the desired tax classification (usually as a partnership), virtually all well-advised taxpayers satisfy the four-factor test that is currently imposed by the classification regulations. However, tremendous resources are devoted, by both government and the private sector, to interpreting and complying with the technical and rather arcane criteria of the current

regulations. The current classification system is therefore effectively elective, but achieving partnership status under the current system involves considerable inefficiencies and complexities. Your proposal to replace the current classification regime with a purely elective system would, in our view, considerably simplify the tax law without materially changing the substantive results in most cases. We commend the Treasury and the Internal Revenue Service for taking the initiative to propose this dramatic and innovative simplification, and we enthusiastically support it.

The report does offer a number of specific comments on the scope and application of the elective classification system. The report urges that the system be available to single-member entities, which could elect to be treated either as a sole proprietorship or branch, or as an association. The report supports the unanimous consent required for a domestic entity to elect association status, but suggests a number of different ways in which the consent requirement can be satisfied, in order to minimize the procedural burdens of obtaining the requisite consents without undermining the importance of having the principals' clear consent to corporate treatment. The report also offers comments on the collateral effects of a change in classification, on the consequences of section 708 terminations, and on the classification of trusts and of joint business arrangements that do not involve the creation of a separate legal entity.

In the foreign context, the report strongly urges that the elective classification system be extended to foreign entities. Again, the report concludes that in the foreign area entity classification is largely elective under current law. Furthermore, while the report discusses a number of potential areas of abuse, it concludes that the potential for abuse would not be exacerbated to any significant extent by applying an elective classification system to foreign entities. In our judgment, the appropriate means to deal with potential abuses in the foreign area is to adopt specific reforms targeted to the particular abuses involved, not to deny elective entity classification to foreign entities. We therefore urge that the elective system apply to foreign entities as well as domestic entities.

The report does, however, recommend that the default rule for foreign entities be different from

that applied to domestic entities. In the domestic context it is extremely likely that an entity that is neither organized as a corporation nor elects association treatment is intended by its principals to be a non-taxable pass-through entity. The application of a partnership default rule to domestic entities therefore clearly follows the intended result in the vast majority of cases. In the foreign area, however, the considerations are different. When foreign entities are involved it is not necessarily clear whether corporate or partnership classification is more desirable as a tax matter. Furthermore, the imposition of U.S. election requirements on the owners of foreign entities raises a number of procedural and practical problems; foreigners may not be sensitive to the need to file a U.S. election to achieve their intended entity classification, or may be resistant to making U.S. filings. We therefore recommend that in the foreign area the default classification of entities that fail to elect partnership or corporate classification should be determined under the four-factor formula of the current regulations. The report also notes certain problems and recommendations in applying unanimous consent requirements to owners of foreign entities, as well as other technical points.

Finally, we discuss the question of the Treasury's authority to implement the proposed elective entity classification system administratively. The classification of partnerships and associations has long been determined by the income tax regulations and case law. One could argue, based on this history, that there is an overarching common law distinction between partnerships and associations that cannot now be abandoned in favor of elective classification. The report expresses the belief, however, that the historical distinctions between associations and partnerships have been supervened by developments in the variety and characteristics of business entities and that judicial authorities lend support to the Treasury's authority to issue regulations modifying the standards for classifying entities to reflect these changes. Given the evolution of the business law, it is appropriate to rethink the tax law definitions of entities, and to acknowledge the essentially elective nature of entity classification that exists as a practical matter under current law. Viewing the tax system as a whole, it is clear that elective classification would greatly simplify entity classification without substantially departing from the current tax treatment of unincorporated businesses. For these reasons, while we recommend that

consideration be given to seeking legislation expressly authorizing an elective classification system in order to avoid disputes on this issue, we do believe that, even without such legislation, the Treasury does have the authority to issue regulations implementing an elective classification system along the lines proposed in Notice 95-14, for both domestic and foreign entities.

Again, we commend you for this most welcome proposal for simplifying the tax law, and we urge that the proposed elective classification system be implemented promptly. Please contact me if we can be of any further assistance in the development of this proposal.

Very truly yours,

Carolyn Joy Lee

Carolyn Joy Lee
Chair

Tax Report #845

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on the "Check the Box" Entity Classification System Proposed in Notice 95-14

August 30, 1995

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NEW YORK STATE BAR ASSOCIATION
TAX SECTION */

Report on the "Check the Box" Entity Classification System Proposed in Notice 95-14

I. Introduction

This report comments on the elective entity classification system proposed in Notice 95-14, which is usually referred to as the "check the box" proposal. 1/ Under that system, any domestic unincorporated entity may elect to be treated as either a partnership or an association, without regard to the characterization of the entity under the traditional four-factor classification test set forth in Treasury Regulation § 301.7701-2. Any domestic

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*/ This report was prepared by an ad hoc committee (the "Committee") consisting of certain members from each of the Committee on Partnerships, the Committee on Foreign Activities of U.S. Taxpayers and the Committee on U.S. Activities of Foreign Taxpayers. The principal authors of the report were Andrew N. Berg, William B. Brannan and Philip R. West. Significant contributions were made by Reuven S. Avi-Yonah, Jill E. Darrow, David P. Mason, Robert D. Schachat, Daniel Shefter and Robert J. Staffaroni. Helpful comments were received from Kimberly S. Blanchard, Thomas A. Bryan, Patrick S. Cheng, Arthur B. Cilley, Thomas J. DeLeo, Arthur A. Feder, Gary M. Friedman, Alan W. Granwell, Ronald D. Greenberg, Michael Hirschfeld, Robert C. Holmes, Stephen B. Land, Carolyn Joy Lee, Huey-Fun Lee, Richard O. Loengard, Jr., Emily S. McMahon, Pinchas Mendelson, David S. Miller, Charles M. Morgan, III, Guy P. Novo, Joel A. Poretsky, Richard L. Reinhold, Michael L. Schler, Alan J. Tarr and Willard B. Taylor.

1/ 1995-14 I.R.B. 7.

unincorporated entity that does not make an election would be classified as a partnership; any domestic unincorporated entity that would otherwise be treated as a partnership under these rules would be subject to possible recharacterization as a corporation under Section 7701(i) or 7704. 2/ Notice 95-14 also indicates that consideration is being given to extending the "check the box" system to all foreign entities, with the "default" classification for any foreign entity that failed to make a valid election being association status.

Notice 95-14 represents a bold and innovative proposal that would avoid the substantial expenditure of resources on entity classification issues that is required of both taxpayers and the government under the traditional four-factor test. As discussed below, that test requires a detailed inquiry into the substantive characteristics of the entity and the application of a somewhat uncertain body of classification law, which is burdensome and creates traps for the unwary. Yet, in the final analysis, the traditional four-factor test often emphasizes entity characteristics that are purely formal, have little practical significance and have no obvious connection to whether an entity should

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2/ Unless otherwise indicated, all "Section" references herein are to the Internal Revenue Code of 1986, as amended to date (the "Code").

be subject to entity-level tax. As a result, tremendous resources are being devoted to what is ultimately an unproductive use. Moreover, well-advised taxpayers can achieve the desired classification (without undermining the business objectives of the parties), with the consequence that the present system is effectively elective in almost all circumstances. Thus, the "check the box" system should not result in any significant increase in the utilization of pass-through entities, although unincorporated entities undoubtedly would tend to have more corporate characteristics (such as free transferability of interests and limited liability) than they do today.

In view of the foregoing, the Committee strongly supports the adoption of the "check the box" entity classification system in the domestic context. In addition, the Committee has a number of specific recommendations concerning the application of the "check the box" system in the domestic context, including that the "check the box" system apply to one-member entities (with branch or sole proprietorship status being available in lieu of partnership treatment), and that the unanimous member consent requirement for a classification election be deemed satisfied where the organizational documents for the entity provide that all members consent to an election.

The Committee also recommends that the "check the box" entity classification system be extended to the foreign context. As discussed below, the question is more difficult in the foreign context because of certain special considerations that apply in that context, including the absence of a clear expectation as to how foreign entities will be classified, the lesser degree of electivity in some circumstances, the greater potential for the "hybrid" entity issue to arise and the difficulty in choosing an appropriate default classification. Nevertheless, the Committee believes that the benefits of simplicity and certainty that the "check the box" system would offer in the foreign context are sufficiently compelling to warrant extending it to foreign entities, although the Committee does recommend that the default classification in the foreign context be the result under the traditional four-factor test (as opposed to the proposed corporate default).

II. Background

To help put the Committee's analysis of the "check the box" proposal in perspective, set forth below is a brief summary of the principal elements of current entity classification law and certain relevant trends in taxpayer behavior.

A. Summary of Existing Classification Law

1. Traditional Four-Factor Entity Classification Test

There is no comprehensive definition of the term "partnership" in the Code or the Treasury Regulations thereunder. Section 7701(a)(2) defines a partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not within the meaning of this title, a trust or estate or corporation . . .". Section 7701(a)(3), in turn, provides that the term corporation "includes associations, joint-stock companies, and insurance companies". Under this statutory framework, an "incorporated" entity is automatically treated as a corporation. For an unincorporated entity conducting a business or investment activity, the key issue is whether it is an "association", in which event it will be taxable as a corporation. If the unincorporated entity is not an association, it generally will be treated as a partnership. 3/

The term "association" is defined in Treasury Regulation § 301.7701-2, which adopts a corporate resem-

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3/ The only exception is the one-member unincorporated entity, which, as discussed in Section IV.A, infra, may not be classified as a partnership (although it still may be treated as a pass-through arrangement).

blance test based upon Morrissey et al. v. Commissioner. 4/ That test focuses upon six major characteristics normally found in an ordinary corporation: associates, an objective to carry on a business and divide the profits therefrom, continuity of life, centralization of management, limited liability and free transferability of interests. 5/ Because associates and an objective to carry on a business and divide the profits therefrom are generally common to all business organizations, those factors are disregarded in classifying an entity as a partnership or an association taxable as a corporation. 6/ Thus, classification as a partnership or an association depends on the mechanical test of whether the entity possesses the four remaining corporate characteristics, i.e., continuity of life, centralization of management, limited liability and free transferability of interests. 7/ An unincorporated entity will be classified

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4/ 296 U.S. 344 (1935). It is widely acknowledged that Treas. Reg. § 301.7701-2 reflects a historic bias the government once had to favor partnership classification for unincorporated entities.

5/ Treas. Reg. § 301.7701-2(a)(1).

6/ Treas. Reg. § 301.7701-2(a)(2).

7/ Id. The regulations also provide that "[i]n addition . . . other factors may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust." Treas. Reg. § 301.7701-2(a)(1). At least one court has identified some of these "additional" characteristics that could be relevant

as a partnership if it does not have more than two of those four corporate characteristics; if the entity possesses more than two of those corporate characteristics, it will be classified as an association. Whether an entity possesses any of those corporate characteristics is determined by analyzing the local law under which the entity is organized and its organizational documents. 8/

There is a relatively large body of law on the specific meaning of the four corporate characteristics, which consists primarily of Treasury Regulations and published and private rulings issued by the Service. Nevertheless, there still are a number of specific issues under the four-factor test as to which there is no clear legal authority.

Under Treas. Reg. § 301.7701-2, the four-factor classification test is applied only to "unincorporated" entities. Consequently, entities organized under domestic corporation statutes are automatically classified as

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in distinguishing a limited partnership from an association. See Larson v. Comm'r, 66 T.C. 159, acq. 1979-2 C.B. 1. Most judicial decisions have not attached any significance to any such additional characteristics, and the Service generally does not consider them in making classification determinations. See, e.g., Rev. Rul. 79-106, 1979-1 C.B. 448.

8/ Treas. Reg. § 301.7701-1(c).

corporations. 9/ However, in the foreign context, the Service's view apparently is that the label attached to a foreign statute is not necessarily determinative as to whether an entity organized under the statute is the equivalent of a domestic corporation. Accordingly, the Service takes the position that all foreign entities should be classified based upon a substantive analysis under the four-factor classification test. 10/

9/ See, e.g., Rev. Rul. 70-101, 1970-1 C.B. 278, and Rev. Rul. 82-212, 1982-2 C.B. 401. See also G.C.M. 39693 (Jan. 22, 1988). Adoption of the "check the box" system would place new emphasis on the distinction between incorporated and unincorporated entities. See Part II.3, infra.

10/ See Rev. Rul. 88-8, 1988-1 C.B. 403, and G.C.M. 39693, supra note 9. See also Rev. Rul. 73-254, 1973-1 C.B. 613. But see Rev. Proc. 95-3, 1995-1 I.R.B. 85 at § 4.01(45) (the Service will not ordinarily rule whether "what is generally known as a foreign corporation" is a partnership). The Service's position regarding the classification of foreign entities creates the anomaly that a foreign entity organized under a foreign statute that is substantively the same as a domestic corporate statute could be taxed as a partnership, even though an entity organized under the corresponding domestic statute would be a per se corporation. It should be noted that prior to 1988, the Service apparently would treat foreign entities that were corporations under the common law definition of corporation as being "incorporated" for Federal income tax purposes, without ever reaching the four-factor test. See G.C.M. 34376 (Nov. 13, 1970), revoked by G.C.M. 39693.

2. Publicly Traded Partnership Rules

In response to the development of so-called "master limited partnerships" in the early 1980's, Congress enacted Section 7704, which provides that a publicly traded partnership generally should be treated as a corporation for Federal income tax purposes. 11/ Section 7704 applies to all domestic and foreign entities that are otherwise treated as partnerships for Federal income tax purposes, including limited liability companies and other nontraditional partnerships. Under Section 7704(b), a partnership is a publicly traded partnership if interests in the partnership are traded on an "established securities market" or are readily tradable on a "secondary market" or the "substantial equivalent thereof". Section 7704(c) generally excepts from corporate treatment any publicly traded partnership at least 90% of whose income consists of certain "qualifying income" (including interest, dividends, rent from real property, gain from the sale of real property, certain types of natural resource income and gain from the sale of nondealer property that produces any of the foregoing types of income).

11/ Publicly traded partnerships that were in existence when Section 7704 was enacted are generally grandfathered until 1997.

In 1988, the Service issued Notice 88-75 to provide interim guidance as to the circumstances under which interests in a partnership would be treated as publicly traded within the meaning of Section 7704(b). 12/ Notice 88-75 provides that interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof for purposes of Section 7704(b)(2) if the interests are: (1) issued in certain private placements; (2) transferred pursuant to transfers not involving trading; (3) traded in amounts that meet the requirements of a 5% or 2% trading volume safe harbor; (4) transferred through a matching service that meets certain requirements; or (5) transferred pursuant to a qualifying redemption or repurchase agreement. Notice 88-75 does not address when partnership interests should be treated as traded on an established securities market for purposes of Section 7704(b)(1).

In May, the Treasury issued proposed regulations under Section 7704 regarding when interests in a partnership will be treated as publicly traded. 13/ The Tax Section recently submitted a separate report commenting on those

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12/ Notice 88-75, 1988-2 C.B. 386.

13/ Prop. Treas. Reg. § 1.7704-1, 60 Fed. Reg. 21475 (May 2, 1995).

regulations. 14/ To help put the "check the box" proposal in context, the Committee notes here that the proposed Section 7704 regulations apparently would substantially expand the meaning of the term "publicly traded partnership" and introduce a number of new uncertainties in the classification of partnerships. In particular, the proposed regulations would narrow the private placement safe harbor contained in Notice 88-75 and define the terms "secondary market", "substantial equivalent thereof" and "interest" very broadly. As a consequence, Section 7704 may become even more of a consideration in classifying unincorporated entities. The Committee urges that the "check the box" initiative be coordinated with the Treasury's review of the proposed Section 7704 regulations, so that the simplification achieved by an elective classification system is not offset by a burdensome and unnecessarily broad definition of "publicly traded partnership".

3. Major Classification Law Changes Have Been Considered but Rejected

From time to time, Congress, the Treasury and the Service have considered making major changes to the current entity classification law.

14/ Report on Proposed Regulations Defining Publicly-Traded Partnerships (Aug. 15, 1995), reprinted in Highlights and Documents (Aug. 18, 1995) at 2313-21.

In 1977, the Treasury proposed new regulations that would have revised the standards for determining whether each of the four corporate characteristics exists in a particular case and would have eliminated the rule that more than two corporate characteristics must exist for an unincorporated entity to be classified as an association. In the face of heavy criticism, those regulations were withdrawn two days after their publication. 15/

In a similar vein, in 1980, the Treasury proposed new regulations providing that an unincorporated organization would be classified as an association if no member of the organization was personally liable for the debts of the organization. 16/ That proposal, which would have made the corporate characteristic of limited liability a "superfactor", was also withdrawn after heavy criticism. However, the Service continued to study the idea of making limited liability a superfactor until 1988. 17/ In that

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15/ Prop. Treas. Reg. §§ 301.7701-1, -2 and -3, 42 Fed. Reg. 1038 (Jan. 5, 1977), withdrawn, 42 Fed. Reg. 1489 (Jan. 7, 1977).

16/ Prop. Treas. Reg. § 301.7701-2(a)(2), 45 Fed. Reg. 75709 (Nov. 14, 1980).

17/ See News Release 145 (Dec. 16, 1982). The Service also continued to require that all limited partnerships seeking a private letter ruling on partnership classification lack limited liability. See Rev. Proc. 72-13, 1972-1 C.B. 735. Although the "superfactor" regulations were withdrawn, they (together with the

year, the Service officially abandoned the idea and issued a published ruling holding that a Wyoming limited liability company should be classified as a partnership based on the lack of continuity of life and free transferability of interests. 18/

Very recently, the Treasury suggested that legislation be considered that would allow S corporations to elect to be treated as partnerships for Federal income tax purposes. 19/ While the details of the proposal are not clear, it apparently contemplates that S corporations could convert to partnership status without recognizing any General Utilities gain (but also that large C corporations converting to S corporation status would recognize General Utilities gain).

There also has been some legislative activity relating to entity classification law. In 1978, President

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above-described ruling policy) continued to influence tax practice through most of the 1980's. Notwithstanding the equal weight ascribed to each of the four corporate characteristics under Treas. Reg. § 301.7701-2, many practitioners advising unincorporated entities during the 1980's required those entities to lack the corporate characteristic of limited liability in order to render a favorable tax opinion on partnership classification.

18/ See Announcement 88-118, 1988-38 I.R.B. 26, and Rev. Rul. 88-76, 1988-2 C.B. 360.

19/ See Letter from Leslie B. Samuels to Hon. Orrin G. Hatch (July 25, 1995), reprinted in Highlights and Documents (July 27, 1995) at 1285.

Carter suggested a legislative proposal that generally would have treated any limited partnership with more than 15 limited partners as a corporation. 20/ Similarly, in 1984, the Treasury Department proposed that all limited partnerships with more than 35 limited partners should automatically be treated as associations taxable as corporations. 21/ In 1983, the Senate Finance Committee staff identified changing the treatment of publicly traded partnerships as a possible tax reform. 22/ That proposal ultimately led to the enactment of Section 7704 in 1986, which has been the only major legislative change in the classification law affecting business entities since Morrissey. 23/

20/ See Staff of the Joint Committee on Taxation, 95th Cong., 2d Sess., Summary of the President's 1978 Tax Reduction and Reform Proposals 6 (Comm. Print 1978).

21/ Tax Reform for Fairness, Simplicity and Economic Growth, Treasury Department Report to the President (Vol. 2), at 146-150 (1984).

22/ See S. Prt. No. 98-95, 98th Cong., 1st Sess. 80 (1983).

23/ There have been two other legislative changes, but those changes were much more limited in scope. The first was the repeal of Section 1361 (which, as discussed in note 37, infra, permitted certain unincorporated entities to elect to be taxed as corporations) in 1966. The second was the enactment of the "taxable mortgage pool" rules of Section 7701(i) in 1986.

The Committee is not aware of any major change in the current entity classification law (other than Notice 95-14 and the recent Treasury proposal for S corporations) that is under serious consideration by Congress, the Treasury or the Service at the present time. Although the Committee does not express any view as to the merits of the traditional four-factor entity classification system as compared to any possible alternatives as a policy matter, the Committee believes that the "check the box" proposal should be evaluated on the assumption that the alternative is the current classification system.

B. Proliferation of LLCs and Other Nontraditional Unincorporated Entities

Limited liability companies ("LLCs") were first introduced in the United States by Wyoming in 1977. 24/ To date, all but three states have enacted LLC legislation. 25/ LLCs are similar in many respects to limited partnerships, except that no member has personal liability for claims against the entity and management authority may be delegated to designated "managers" that do not have to be

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24/ Wyo. Stat. §§ 17-15-101 et seq.

25/ The three states without LLC statutes are Hawaii, Massachusetts and Vermont (although the Committee understands that LLC legislation is currently pending in each of those states).

members. 26/ In addition, at least twenty states and the District of Columbia now authorize the formation of limited liability partnerships ("LLPs"). 27/ An LLP is essentially the same as an ordinary general partnership, except that a partner in an LLP generally does not have personal liability for professional malpractice claims resulting from the actions of his partners or other persons not acting under his direction and control. 28/ The Committee expects that taxpayers will make increasing use of LLCs (and, in the professional service context, LLPs), with less use being made of traditional general and limited partnerships and especially S corporations. 29/

26/ Certain state LLC statutes expressly permit a member of an LLC to assume the liabilities of the LLC (although it would be extremely rare for a member to do so). See, e.g., Del. Code Ann., tit. 6, § 18-303(b); and N.Y. Limited Liability Company Law, § 609(b).

27/ Those states are Arizona, Connecticut, Colorado, Delaware, Illinois, Iowa, Kansas, Kentucky, Louisiana, Michigan, Minnesota, New York, North Carolina, Ohio, Pennsylvania, South Carolina, South Dakota, Texas, Utah and Virginia.

28/ See, e.g., Del. Code Ann., tit. 6, § 1515; and N.Y. Partnership Law, § 26. Under the New York statute, an LLP may provide protection against all types of claims against the entity, other than professional malpractice claims attributable to the partner's own actions or the actions of another person acting under the partner's direction and control.

29/ It should be noted that the principal nontax impediments to the use of LLCs (including a general lack of familiarity with them and the concern that LLCs may not

These and other modern business practices have blurred the distinctions between corporations and partnerships. As observed in Notice 95-14, the recent proliferation of LLC statutes has completely eliminated the traditional distinction between corporations and partnerships based upon personal liability by making it possible for the owners of a business to avoid personal liability without resorting to incorporation or the use of a special purpose corporate general partner. The LLC phenomenon actually represents the continuation of a trend narrowing the traditional corporation/partnership distinction regarding personal liability that began in the 1970's with the increased use of the limited partnership form of conducting business, under which limited partners are protected from liability by statute.

In addition, as partnerships and other unincorporated entities come to be used more for large, complex businesses, there seems to be a trend towards greater management authority with respect to unincorporated

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limit liability in some circumstances because of the "choice of law" problem) are rapidly evaporating as LLC statutes are becoming universal and taxpayers are making increasing use of LLCs. The S corporation reform legislation currently pending in Congress may help encourage the use of S corporations, but they will remain much less flexible and tax efficient than LLCs (except, possibly, if the recent Treasury proposal described in Part II.A.3, supra, is adopted).

entities being exercised by management committees (which may resemble corporate boards of directors) and by partnership "officers", as opposed to traditional management by general partners. Thus, there can be corporate-like centralization of management even with the partnership format. In addition, limited partners now may participate in management to a significant extent without losing their limited liability under many limited partnership statutes.

Finally, subject to the limitations of Section 7704, partners can achieve the same level of liquidity for their interests that corporate shareholders enjoy. The best illustration of that point is the fairly large number of "master limited partnerships", the interests in which are listed on the New York Stock Exchange or other established securities markets. For other partnerships, there are brokerage house "matching services", various partnership interest exchanges and other sources of liquidity.

As the foregoing discussion indicates, taxpayers can now structure partnerships that are, for most practical purposes, effectively indistinguishable from a corporation. (As discussed below, certain steps with nontax significance may need to be taken to insure partnership classification for tax purposes, but those steps usually are tolerable and

justified by the importance of achieving flow-through treatment.) These trends probably will continue, particularly as state statutes governing unincorporated entities become more corporate-like. 30/

III. Application in the Domestic Context

The Committee enthusiastically supports the adoption of the "check the box" approach to classifying domestic unincorporated entities for the reasons set forth below.

A. The Current System Is Burdensome

The current entity classification system is burdensome in two respects. First, the current system requires a detailed examination of the organizational documents for the entity, the governing local law and other relevant facts and circumstances to determine the characteristics of the entity. This analysis requires a very significant degree of involvement by the tax lawyer and can be quite time consuming, particularly when the tax lawyer is

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30/ This may include the creation of new types of "unincorporated" entities, as illustrated by the recent enactment of legislation in Texas for the creation of "limited banking associations", which is an unincorporated entity with limited liability that is authorized to engage in the banking business. See Tex. Rev. Civ. Stat., Title 16. We understand that a number of private letter ruling requests relating to the classification of such entities are currently pending before the Service.

dealing with an unfamiliar form of organizational document or an unfamiliar governing law. It also makes it difficult for a revenue agent to examine entity classification issues, since such issues require significant factual inquiry and detailed knowledge of local law. 31/

Second, many aspects of current entity classification law are not entirely clear, requiring legal judgments based upon subtle distinctions, thereby imposing unnecessary cost and complexity and creating serious traps for the unwary. Many issues that frequently arise under the current classification system have not been definitively resolved by cases or published rulings. 32/ The following are just a few examples:

1. There are no clear rules for determining when a general partner of a limited partnership is a mere "dummy" of the limited partners, even though the presence or absence of "dumminess" is relevant in determining whether the partnership lacks limited liability. 33/

31/ In the Committee's experience, the Service very rarely challenges taxpayer classification positions on audit.

32/ Legal advice in the classification area often relies heavily on the Service's ruling guidelines, perhaps more so than any other area of the tax law.

33/ A related question that often arises in practice is whether the general partner has a sufficiently large economic interest to be regarded as a "member" of the entity for Federal income tax purposes, which can implicate the limited liability, continuity of life and free transferability of interests tests.

2. Whether a general partner or member with unlimited liability has "substantial" assets involves a judgment call by tax practitioners, unless such general partner or member happens to have a net worth that satisfies the Service's ruling guidelines (which most practitioners would agree are more stringent than substantive law, at least for partnerships with large equity capitalizations).

3. It is unclear whether an entity lacks free transferability if the partners or members have a right to transfer their interests to certain categories of transferees (for example, family members, controlled entities, lenders holding debt secured by such interests or legal successors in corporate transactions) without first obtaining the consent of the other partners or members.

4. Determining when centralized management exists continues to involve a facts and circumstances analysis as to the substantiality of the general partner's or manager's interest in the entity, the scope of such person's authority to manage and the amount of control (in the form of removal provisions or consent rights) given to limited partners or nonmanager members.

The complexities and uncertainties associated with the current entity classification system pose legitimate questions for the Treasury and the Service concerning proper resource allocation. That is plainly evidenced by the volume of both published and private entity classification rulings that have recently been issued to provide guidance to taxpayers. 34/ Given the growing popularity of LLCs and

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34/ In the last 18 months over 100 private letter rulings on classification have been issued. In fact, to help manage its workload, the Service has already had to resort to refusing to grant "comfort" rulings on certain continuity of life issues. See Rev. Proc. 92-87, 1992-2 C.B. 496, superseded, Rev. Proc. 95-3, 1995-1 I.R.B. 85.

the novel issues they raise, the Committee believes the heavy demand on Treasury and Service resources will continue for that reason alone for some time. The recent promulgation of entity classification ruling guidelines for limited liability companies 35/ is a helpful first step in dealing with several issues that arise concerning the classification of domestic LLCs. However, because many practitioners believe those ruling guidelines are more stringent than substantive law in several respects, a complete reexamination may be required at some point. Moreover, there still are a number of unanswered classification issues regarding LLCs. 36/

As a result of these factors, the current entity classification system imposes substantial compliance costs on taxpayers, both in terms of the resources required to address entity classification issues and the effect of the uncertainties in the law. Needless to say, those costs may be particularly burdensome for small taxpayers, and they affect the government as well. The current system also creates economic inefficiencies in that it requires taxpayers to make certain business decisions (such as

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35/ Rev. Proc. 95-10, 1995-3 I.R.B. 20.

36/ See, e.g., Letter from NYSBA Tax Section Chair Michael L. Schler to Leslie B. Samuels regarding tax issues for professional LLCs and LLPs (Dec. 9, 1994).

management structure, transferability of interests in the entity and exposure to liabilities) based on tax considerations. Except for cases in which the Code affirmatively seeks to influence taxpayer behavior, tax considerations should have minimum impact on taxpayers' business decisions.

The "check the box" entity classification system would eliminate these costs and inefficiencies, at least on a prospective basis, by eliminating the currently required case-by-case technical analysis and making academic the many unanswered questions in the entity classification area. The question thus becomes whether the costs of the current system are nonetheless warranted. Many of the legal distinctions in the classification area are largely formalistic and/or do not seem particularly relevant to the question of whether an entity should be treated as a corporation. However, even if those distinctions are entirely appropriate as a theoretical matter, the costs associated with the current system still would be difficult to justify if it is concluded that the current system is already effectively elective and an expressly elective approach would not significantly increase the use of pass-through entities. Those considerations are discussed in the following sections of this report.

B. The Current System Is Effectively Elective

The Committee shares the view stated in Notice 95-14 that entity classification under current law is effectively elective in the domestic context, at least for well-advised taxpayers. If the parties to a transaction desire to create an entity that will be treated as a corporation for Federal income tax purposes, the parties would simply organize the entity as a corporation under a state corporate statute. 37/ In that manner, corporate treatment can be assured without having to delve into the four-factor entity classification test. 38/ On the other hand, if the parties desire to have an entity that would be treated as a partnership for Federal income tax purposes, the parties would organize the entity as a partnership, LLC or other unincorporated organization under a state statute and then, taking into account the terms of the state statute

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37/ It is possible that an entity seeking corporate classification would be organized in an unincorporated form for some nontax reason, but in the Committee's experience it is rare, (except in the case of certain business trusts) for a domestic unincorporated entity to seek to be classified as a corporation. The Committee notes that, prior to 1969, Section 1361 permitted certain unincorporated entities to elect to be taxed as a domestic corporation. That provision was repealed in 1966 because "fewer than 1,000" entities had made the election since it was introduced in 1954. See S. Rep. No. 1007, 89th Cong., 2d Sess. 9-10 (1966).

38/ As mentioned earlier, the four-factor test does apply for purposes of classifying foreign corporate entities. See note 10 and the accompanying text, supra.

relating to the four-factor test, include appropriate provisions in the organizational document and arrange for any other change necessary to achieve partnership status. While some of those steps may have nontax significance, it is the Committee's experience that the parties always find a way to take them because of the paramount importance of achieving the desired entity classification.

In practice, the continuity of life and centralization of management characteristics usually are not the focus of tax engineering. Continuity of life is a largely formalistic factor that usually can easily be avoided by providing in the entity's organizational documents that it will dissolve upon the occurrence of at least one of six enumerated dissolution events. 39/ Such events generally are very unlikely to occur as a practical matter and the

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39/ Under Treas. Reg. §§ 301.7701-2(b)(3) and 301.7701-2(a)(5), a limited partnership organized under a statute "corresponding" to the Uniform Limited Partnership Act or the Revised Limited Partnership Act is deemed to lack continuity of life, which in theory means that no further inquiry as to the substance of the transaction as it relates to continuity of life is required. The Service has ruled that the limited partnership statutes of 33 states "correspond" to the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act. Rev. Rul. 95-2, 1995-1 I.R.B. 7. The Tax Section has requested that the Service so rule with respect to the New York Uniform Limited Partnership Act, but the Service has not done so yet. See New York State Bar Association Tax Section, Report on the Conformity of New York's Revised Limited Partnership Act to the R.U.L.P.A. for Purposes of Entity Classification Under Treasury Regulation § 301.7701-2 (Nov. 8, 1994).

risk that the operations of the entity would be disrupted by the occurrence of a dissolution event can be mitigated by including a provision authorizing the entity to be reconstituted by a majority in interest of the remaining members upon the occurrence of a dissolution event. Hence, the business risks associated with defeating continuity of life generally are tolerable. On the other hand, whether an unincorporated entity lacks centralization of management usually is dictated by the size of the interests held by the members that will actively manage the entity, as well as other relevant facts with nontax significance. As a result, the presence or absence of centralized management usually is dictated by business considerations that cannot be affected by tax advisors. 40/

Where centralization of management is present, but continuity of life is not (which is the typical case), partnership classification will require that the entity lack either free transferability of interests or limited liability. As a practical matter, defeating free transferability of interests often is not difficult. In many situations (such as corporate joint ventures and other

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40/ In the LLC context, however, there is a somewhat subtle body of law that can create traps for the unwary, although some of those traps appear to have been eliminated by Rev. Proc. 95-10, supra note 35. See, e.g., Rev. Rul. 93-6, 1993-1 C.B. 430.

closely-held situations), the parties actually want restrictions on transfers as a business matter. In other cases, the restrictions that need to be imposed to defeat free transferability of interests have limited practical significance. In particular, a domestic unincorporated entity generally can avoid free transferability of interests by allowing unlimited assignments (which only give the transferee the right to cash distributions) but limiting substitutions (which give the transferee all the rights of an owner, including voting rights). Where participation in management has little significance (as is common in the widely-held context), this is often an acceptable approach. 41/ Alternatively, since it is only necessary to limit the transferability of a small portion of the interests, the members could choose to restrict the transferability of only that portion of the interests and permit the other interests to be freely transferable. 42/

41/ In the case of entities where all the members are closely affiliated, free transferability generally can be avoided by imposing an outright prohibition on transfers in the organizational document. See Rev. Rul. 93-4, 1993-1 C.B. 225. For recent private letter rulings applying that principle, see PLR 9521015 (Feb. 24, 1995) and PLR 9522007 (Feb. 17, 1995).

42/ Treas. Reg. § 301.7701-2(e)(1) states that free transferability of interests exists only if members owning "substantially all" the interests in the entity may freely transfer their interests. Rev. Proc. 92-33, 1992-1 C.B. 782, and Rev. Proc. 95-10, supra note 35, state that

To be sure, for certain unincorporated organizations, obtaining partnership status under the current classification system involves accepting restrictions on transferability or taking economic risks that are undesirable as a business matter. In particular, in situations where free transferability is important, the entity would typically need to lack the corporate characteristic of limited liability. That usually requires that a member with substantial assets be willing to expose those assets to the creditors of the entity, which obviously is undesirable as a business matter. 43/ In addition, where free transferability of interests is defeated by requiring consent for substitution (but allowing free assignability), that limitation may seriously impair the marketability of an interest in some situations, since the ability to participate in management sometimes is a significant feature of the interest (particularly in corporate joint ventures and other closely-held situations).

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the Service will rule that a partnership lacks free transferability if interests representing "more than 20%" of the interests are restricted.

43/ A literal reading of Treas. Reg. § 301.7701-2(d)(2) indicates substantial assets are not required so long as the member with unlimited liability is not a "dummy" (although the meaning of that term is not clear). Nonetheless, most tax practitioners usually require substantial assets, especially when dealing with special purpose corporate general partners.

In the Committee's experience, virtually all domestic unincorporated entities that desire partnership classification under current law can achieve it, with the result that the current classification system is effectively elective for domestic entities. Since the issuance of Revenue Ruling 88-76, 44/ achieving partnership status under the current classification system has been trending away from reliance upon the absence of limited liability and toward reliance upon the absence of free transferability and the absence of continuity of life. The case where the current classification system places the most meaningful barrier to partnership status is that of the widely-held (but non-publicly traded) unincorporated entity. It is typically not practical for such an entity to lack the corporate characteristics of free transferability of interests or centralization of management, making it necessary to avoid the corporate characteristic of limited liability. Since lacking the corporate characteristic of limited liability may involve substantial monetary exposure to some party to the transaction, widely held unincorporated entities are the most difficult to engineer as partnerships

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44/ 1988-2 C.B. 360.

under the current system. 45/ Notwithstanding the increased difficulty of qualifying a widely held unincorporated entity as a partnership, the Committee believes that well-advised parties to such a transaction virtually always achieve the desired partnership classification.

C. Authority for "Check the Box" Regulations

The Treasury is proposing to adopt the "check the box" entity classification system by promulgating new classification regulations. That raises the question of whether the Treasury has the authority to change the entity classification law as proposed without specific legislative authority. That question depends on whether the statutory terms "association" and "partnership" have a core meaning, apart from any regulatory definition, that cannot now be disregarded by the Treasury.

As a practical matter, the default classification for an entity that fails to file an election will determine the constituency that is likely to be adversely affected and, therefore, is likely to raise the issue. 46/ Had

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45/ In the widely-held context, the general partner is less likely to be viewed as the dummy of the limited partners, so it may be possible to avoid limited liability based upon the absence of dumminess.

46/ Where all the members of any entity (or at least those persons that are members at the inception of the entity) agree through an election or consent mechanism to the entity's classification, there is at least a practical

Notice 95-14 suggested that all nonelecting domestic business entities would be classified as corporations, there would no doubt be widespread concern that the Treasury was proposing to impose corporate tax on entities that unquestionably would be partnerships under current law, based simply on a failure to satisfy election formalities not expressly authorized by the Code. The partnership default classification of a nonelecting entity that would be a corporation under current law would similarly be unwelcome in some situations. Examples of this include cases where interests are owned by foreign persons that do not want to be subject to U.S. tax, where tax-exempt entities do not want to have unrelated business income or where taxable U.S. persons face an allocation of "phantom" income from the entity and do not want to be personally responsible for paying tax on that income. While the default classification proposed in Notice 95-14 clearly reflects the choice domestic unincorporated entities would make in virtually all cases and certainly makes a good deal of common sense, it would have adverse consequences for certain persons in certain circumstances.

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basis for concluding that its classification will not be successfully challenged.

The terms "association" and "partnership" have been included in the income tax law since its inception in 1913, 47/ and have long been defined in the regulations, albeit with increasing refinement and specificity. Regulations promulgated under the Revenue Act of 1918 distinguished associations from partnerships as follows:

> "Association distinguished from partnership -- An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members can not be so transferred is a partnership." 48/

The definition of association has also been considered by the courts, most notably in Hecht, 49/ which defined the term "association" by reference to the "ordinary meaning" of the term as found in various dictionaries, 50/ and in Morrissey, 51/ often viewed as the seminal classification

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47/ See Revenue Act of 1913, Section G(a)(1).

48/ Regulations Nos. 45, Article 1503.

49/ Hecht v. Malley, 265 U.S. 144 (1924).

50/ Id., 265 U.S. at 157.

51/ Morrissey, supra note 4.

case, in which the Supreme Court articulated seven indicia of associations, as distinguished from trusts and partnerships. The factors listed in Morrissey, with refinements prompted by Kintner, 52/ form the basis of the existing classification regulations.

One could argue, based on the long regulatory and case law history distinguishing associations from partnerships, that there is an overarching common law distinction that cannot now be dispatched by a new elective system, i.e., that the term "association" cannot refer only to those unincorporated organizations that elect to pay corporate-level tax (or, conversely, that the term "partnership" cannot include every unincorporated organization that elects not to pay that tax). On balance, however, the Committee believes that the Treasury can legitimately conclude that the distinctions between associations and partnerships as heretofore set forth in the regulations and case law have been supervened by developments in the variety and characteristics of business entities now available under State law, most significantly the torrent of state statutes that now authorize limited liability companies and limited liability partnerships. 53/

52/ U.S. v. Kintner, 216 F.2d 418 (9th Cir. 1954).

53/ See Part II.B, supra.

Modern business law differs so significantly from the state of the law as it existed when Morrissey was decided and the regulatory formulae for business entity classification were developed that it is reasonable to conclude those old definitions are outmoded.

It is therefore appropriate to rethink the meaning of the terms "association" and "partnership" and to acknowledge the essentially elective nature of classification that has come to exist, as a practical if not a formal matter, under current law. Furthermore, the Committee believes that, since the tax law has developed to the point where partnership classification is, in the vast majority of cases, much more desirable, it is reasonable to assume that the owners of a domestic entity that neither incorporates nor elects corporate classification intended to form a partnership. Finally, viewing the system as a whole, it is clear that the promulgation of regulations implementing the "check the box" system would dramatically reduce interpretative and compliance burdens for taxpayers and the government without changing the classification outcome in very many cases. The Committee has therefore concluded that the Treasury does have the authority to issue regulations implementing the "check the box" system for domestic unincorporated entities.

In reaching this conclusion, the Committee notes that entity classification is largely a regulatory matter. The terms "association" and "partnership" are not defined in the Code, leaving the Treasury with regulatory authority to define those terms. Morrissey itself contains language that supports the Treasury's ability to revise the classification regulations, stating that "[a]s the statute merely provided that the term 'corporation' should include 'associations', without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction", 54/ and that the Treasury's authority to issue regulations cannot "be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision". 55/ Furthermore, the Treasury has general authority under Section 7805(a) to "prescribe all needful rules and regulations", the general standard of review being whether a regulation is "unreasonable and plainly inconsistent with the revenue statute" in light of the specific statutory provisions being interpreted and the legislative intent underlying such

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54/ Morrissey, 296 U.S. at 344-45.

55/ Morrissey, 296 U.S. at 354-55.

provisions. 56/ Regulations must implement Congressional intent "in some reasonable manner", 57/ but the Supreme Court has noted that the manner in which a regulation evolves is an appropriate factor to be taken into consideration in determining whether a regulation is valid. 58/ The "check the box" system for domestic business entities would codify the effectively elective nature of the current classification system, as well as reduce burdens on taxpayers and the government, and the Committee believes that the Treasury has the authority to promulgate such regulations.

Notwithstanding the foregoing, the Committee recognizes that it is possible to construct an argument that the Treasury does not have the authority to adopt the "check the box" system by way of regulation, which argument would rely on the fact that the four-factor test is grounded in

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56/ Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948); Brooks v. United States, 473 F.2d 829 (6th Cir. 1976).

57/ United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982). See also Rowan Co. v. United States, 452 U.S. 247 (1981). The question of validity turns on whether the Service's implementation of the statute is reasonable, not whether it is the best of all the possible interpretations. Earl A. Brown, Jr. v. United States, 890 F.2d 1329 (5th Cir. 1989).

58/ See National Muffler Dealers Ass'n v. United States, 440 U.S. 472 (1979).

the early case law that purports to classify based upon corporate resemblance. 59/ Because situations undoubtedly will arise where taxpayers will be tempted to take the position that the regulations are invalid, the Committee recommends that consideration be given to seeking legislation expressly authorizing "check the box" regulations to avoid disputes on the authority issue. Even in the absence of such legislation, however, the Committee believes that the Treasury has the authority to issue regulations along the lines proposed in Notice 95-14.

IV. Technical Comments in the Domestic Context

A. One-Member Entities

In Notice 95-14, the Service and the Treasury specifically invited comments on "the proper treatment of unincorporated organizations that have a single member or owner". 60/

59/ The strength of the argument against authority would depend in part upon the election procedures that are adopted and the default classification that applies where no election is made, which issues are discussed later in this report. Those considerations are especially important when evaluating the authority issue in the foreign context, as discussed in Part V.E.2, infra.

60/ One Treasury official was recently quoted as saying that Treasury "has no clear view" on the issue of how the "check the box" system should relate to a one-member entity. Daily Tax Report (May 12, 1995) at G-3, (quoting Michael Thomson, deputy tax legislative counsel). See also Tax Notes (May 22, 1995) at 1009; Highlights and Documents

1. Analysis of Current Law

Current law is not entirely clear as to how a single-member unincorporated entity should be classified for Federal income tax purposes because of the very limited amount of authority on the issue. In the past, this issue arose infrequently. State partnership statutes universally require that there be at least two partners. Although it is possible that an owner that is recognized as a partner under state law may be disregarded as such for Federal income tax purposes if its interest is too small or it is not treated as a separate entity, 61/ leaving the entity with only one owner for Federal income tax purposes, there does not appear to be any court decision addressing any such situation. Other types of entities that may be organized under applicable law with only one member, such as domestic trusts, certain LLCs and various foreign entities, also may face the issue. 62/

(June 8, 1995) at 3718; and Highlights and Documents (July 14, 1995) at 673-5.

61/ Cf. the minimum interest requirement of a general partner of a limited partnership under Rev. Proc. 89-12, 1989-1 C.B. 78, or the minimum interest of the manager of a limited liability company under Rev. Proc. 95-10, supra note 35.

62/ Most state LLC statutes require that there be at least two members, but certain state LLC statutes (including the New York and Texas statutes) do authorize one-member LLCs.

Under Section 7701 and the regulations thereunder, every unincorporated entity conducting a business or investment activity generally must be treated as a partnership, an association or a sole proprietorship. 63/ It seems indisputable that a one-member entity may not be a partnership, since the essence of a partnership is the conduct of a business or investment activity and the division of the profits therefrom by two or more owners. 64/ Thus, the only two possible classification choices are association and sole proprietorship and the only way to determine whether association classification is applicable would be to apply the four-factor test set forth in Treasury Regulation § 301.7701-2. That is the approach that has been taken in the few cases and rulings to consider the classification of one-member entities.

63/ As used herein, the term "sole proprietorship" is used to mean the absence of a separate entity for Federal income tax purposes (similar to the treatment of a grantor trust). The terms "branch", "division", "agency" or even "nothing" also could be used to describe that result (and perhaps would be more appropriate, since the term "sole proprietorship" connotes an individual as the owner).

64/ See, e.g., the cases and rulings cited below and Treas. Reg. § 1.761-1(a). If a multi-member partnership ever ceases to have more than one member, the partnership terminates. See Treas. Reg. § 1.708-1(b)(1)(i). In contrast, it is well established that an incorporated organization with a single shareholder is properly classified as a corporation.

In Hynes v. Commissioner, 65/ the Tax Court held that a trust with a single beneficiary that was engaged in business for profit was taxable as a corporation. The Tax Court stated that "[i]t is clear that when there is a single owner, the regulations are not intended to require multiple associates or a sharing of profits among them". 66/ The Tax Court then went on to apply the four-factor test to determine whether the entity was a corporation. Similar reasoning was employed in Barnette v. Commissioner, 67/ in which a German GmbH with a single shareholder was determined to be a corporation after applying the four-factor test.

In TAM 8533003, the Service cited Hynes, but, with no discussion of the issue, rejected the notion that a single-member unincorporated entity could be viewed as a partnership on the theory that it could not have associates in the "partnership sense". The Service applied the four-factor test and concluded that the trust at issue was a sole proprietorship based on the absence of limited liability and

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65/ 74 T.C. 1266 (1980).

66/ Id. at 1279-1280.

67/ 63 T.C.M. 3201 (1992).

continuity of life. The same approach has been taken in other rulings. 68/

The four-factor test does not expressly address how to determine whether the four corporate factors exist in the single-member situation. Without question, avoidance of at least two of the corporate factors may be difficult in view of the absence of parties with adverse interests, as is the case where an entity has multiple, but closely affiliated, partners. However, the Committee believes that the four-factor test often would indicate sole proprietorship status and, with appropriate changes to the organizational documents for the entity, usually could be made to produce that result.

As an illustration, consider the case of a one-member LLC. An LLC would have the corporate characteristic of limited liability as a matter of local law, except in the highly unusual circumstance where a member was personally liable for LLC liabilities by reason of a contractual assumption of liabilities or a statutory election to be liable. However, a well advised single-member LLC should be able to avoid all three of the other four corporate characteristics. Free transferability of interests can be

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68/ See TAM 8552010 (Sept. 25, 1985); GCM 39395 (Aug. 5, 1985); and PLR 8139048 (June 30, 1981).

avoided if the organizational documents either flatly prohibit any transfer of an interest in the LLC or require that the LLC dissolve upon a transfer. 69/ A single-member LLC can easily avoid continuity of life by providing for automatic dissolution upon the death, disability, bankruptcy or other event involving the owner, since there would be no other member to reconstitute and continue the LLC. 70/ Centralized management can be avoided simply by providing for management by the member in its capacity as such.

As illustrated by the foregoing example, a well-advised single-member entity should be able to avoid the corporate characteristics of free transferability of interests, centralized management and continuity of life and, therefore, should not be an association under the four-factor test. Consequently, it must be a sole proprietorship, since that is the only potentially applicable classification under Section 7701. As indicated above, that conclusion is supported by the Tax Court and the

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69/ See note 41, supra. The rulings referred to therein dealt with entities that were owned by two closely affiliated persons, but their rationale should extend to the single-member situation. The dissolution approach may not work, however, if dissolution would not occur automatically under local law.

70/ Compare Rev. Rul. 93-4, supra note 41. There may be some question as to whether this approach works where dissolution would not occur automatically under local law.

Service in the few cases and rulings dealing with this issue. 71/

2. Recommendation

The Committee recommends that single-member unincorporated entities qualify for the "check the box" classification system, with the two choices being sole proprietorship and association status, for all the reasons that the "check the box" system makes sense generally. As indicated by the above analysis of current law, the Committee believes that the "check the box" system would reflect the practical reality that well-advised one-member entities can achieve sole proprietorship status under the four-factor test. Moreover, the special classification concern with respect to the single-member entity is ultimately only a technical problem, since the whole question can be avoided by having another party (perhaps even another entity wholly-owned by the member) hold a small interest in the entity. Thus, absent clarification of the single-member unincorporated entity issue, some conservative taxpayers with sufficient resources will feel compelled to incur the time

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71/ The Committee notes that the corporate characteristic of limited liability was not present on the facts of the rulings concluding that the entity was a sole proprietorship, but the Committee does not believe the absence of limited liability is required in all cases in view of the equal weight assigned to each of the four corporate characteristics under the four-factor test.

and expense of arranging for a second member of the LLC solely to avoid the single-member issue. It is precisely that sort of nonproductive tax engineering required to assure partnership classification under current law that the Treasury and the Service seek to eliminate. By the same token, this is an area where there are significant traps for the unwary that could be eliminated.

B. Classification Elections

1. Unanimous Owner Consent Requirement

Notice 95-14 states that all elections made pursuant to the "check the box" system would have to be executed by all members of the entity. Once made, an election would be binding on all members at all times thereafter, unless an election is subsequently made to change the entity's classification. The default election for an unincorporated entity that fails to file a valid classification election would be partnership status.

The Committee generally supports this approach to classification elections. A unanimity requirement in all cases obviously would ensure that an entity's status for Federal income tax purposes is consistent with the intent of all its members, but it also would create procedural burdens and give each member a veto over any affirmative classification election. The proposed system strikes an

appropriate balance in the domestic context by effectively requiring an affirmative election only where corporate treatment is sought. Since the default classification as a partnership would be the one the entity would virtually always be seeking, it would be necessary to seek partner consent only in very rare and unusual cases. 72/ The unanimity requirement would still pose a procedural limitation for any unincorporated entity seeking to be treated as a corporation, but since the choice of corporate treatment would clearly be the exception and not the rule, and likely would entail higher tax costs, it would appear to be an appropriate safeguard to require unanimous consent to corporate classification. 73/

The Committee does recommend that the term "consent" be defined broadly to include several forms of consent to minimize the burden of the unanimity requirement in cases where an affirmative election is sought to be made in the domestic context. Taking into account the need to have a

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72/ As indicated in note 37, supra, given present business practices the Committee believes it would be unusual for a domestic unincorporated entity to seek to be classified as a corporation. Present business practices could, of course, change over time.

73/ The members of any unincorporated entity that seeks to be treated as a corporation but fails to muster the required unanimous consent may seek to challenge the "check the box" regulations if the entity would have been treated as a corporation under the four-factor test.

clear expression of the members' intent, the Committee suggests that the consent requirement should be able to be satisfied in any of the following four ways: (i) having each member sign a specific election form similar to the Form 2553 used by S corporations, (ii) having each member execute his own written consent to a classification election, (iii) making consent to an election part of the organizational agreement for the entity that is signed by all the members (whether the agreement specifies the election, states that the election will be determined by a vote of the members or states that the election will be left to the discretion of a specified member) or (iv) having each member that does not consent in any of the ways described in (i)-(iii) above execute a power of attorney expressly authorizing another member to execute a classification election consent on such member's behalf (whether or not the election is specified in the power of attorney). It is likely that alternative (iii) would most often be used in practice, since that method is the most practical one and is how other partnership tax election matters typically are handled today. 74/ The Committee acknowledges that

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74/ The Committee recognizes that alternative (iii) is inconsistent with the rule for S corporation elections under Treas. Reg. § 1.1362-6(b) (which provides that each shareholder must sign a specific written consent to the S corporation election), but the Committee believes that

alternative (iii) does not involve a direct communication between each member and the Service, but it does represent a form of express consent that can be verified. 75/

The regulations also should very clearly specify the time frame within which membership is measured. For example, for an entity to be treated as a corporation from inception, the regulations might require an election to be filed by all of the initial beneficial owners of interests in an organization; this seems to us to be an appropriate approach. For entities that elect partnership status under the "check the box" regulations (or are treated as partnerships by default), that status would continue unless and until all the persons owning interests on any given date elect to change to corporate classification. Furthermore, given the potential tax costs associated with a deemed liquidation of a corporation, and the burdensome nature of the unanimity requirement, the Committee assumes that the election requirement for corporate status also would be imposed just once, and that any change of status thereafter

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such rule, which is manageable in the context of an entity with no more than 35 owners, would not be practical in the context of widely held partnerships.

75/ It might be appropriate to require that the election provision in the organizational agreement specifically refer to the matter of classification elections, rather than simply be a generic authorization to make tax elections.

would not be triggered by a failure to file another corporate election, but instead would require the filing of a new election for partnership classification.

2. Collateral Effects of a Change in Classification

Notice 95-14 provides that an affirmative election to change the classification of an unincorporated business organization would have the same consequences as a change in the classification of the organization under current law. For example, if an association previously taxable as a corporation elects to be treated as a partnership, the deemed conversion would be treated as a complete liquidation of the association and the subsequent transfer of the distributed assets to a newly-formed partnership, with attendant tax consequences under Sections 331, 336 and 721. Those results would ensue even though the election effected no change in the organization's status under local law.

In the case of an entity previously taxable as a partnership that elects to be treated as a corporation, the tax consequences are not spelled out in Notice 95-14. While a Section 351 transaction is undoubtedly the result, it must be decided which of the three possible ways to incorporate should be deemed to have occurred. 76/ Depending upon the

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76/ See Rev. Rul. 84-111, 1984-2 C.B. 88. A partnership can transfer its assets to a newly formed corporation in exchange for stock and then liquidate.

incorporation method chosen, there can be different results with respect to the basis and holding period of the assets of the new corporation and the stock received by the former partners. 77/ Under current law, taxpayers are permitted to freely select among these three alternative structures. 78/ The Committee believes that taxpayers should be allowed the same flexibility to choose the form of incorporation resulting from a corporate election under the "check the box" system.

If the above recommendation is not adopted, and in any case where an entity fails to select a structure at the time it elects to convert to a corporation, the Committee believes that a default incorporation structure should be established. The Committee believes that the most straightforward incorporation method is for a partnership to transfer all of its assets to a newly-formed corporation in exchange for all its stock and then liquidate, distributing

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Alternatively, a partnership can distribute all of its assets to its partners in liquidation and then have the partners incorporate the assets. Finally, the partners can transfer their partnership interests to a newly formed corporation in exchange for stock.

77/ Id.

78/ Id.

the stock to its partners. 79/ Accordingly, the Committee recommends that incorporation structure as the default incorporation structure. 80/

The Committee does not believe there needs to be any restriction on the ability of an entity to change its classification election (other than that the requisite member consent must be obtained). Since taxpayers are free under the current system to change the classification of an unincorporated entity in a variety of ways (including amending the provisions in the organizational agreement affecting the four corporate factors, merging into another entity with suitable characteristics or liquidating the entity and transferring its assets to a successor entity with suitable characteristics), the Committee does not see any reason why the "check the box" system should be more restrictive.

79/ The Committee also notes that this is the incorporation structure prescribed by Section 7704(f) for a partnership that becomes taxable as a corporation as a result of interests therein becoming publicly traded.

80/ While the Committee believes that it is important to specify some default incorporation structure, the Committee is less concerned with precisely which default structure is specified. The Committee notes, however, that it would not be desirable to specify as the default structure the liquidation of the partnership followed by an incorporation of its assets, as that structure has the potential to produce unanticipated gain recognition under Section 704(c)(1)(B) or 737.

3. Result of a Section 708 Termination

Under Section 708(b)(1)(B), if an unincorporated entity that is classified as a partnership experiences a sale or exchange of 50 percent or more of the total interests in its capital and profits within a 12-month period, the partnership will be deemed to have terminated. If a partnership is terminated pursuant to a sale or exchange of partnership interests, the partnership is deemed to distribute all its assets to its partners in proportion to their respective interests and immediately thereafter the distributee partners are deemed to contribute such assets to a new partnership.

Because the concept of a termination by virtue of a sale or exchange of ownership interests is unique to partnerships, a Section 708 termination will only occur if the unincorporated business organization has not elected to be treated as a corporation. In the event of a Section 708 termination, the "new" partnership should, of course, be entitled to make its own election to be taxed as a partnership or an association under the normal election procedure for a newly-formed entity. However, the intention of the parties ordinarily would be to continue partnership treatment (since if they had wanted corporate treatment they would have previously elected that the entity be so

treated). That intention would automatically be effectuated in the domestic context without the parties having to make an affirmative election after the termination, because the default classification would be to partnership status.

4. Treatment of Trusts and Other Arrangements Not Intended To Be Partnerships or Associations

Notice 95-14 does not propose that trust status be elective. It would appear, therefore, that trust classification will continue to depend upon the factors set forth in Treasury Regulation § 301.7701-4. Furthermore, the Notice refers to "unincorporated organizations", leaving the classification of some joint business arrangements not involving a separate legal entity unclear. The Committee recommends that the treatment of trusts and other arrangements that the owners did not treat as involving the creation of an association or a partnership be clarified.

In addition, the Committee recommends that taxpayers be permitted to make protective elections for arrangements that the taxpayer intends to treat as not involving the creation of an association or a partnership. For example, many unincorporated investment vehicles are organized as state law trusts (frequently under a state business trust statute) and are structured to qualify as grantor trusts for Federal income tax purposes. To reduce the potential costs of the uncertainty related to the

trust's status for Federal income tax purposes, many of these trusts also include provisions designed to enable them to be classified as partnerships under the four-factor test should their trust status be challenged successfully. 81/ Another example would be "joint undertakings" of the type described in Treasury Regulation § 301.7701-3, which are not treated as separate legal entities for tax purposes. To provide some degree of certainty while furthering the goals of Notice 95-14, the "check the box" regulations should allow these types of organizations and arrangements to make a protective partnership election that would allow them to be treated as partnerships in the event their status for Federal income tax purposes is challenged. 82/

81/ The Committee also recommends that such a protective partnership election be available to trust entities that are set up as finance vehicles for securitizing certain types of assets (e.g., credit card receivables). For Federal income tax purposes, the trust certificates issued by these financing trusts to the public are usually structured to qualify as indebtedness of the trust, and the trust itself is structured to be treated as either a trust or a "nothing" for Federal income tax purposes. A substantial amount of time often is expended in drafting the terms of the trusts to insure they will be treated as partnerships (rather than associations) if their status as "trusts" or "nothings" for Federal income tax purposes is challenged successfully.

82/ One might argue that, even under the current four-factor test, it would not be appropriate for the Service to attempt to treat such a constructive entity as an association, since the legal authorities upon which the Service would be relying (such as Beck Chemical Equipment Corp. v. Comm'r, 27 T.C. 840 (1957)) deal with the common

Because the default classification in the domestic context is to partnership status and that would be much more consistent with the expectations of the parties than would corporate classification (since they would not have been contemplating the existence of a separate taxable entity), there should be no need in the domestic context for the parties to make a protective election of partnership classification. However, in the foreign context, it is more likely that a protective election would be needed, especially if the default classification in the foreign context is to corporate treatment and there is no special relief for these types of arrangements. 83/

C. Transition Rules and Retroactive Elections

Notice 95-14 provides that the "check the box" classification system would not be effective retroactively. It further provides that classification elections would only be effective prospectively from the date the election is filed (or any later date designated in such election).

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law definition of the term "partnership". It would seem somewhat unfair for the Service to rely on those authorities to create a separate entity but then claim that the entity should be treated as an association, since those authorities involve entities that were treated as partnerships and the four-factor test was not designed to apply to constructive entities.

83/ See Part V.E.3, infra.

The Committee generally supports the foregoing proposals. The Committee considered whether unincorporated domestic business entities that were formed prior to the issuance of any future Treasury regulations implementing the "check the box" system should be entitled to make a retroactive classification election. While a retroactive election option would be consistent with the general policies behind Notice 95-14 by providing greater certainty to taxpayers and reducing the continuing burden on the Service with respect to the pre-regulation tax years that remain subject to audit, the Committee nevertheless believes that a retroactive classification election procedure should not be available. The only policy objective it would really serve would be that of minimizing the amount of resources devoted to classification issues by the Service and taxpayers on audit, since the policy objective of providing simplicity and greater certainty in tax planning is, by definition, not implicated by a retroactive election procedure. The burden associated with auditing prior taxable years of existing entities obviously will diminish over time as those years close. More importantly, a retroactive election procedure would be tantamount to an amnesty program that would reward aggressive taxpayer practices on classification issues by validating prior

classification positions that are subject to challenge under the four-factor test.

The Committee does recommend that there be a very minor exception to the general rule that classification elections be effective only prospectively from the date on which they are made. That exception relates to newly-formed entities, where it may not be practicable to obtain the requisite consents and file the election on the date on which the entity is formed (which generally would be the date on which the parties would want the election to be effective). Thus, there should be some limited delay permitted for the filing of a classification election for a newly-formed entity. 84/

V. Application in the Foreign Context

A. Introduction

As recognized in Notice 95-14, a number of special considerations must be taken into account in evaluating the application of the "check the box" classification proposal to foreign entities. First, unlike the case with domestic entities, there are no foreign entities that are classified

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84/ The Committee notes that an S corporation may file its S election within 2-1/2 months after the beginning of the first taxable year as to which the election is to be effective. See Treas. Reg. § 1.1362-6(a)(2)(ii).

as corporations per se. 85/ In the domestic context, the existence of per se corporations has long been required by the law and presumably helps preserve the corporate tax base. As discussed below, the considerations in the foreign context are different.

Second, special concerns arise because of the possibility that an entity may be classified inconsistently in the United States and the jurisdiction in which the entity is organized or operating (i.e., the entity may be a "hybrid"). Although, as Notice 95-14 recognizes, domestic entities with foreign operations or foreign members also may be hybrids, there seems to be a perception that foreign hybrids are more susceptible of abuse. The extent to which hybrid entities actually may create a U.S. tax abuse problem is discussed below.

Third, under the current entity classification system, there may be more flexibility to achieve the desired tax result with a domestic entity than with a foreign entity. If so, the "check the box" system would represent more of a substantive change in the law in the foreign context than in the domestic context, where it would essentially represent a codification of current practice.

85/ See note 10 and the accompanying text, supra.

Fourth, as Notice 95-14 recognizes, if the "check the box" system is adopted for foreign entities but no election is made by the foreign entity in a particular case, the default classification of the entity should not necessarily be the same as the default classification of a domestic entity. Indeed, as discussed below, there is no obvious default classification in the foreign context as there is in the domestic context, where the entities to which the "check the box" system would apply are almost universally intended to be classified as partnerships.

B. Application of the "Check the Box" Proposal to Foreign Entities

1. Applicability of the Purposes of the "Check the Box" Proposal in the Foreign Context

In the Committee's experience, the resources required to make entity classification determinations are generally much greater with respect to foreign entities than domestic entities. The detailed understanding of foreign organizational documents and foreign laws needed to insure the desired classification often greatly complicates the analysis and results in significant transaction costs for the parties. In fact, foreign entity classification determinations typically require consultation with foreign counsel on matters that otherwise would be of little concern to the parties (such as whether the entity would dissolve

automatically under local law without any action of the parties if a triggering event occurs). In certain circumstances, foreign law may not define the legal relationships among the owners with sufficient clarity, or provide sufficient flexibility to adjust those relationships, to provide the U.S. tax advisor with the customary level of certainty as to classification. In addition, the U.S. tax advisor is often operating with little or no U.S. legal authority on the classification of the particular type of entity, except in the relatively few cases where the entity's U.S. tax classification is fairly well-settled.

The Committee expects that, in general, the Service has even greater difficulty than taxpayers in making foreign entity classification determinations, both when taxpayers seek advance guidance from the Service and when the issue arises on audit. The Committee believes that, as a general matter, the Service's familiarity with foreign law is no greater, and its need for foreign counsel is no less, than that of taxpayers. 86/ Yet the Committee understands

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86/ In analogous situations, such as the interpretation of foreign law to determine the creditability of a foreign tax, the Service has even expressed reluctance to proceed without its own foreign counsel, perhaps due to perceived "blindsiding" in the past. See, e.g., Continental Illinois Corporation v. Commissioner, 998 F.2d 513 (7th Cir. 1993), Brief for Appellee-Cross Appellant (Commissioner) 51 n.33

that the Service retains foreign counsel only in unusual circumstances (such as major litigation). Viewed in that light, the purposes of Notice 95-14 would be well served if the "check the box" system were extended to foreign entities. Finally, the economic efficiency considerations discussed in Part III.A above in the domestic context are equally applicable in the foreign context.

There are certain countervailing considerations. The Committee's perception is that domestic unincorporated entities are used much more frequently than foreign entities by U.S. taxpayers. Thus, measured by the number of entities involved, the total burden on taxpayers and the Service is not as great with respect to foreign entity classification as it is with respect to domestic entity classification. Moreover, the Committee's perception is that U.S. taxpayers seeking to organize foreign entities and foreign taxpayers seeking to do business in the United States generally are not the types of small businesses that cannot afford the

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(Revenue Rulings affirming creditability of Brazilian interest withholding tax "reflect a misapprehension of the applicable Brazilian legal principles". We understand that the rulings were based on taxpayer representations regarding Brazilian law that were considered to be inaccurate when later examined by Service-hired experts.)

resources needed to cope with the complexity of the current system. 87/

Notwithstanding the foregoing, extending the "check the box" classification system to foreign entities obviously would conserve substantial amounts of resources for both taxpayers and the government. Moreover, extending the "check the box" system to foreign entities would help minimize the impact of formalistic tax considerations on business decisions. Thus, there are compelling policy reasons to extend the "check the box" system to foreign entities.

2. Extent to Which Entity Classification Is Elective in the Foreign Context

As stated above, one concern expressed in Notice 95-14 is that entity classification currently may be more elective in the domestic context than in the foreign context. This may be for either of two reasons: First, the law of the relevant foreign jurisdiction may not provide for an entity that is both suitable for use in the particular business activity and readily capable of being classified as desired by the U.S. taxpayer. Second, foreign persons

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87/ We recognize that, on an absolute if not relative basis, large taxpayers suffer from unnecessary complexity every bit as much as small taxpayers. However, to the extent that small businesses do seek to organize foreign entities, the costs of the current classification system may be prohibitive.

investing in the entity may be unwilling to utilize the type of legal entity, or to make the substantive changes in the organizational documents, that may be required to accommodate U.S. tax planning objectives.

In the Committee's experience, the first problem is not significant. There may be certain jurisdictions in which certain business activities can be carried on only through a specific type of entity whose characteristics may not be flexible enough for it to be classified as either a partnership or a corporation. 88/ However, in our

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88/ For example, we understand that, in both China and Italy, certain activities may be carried on only through entities that would normally be classified as corporations for U.S. tax purposes. See, e.g., PLR 9152009 (Sept. 27, 1991) (holding that, as a result of the procedural workings of the Chinese joint venture law, it would not be possible to have an automatic termination of the equity joint venture addressed in the ruling and, therefore, the entity possessed the corporate characteristic of continuity of life as well as limited liability and centralized management and hence was properly characterized as a corporation for U.S. tax purposes). Note, however, that while this ruling does make it difficult to achieve pass-through status using a Chinese equity joint venture, some practitioners are attempting to negate centralized management by having all of the members of the entity participate directly in the management of the venture. Moreover, we understand that the Chinese authorities have recently been willing to allow the use of a "contractual" or "cooperative" joint venture for those activities for which previously only an equity joint venture could be used. The cooperative joint venture which is formed by contract rather than statute is not subject to the same statutory requirements upon which the holding of PLR 9152009 is based. Therefore, it may be possible to achieve partnership status for activities previously limited to equity joint ventures by using a cooperative joint venture.

experience, there are very few instances in which a U.S. owner with fully cooperative partners cannot obtain the desired U.S. tax classification for a foreign venture. For example, the Committee is not aware of any jurisdiction in which corporate classification cannot be obtained if the appropriate legal vehicle is selected. 89/ When partnership classification is sought, the law governing the foreign entity usually will either prescribe characteristics that mandate partnership classification 90/ or provide sufficient flexibility to allow the owners to accomplish that result through the entity's organizational documents. 91/

89/ See, e.g., Rev. Rul. 93-4, supra note 41 (German Gesellschaft mit beschrankter Haftung ("GmbH")); and PLR 7841047 (July 14, 1978) (Japanese yugen kaisha). See also Raffety Farms, Inc. v. U.S., 511 F.2d 1234 (8th Cir. 1975), cert. denied, 423 U.S. 834 (1975) (Over a dissent, Mexican sociedad de responsibilita limitada ("SRL") held to be taxable as a corporation in a two-paragraph decision by Justice Clark, sitting by designation).

90/ See, e.g., PLR 7943083 (July 27, 1979) (Ontario partnership); PLR 7934096 (May 24, 1979) (French societe en nom collectif ("SNC")); PLR 8243193 (July 29, 1982) (German Offene Handelsgesellschaft ("OHG")); PLR 8012063 (Dec. 27, 1979) (German Stille Gesellschaft); PLR 7935019 (May 29, 1979) (same).

91/ Most commonly, the foreign entity will possess limited liability and centralized management. Thus, classification as a partnership will be based on whether the entity lacks free transferability of interests and continuity of life. We know of few provisions of foreign law that would void all consensual restrictions on transfer. As such, the ability to obtain partnership classification with a cooperative partner will most commonly turn on whether the foreign entity can dissolve on the death,

Thus, in the Committee's view, the most significant impediment to practical electivity in the foreign context today is the second reason noted above, i.e., the potential unwillingness of foreign investors to utilize the type of legal entity, or make the substantive changes in the organizational documents, that may be required to accommodate U.S. tax planning objectives. That impediment would not be significant where the investors are all U.S. persons or the foreign investors have U.S. tax interests that are aligned with those of the U.S. investors. On the other hand, that impediment would be most significant when the entity is not doing business in the United States (and, therefore, the foreign investors generally would have nothing at stake) or the U.S. investors have a relatively small interest (and, therefore, the U.S. investors may have

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insanity, bankruptcy, withdrawal or expulsion of a partner. In our experience, many foreign legal systems provide this flexibility. See, e.g., Rev. Rul. 93-4, supra note 41 (German GmbH's memorandum of association can be modified to provide that it lacks continuity of life); PLR 9002056 (Oct. 18, 1989) (same for British private company limited by shares; note, however, that Service officials have suggested that the "without further action" language of Rev. Rul. 93-4 might alter the conclusion of this ruling, at least in the absence of separate economic interests, since a shareholder vote subsequent to the dissolution event was required, although all shareholders were required to vote in favor of dissolution); PLR 8401001 (June 16, 1983) (same for Brazilian "Limitada" but continuity of life found to exist because of the absence of separate economic interests). See also PLR 9511023 (Dec. 16, 1994) (same apparent result for private limited company in unidentified jurisdiction).

no real bargaining power). The best illustration of this impediment would be the case where a U.S. investor makes a small portfolio investment in a large, publicly traded foreign corporation. 92/

Where the U.S. investors have bargaining power, it usually is possible to make the required adjustments to achieve partnership classification. As discussed above, the primary points of contention are likely to be free transferability of interests and continuity of life. In our experience, however, U.S. investors usually are able to structure foreign entities to lack these characteristics for a number of reasons.

The characteristic of continuity of life is generally easy to avoid, since it is, among the four factors, the most formalistic. 93/ That is, unless the U.S. investor is coming into the transaction only after the entity has been formed (in which case even the "check the box" system may be of little benefit to it), or the U.S.

92/ In such cases, partnership treatment usually would not be an option anyway because of Section 7704, which, as noted earlier, would supersede any classification election.

93/ See pp. 25-6, supra. If the parties are not at a point at which there is a high level of trust among them, and the foreign investors are not experienced in dealing with U.S. investors, the foreign investors may perceive hidden motives in a U.S. investor's attempt to cause premature, albeit technical, dissolution of the venture.

investor is a true portfolio investor, foreign investors are likely to offer less resistance to satisfying continuity of life than any other factor.

Free transferability of interests is harder to avoid, but U.S. investors often are successful. In many cases, for example, the foreign investors will seek assurance that the U.S. investors will stay in the deal and, therefore, actually will want restrictions on transferability as a business matter. The role of the U.S. investor in the transaction will affect its ability to overcome any foreign investor objections to restrictions on the transferability of interests. Obviously, the larger the U.S. interest, the more leverage the U.S. investors will have and the easier it will be to obtain the desired classification. But even if the U.S. investors are not the controlling owners, as is frequently the case for U.S. natural resource companies, they may be contributing vital technology or distribution services, or their capital may be sufficiently important to the transaction to provide them with the good offices necessary to modify the entity's characteristics.

Thus, although the Committee believes that elective classification would change the tax characterization of a relatively small number of foreign entities, the

Committee believes that, in the great majority of cases, either through choice of entity type or the design of the entity, U.S. taxpayers have the freedom to effectively elect whether their foreign entity will be classified as a partnership or a corporation for Federal income tax purposes under current law. This is especially so where the Federal income tax consequences are important to the U.S. investors, since such investors (i) may be less likely to invest with foreign investors whose preferences would be a serious impediment to achieving the desired U.S. tax classification, (ii) would less likely organize their entity in a jurisdiction in which there would be significant constraints to achieving the desired classification and (iii) would be more likely to expend the resources and make the concessions necessary to achieve the desired classification.

3. Advantages and Disadvantages of Partnerships in the Foreign Context

A key policy issue raised by extending the "check the box" system to foreign entities, and thereby removing any remaining barriers to partnership classification, is whether it would exacerbate any tax abuses that may be occurring through the use of foreign entities classified as partnerships. The Committee does not believe that the extension of the "check the box" system to foreign entities significantly increases the potential for abusive uses of

partnerships. The following sections of this report discuss this potential in some detail, acknowledging the importance of giving full consideration to the issues presented by a proposal to extend an elective system to foreign entities. The Committee emphasizes, however, that in its view the considerations discussed below are not grounds for excluding foreign entities from the proposed elective classification system. Instead, we believe that, as in the domestic area, the adoption of a "check the box" system for foreign entities would greatly simplify and streamline an area of the tax law that currently demands unwarranted expenditures of resources, and would do so without materially changing the substantive outcome of the vast majority of cases. 94/

To evaluate this issue, it is useful to identify the potential U.S. tax benefits associated with the use of

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94/ The tax benefits summarized below are not necessarily dependent on the inconsistent classification of the entity as between the U.S. and a foreign jurisdiction. That phenomenon, which is discussed below, is referred to herein as the "hybrid" issue. In addition, we distinguish the tax benefits summarized below from the use of a partnership to obtain a deferral benefit. See, e.g., Brown Group Inc. v. Comm'r, 104 T.C. 105 (1995). Although such a use strikes us as being potentially abusive, we also believe that current law provides sufficient weapons for the Service to combat potential abuses of that nature.

partnerships in the foreign context and determine whether any of those benefits are abusive. Such tax benefits include the following:

1. A domestic corporation owning 10% or more (by voting power) of a foreign corporation that is not a controlled foreign corporation (a "noncontrolled Section 902 corporation") can avoid separate foreign tax credit limitation treatment under Section 904(d)(1)(E) for the dividends from the foreign corporation by structuring it instead as a pass-through entity.

2. A 10% corporate owner of a foreign entity may be able to avoid Section 902's three-tier limitation on the indirect foreign tax credit to the extent that additional tiers are added in the form of pass-through entities rather than corporations. 95/

3. The owners of a foreign entity can structure the entity as a partnership to obtain direct foreign tax credits under Section 901 and avoid the requirements of Section 902 (i.e., corporate status and 10% ownership) that might otherwise prevent them from claiming an indirect foreign tax credit if the entity were a corporation.

4. Each owner's allocable share of the tax losses of a foreign venture will flow through to it for U.S. tax purposes if the venture is structured as a partnership. The foreign loss recapture rules of Section 367 address potential abuses connected with any subsequent incorporation to obtain deferral, 96/ and the dual consolidated loss rules broadly address the most significant jurisdictional tax arbitrage possibility that otherwise would be available in connection with

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95/ Recently proposed regulations ask for comments on the treatment of pass-through entities for purposes of Section 902. See Preamble to Prop. Treas. Reg. §§ 1.902-1 and 1.902-2, 60 Fed. Reg. 2049 (Jan. 6, 1995).

96/ See also Section 904(f).

foreign losses--claiming the same loss in two different jurisdictions. 97/

5. Active income that flows through a partnership to a controlled foreign corporation is not foreign personal holding company income, whereas dividends paid to a controlled foreign corporation by a corporation in an active business (other than certain corporations related to the controlled foreign corporation) generally constitute Subpart F income.

6. For purposes of the passive foreign investment company asset test in Section 1296, a foreign corporation holding a less-than-25% equity interest in another foreign entity would prefer to invest in an entity classified for Federal income tax purposes as a partnership if the entity has predominantly active assets.

7. The application of the interest allocation rules of Section 864(e) to the partners of a foreign partnership may result in a U.S. tax benefit as compared to the result if the entity were classified as a corporation, depending upon the amount of liabilities and the earnings of the entity and other relevant facts. (However, in some circumstances, the Section 864(e) rules may result in a U.S. tax detriment.)

In certain instances, however, the use of a partnership may result in a U.S. tax detriment. The following examples illustrate such detriments:

1. If an entity is classified as a partnership for Federal income tax purposes, its income would automatically flow through to its owners. Accordingly, U.S. owners would be subject to

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97/ See Section 1503(d); Treas. Reg. §§ 1.1503-2 and 1.1503-2A. For a discussion of the breadth of the dual consolidated loss regulations, see Magee, Farmer and Katcher, The Final Dual Consolidated Loss Rules: Reassessing the Congressional Mandate, 57 Tax Notes 1567 (Dec. 14, 1992).

Federal income tax on all the undistributed income of the entity. In contrast, if the entity had been classified as a corporation, the undistributed income of the entity would not flow through, except to the extent required under Subpart F, the "Qualified Electing Fund" provisions of Section 1293 or other special rules.

2. If an entity is classified as a partnership for Federal income tax purposes and 50% or more of the interests in the entity are transferred in a 12 month period, the entity is deemed for tax purposes to have terminated and distributed all its assets to its partners. 98/ The partners are then deemed to have recontributed those assets to a new partnership. Any U.S. partners deemed to have recontributed appreciated assets to the new partnership may be faced with a 35% excise tax on the recontribution. 99/ The new partnership also may be required to use less favorable depreciation methods than the old partnership for Federal income tax purposes. 100/

3. A foreign person that acquires an interest in an entity that is classified as a partnership for U.S. tax purposes will be treated as engaged in a U.S. trade or business if the partnership is so engaged. 101/ As a result, the foreign investor will be directly liable for U.S. income tax on effectively connected income from the partnership 102/ (and possibly on other

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98/ Section 708(b)(1)(B); Treas. Reg. § 1.708-1(b)(1)(iv).

99/ Section 1491. For ameliorative rules, see Section 1492 (providing, in part, that if the taxpayer elects (before the transfer) to apply principles similar to Section 367, the 35% excise tax is inapplicable). To date, no regulations have been issued explaining how the principles of Section 367 are to apply in this context.

100/ See Section 168(i)(7)(B).

101/ Section 875.

102/ Sections 871(b) and 882.

income 103/), may be subject to the branch profits tax on such income, 104/ will be required to file a U.S. tax return and may be subject to U.S. tax on a sale of his interest in the entity. 105/

4. All interest payments made by an entity engaged in a U.S. trade or business are treated as U.S. source income (and are potentially subject to U.S. withholding tax) if the entity is treated as a partnership, regardless of whether such interest payments are attributable to such U.S. trade or business. 106/

5. If an entity is classified as a corporation for foreign purposes and its owners, who assume that it will be so classified for U.S. tax purposes as well, cause it to enter into a merger or other transaction described in Section 368, tax free reorganization treatment under Subchapter C would not be available if the entity actually should be classified as a partnership for Federal income tax purposes. Moreover, a deemed outbound transfer of assets could result, triggering a 35% excise tax under Section 1491.

As the recent debate over the partnership anti-abuse regulation makes clear, it is not per se abusive to use a partnership to come within the terms of a specific Code provision or regulation and thereby obtain a more

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103/ See Section 864(c)(3).

104/ See Section 884.

105/ See Rev. Rul. 91-32, 1991-1 C.B. 107; see also Section 897(g).

106/ Section 861(a)(1); Treas. Regs. §§ 1.861-2(a)(2) and 301.7701-5. In contrast, interest payments by a foreign corporation are not treated as U.S. source (and are not subject to U.S. withholding tax), except as provided in Section 884(f).

favorable tax result than otherwise would be the case. 107/ That is particularly true where the rules are based on administrative convenience considerations rather than substantive tax policy (such as the three-tier rule under Section 902). More generally, the different tax consequences that result from the use of partnerships might be seen as inherent in the general structure of the Code, under which a partnership provides a single level of tax and a general flow through of tax items at the cost of eliminating any deferral of partnership income. Viewed from that perspective, one could conclude that the choice of partnership status does not generate an "advantage" at all, but instead requires the application of a different set of income tax rules, some of which are more favorable than the corporate rules and some of which are less favorable, but all of which are part of the fabric of what is permitted under the tax law.

The Committee does not believe that employing a partnership structure to achieve any of the U.S. tax advantages described above is inherently abusive.

107/ See Preamble to Treas. Reg. § 1.701-2, 60 Fed. Reg. 23 (Jan. 3, 1995). In fact, the partnership anti-abuse regulation expressly permits the use of a foreign partnership to avoid the applicability of the separate foreign tax credit basket for noncontrolled Section 902 corporations mentioned earlier. Treas. Reg. § 1.701-2(d) (Example 3).

Accordingly, the Committee believes that the concern that extension of the "check the box" system to foreign entities would facilitate the realization of such advantages is not an appropriate reason to deny "check the box" to foreign entities. That is particularly true when it is recognized that many (but not all) of such tax advantages are equally available through the use of a domestic entity and that, as discussed in the preceding section, the "check the box" system should not significantly increase the number of foreign entities that are classified as partnerships as compared to the result under current law. 108/

108/ The only possible detriment the Committee can envision is that some foreign entities that are engaged in a trade or business in the U.S. and that had not previously made the substantive adjustments necessary to achieve partnership classification under current law might be tempted to elect partnership status to avoid future U.S. tax at the entity level, which would make the Service's tax collection task more difficult in view of the resulting increase in the number of taxpayers from whom the Service would have to collect tax on the same revenue stream (which increase could be enormous in some cases). While the Committee is not expert in such compliance issues, it makes four observations. First, if there were some substantial U.S. tax advantage to be obtained from such a change in classification, the entity presumably would have already made the required adjustments. Second, there would be impediments to making a partnership election, such as possible General Utilities tax to the entity and foreign investor opposition to having to file U.S. tax returns. Third, Section 7704 would trump any such election in the case of most publicly traded entities (as defined in Section 7704). Fourth, the basic U.S. income tax would be enforced through the Section 1446 withholding tax (although there would be no withholding tax to enforce the branch profits tax to the extent it applied to corporate

4. "Hybrid" Entities

The issue of hybrid entities must be considered as part of the discussion of whether an elective approach should be extended to foreign entities. If hybrid entities present a tax abuse that the "check the box" system would materially expand, the Committee would have serious reservations about whether the "check the box" system should be so extended.

Set forth below are some examples the Committee believes are illustrative of the hybrid entity phenomenon. They do not represent a comprehensive compilation of all possible uses of hybrid entities. As discussed at greater length below, with two exceptions, the Committee does not regard these examples as being particularly abusive from a U.S. tax standpoint, although the Committee acknowledges that some people might differ with that view. Even assuming, however, that all of these examples illustrate some type of real abuse, the Committee does not believe that the overall potential for abuse would be materially enhanced by the "check the box" system given the degree of electivity associated with current law, particularly in tax-motivated transactions. Balancing what the Committee believes to be a small increment of potential abuse as compared to current

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investors).

law against the significant advantages of the "check the box" system in the foreign context, the Committee believes "check the box" should be adopted for all foreign entities and that any hybrid entity abuses should be addressed through specific reforms.

(a) Identification of the Issue. The term "hybrid" normally is used to refer to a situation where the entity is classified inconsistently as between the U.S. and the foreign jurisdiction in which it is organized or operating, which results in a tax benefit that would not have been available had the entity been classified consistently. 109/ Hybrid entities may result in both advantages and disadvantages to taxpayers (although the advantages tend to occur in tax-motivated transactions involving well-advised taxpayers while the disadvantages tend to affect poorly-advised taxpayers).

(i) Examples of Tax Advantages from Hybrid Entities. A variety of types of tax benefits may arise for a taxpayer when a hybrid entity is employed, as compared to

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109/ The term "hybrid" also is used occasionally to refer to the ability of a taxpayer to decide, based primarily on tax considerations (and often without any significant difference in its economic or legal rights), whether a particular foreign entity should be classified as a partnership or as a corporation for U.S. tax purposes. That concern, which was discussed in the preceding section, is not really a "hybrid" concern at all and, to the extent it is referred to as such, represents a misuse of the term.

the situation when the entity is classified consistently for U.S. and foreign tax purposes. Set forth below is a summary of several different situations in which taxpayers have sought to obtain a tax advantage that derives from such inconsistent classification.

In one such instance, the U.S. owners employ a foreign entity that is classified as a partnership under foreign law, but that is classified as a corporation under U.S. law. The entity earns large amounts of income, but makes no distributions. The U.S. owners claim a credit under Section 901 for the foreign taxes paid with respect to their respective shares of the entity's income, even though they are not reporting that income on a current basis for U.S. tax purposes. 110/ That potential advantage would not be available if the entity were not treated as a corporation for U.S. tax purposes. It should be noted that such advantage has been foreclosed by the courts, at least in the Seventh Circuit, by the Abbott Laboratories case, which held that the U.S. owners are not eligible for a Section 901 credit in this circumstance. 111/

110/ Usually the foreign taxes are actually paid by the foreign entity on behalf of its owners, although the owners may be primarily liable for the taxes under foreign law.

111/ Abbott Laboratories International Co. v. United States, 267 F.2d 940 (7th Cir. 1959), aff'g per curiam 160 F. Supp. 321 (N.D. Ill. 1958). Although the Court indicated

Another instance in which taxpayers might seek to obtain a tax advantage from a hybrid entity is the case in which U.S. source dividends (or nonportfolio interest) are paid to a Cayman Islands entity owned by Canadian persons. If the Cayman entity were classified as a partnership for U.S. tax purposes, the Canadian partners apparently could avail themselves of the reduced rate of withholding applicable under the U.S.-Canada tax treaty. 112/ If,

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that it might have reached a different result had the U.S. taxpayer been ineligible for the indirect credit under Section 902 when the income was later repatriated, the case contains an independent ground for the decision that does not depend on the availability of the indirect credit (i.e., the conclusion that the taxpayer had not "paid" the tax). As discussed below, the holding in Abbott Laboratories could produce harsh results if the taxpayer were not eligible for the indirect credit or if the Service used the decision to whipsaw a taxpayer, arguing that the credits arose not under Section 902, but under Section 901. Under that argument, the credits would arise at the time the underlying taxes are paid and would be wasted if, prior to their expiration under Section 904(c), the taxpayer did not have sufficient income in the proper limitation category to use them. For a good, albeit dated, general discussion of Abbott Laboratories, see E. A. Owens, The Foreign Tax Credit 377-80 (Harvard 1961).

112/ Current U.S. practice is to view the partnership as an aggregate for this purpose. See PLR 8738057 (June 25, 1987); and PLR 8738058 (June 25, 1987). For a general discussion supporting this position, see generally, Loengard, Tax Treaties, Partnerships and Partners: Exploration of a Relationship, 29 Tax Law. 31 (Fall 1975). See also U.S. Tax Treatment of Partnerships and Partners Under U.S. Income Tax Treaties, Report of the Committee on Taxation of International Transactions of the Association of the Bar of the City of New York, reprinted in Highlights and Documents (July 10, 1995) at 279. Note, however, that this apparently is not a result that is expressly required by law. As such, the Service might be able to take the

however, the Cayman entity were classified as a corporation for Canadian purposes, and no pass-through regime (such as a Subpart F analogue) applied in Canada (or the income could be repatriated to Canada as an "exempt surplus" distribution), the dividend would escape current (and possibly any) Canadian tax. If the Cayman entity were classified as a corporation for U.S. tax purposes, that Canadian tax benefit could still be achieved, but the U.S. would impose a 30% withholding tax, since the U.S.-Canada treaty would not be applicable.

A variation on this structure involves Canadian persons organizing a Netherlands Antilles limited liability company. The Canadian investors contribute funds to the LLC and the LLC lends the funds to a U.S. borrower, which could even be an affiliate of the lender. If the LLC is not engaged in a U.S. trade or business through a permanent establishment and the interest is portfolio interest, the interest generally will not be subject to any U.S. income or withholding tax. Moreover, we understand that Canada would classify the LLC as a corporation for Canadian tax purposes and, therefore, the interest income generally will not be

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position that the partnership should be viewed as an entity in such cases, although that is not a position we would recommend.

subject to Canadian income tax as long as it is not distributed back to Canada.

Finally, a hybrid entity may be used to create special benefits under the Section 902 "three-tier" rule mentioned in the preceding section. Assume that a U.S. corporation that owns a chain of foreign corporate subsidiaries is required for some non-tax reason to interpose a new entity between the second- and third-tier foreign corporations and that the new entity would be treated as a corporation for foreign tax purposes. If the new entity were classified as a corporation for U.S. tax purposes, the new entity's payment of income taxes would generate credits for the U.S. owner under Section 902, but those credits would be offset by the loss of the credits generated by the old third-tier corporation (which would become a fourth-tier corporation). In contrast, if the new entity were structured so that it would be treated as a partnership for U.S. tax purposes, the credits attributable to the foreign taxes imposed on the old third-tier corporation would be preserved. 113/

(ii) Examples of Tax Disadvantages from Hybrid Entities. The true hybrid situation may also create significant disadvantages from the perspective of the

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113/ See note 95 and the accompanying text, supra.

taxpayer, particularly when the foreign jurisdiction classifies the entity as a corporation and the United States classifies the entity as a partnership. For example:

1. A foreign investor would be required to file a U.S. tax return if it owns an interest in an entity that is classified as a partnership for U.S. tax purposes and the entity is engaged in a U.S. trade or business. 114/ This may come as a surprise to a foreign investor investing in an entity classified as a corporation for purposes of its home country tax law. In addition, the entity presumably would find itself without any credit to offset its home country tax and the foreign investor may have difficulty claiming a credit in its home country for the U.S. tax it pays.

2. If a foreign entity is classified as a corporation by the United States but as a partnership under the laws of a foreign jurisdiction, the U.S. owners would be required to pay the foreign tax, but, consistent with the result in Abbott Laboratories, they may be denied a credit therefor. The U.S. owners would not be eligible for the indirect credit if they were not 10% corporate owners and, in any event, any indirect credit generally would have to await the repatriation of earnings. 115/

(b) Analysis of the Issue. The three key questions in analyzing hybrid entities are the following:

1. To what extent are the tax advantages that can be derived from the use of hybrid entities in any sense abusive?

2. To what extent would the "check the box" system exacerbate any identified abuses?

114/ See, e.g., Sections 875 and 6012; Treas. Reg. § 1.6012-2(g); and Donroy Ltd. v. U.S., 301 F.2d 200 (9th Cir. 1962).

115/ See Section 902.

3. To what extent would any such abuses be better addressed with specific reforms rather than by denying the "check the box" system to foreign entities?

(i) Legitimate Benefit vs. Abuse. As pointed out above, the taxpayer's position in Abbott Laboratories can be viewed as abusive, but the government's position can produce harsh consequences or result in a taxpayer whipsaw. If one agrees with the Seventh Circuit that the tax does not become creditable until the income on which the foreign tax is levied is includable in the U.S. owner's income for Federal income tax purposes, the credit might never be used (if the taxpayer is not eligible for a Section 902 credit or if the Service asserts that the tax is creditable only under Section 901 and the credit expires unused). Viewed in that light, another court might be sympathetic to a taxpayer taking the same position as the taxpayer in Abbott Laboratories. The Committee would not necessarily disagree with a taxpayer-favorable outcome in a case in which the taxpayer was not eligible for the indirect credit or was being subjected to whipsaw. However, in the absence of a threat of loss of the credit, the taxpayer's position in Abbott Laboratories would appear to offer an unwarranted benefit.

Similarly, a strong argument can be made that it is inappropriate to grant benefits under the U.S.-Canada tax

treaty in the case of the transaction exploiting the inconsistent classification of a Cayman entity for purposes of the treaty. The reduction of the U.S. withholding tax rate under the treaty represents the concession of primary taxing jurisdiction over passive income from the source country (the United States) to the residence country. That concession is implicitly premised on the assumption that the country of residence will impose a significant income tax at the time of the payment, as there is no reason to grant a reduced rate of withholding in the source country when there is no taxation in the country of residence. Hence, where no such income tax is imposed, avoidance of the withholding tax seems abusive. However, it could be argued that current taxation in the country of residence should not be a predicate for reduced withholding, since that predicate is not expressly stated in the law (except in certain treaty provisions), a wide variety of other circumstances may exist where there is no taxation in the country of residence (e.g., a local tax exemption) and the Canadian investors may have only achieved a Canadian deferral benefit, not a complete exemption. In addition, it is arguable that this transaction really represents, at most, either an abuse of Canadian law or a shortcoming in Canada's Subpart F analogue (or its rules for taxing distributions from foreign

corporations). 116/ Finally, it should be noted that these tax results apparently can be obtained using a U.S. LLC, which suggests that this example is not even relevant to the question of whether to extend "check the box" to foreign entities.

The use of a Netherlands Antilles LLC to take advantage of the portfolio interest rules does not appear to the Committee to be abusive. The U.S. withholding tax benefit could be obtained through a variety of other means, including, of course, a direct loan by the Canadian parties. Moreover, it may be possible to achieve the Canadian deferral benefit through other structures, including using a U.S. LLC as the intermediate financing vehicle.

The use of a hybrid entity in the context of the three-tier limitation under Section 902 can be viewed either as legitimate tax planning or as abusive. Some might argue that it is abusive because, although any additional credits

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116/ As a general matter, the Committee does not agree with the view that the Treasury should be indifferent to the consequences of a transaction under foreign law. The question is, however, whether the United States should go so far as to affirmatively tailor its general rules regarding the tax treatment of a transaction to reflect the tax treatment of the transaction under the laws of another jurisdiction. In our view, the Treasury should respond to requests for assistance through proper channels in the case of specific instances of foreign tax law abuse. The United States should not, however, base its tax law on whether there is a potential advantage to taxpayers because of inconsistencies between U.S. and foreign tax rules.

generated by U.S. partnership classification come only with the payment of commensurate foreign taxes, those taxes would have been paid regardless of the entity's U.S. tax classification. Others might argue that it is nonabusive, since it is simply another aspect of the Code's "bargain" for partnerships--i.e., no deferral of income inclusions for the partners (to the extent deferral has U.S. tax significance in this situation) in exchange for not counting the partnership for purposes of the three-tier limitation. Moreover, as noted earlier, the three tier limitation seems to be based on considerations of administrative convenience, and, therefore, no real policy-based consideration seems to be implicated by the interposition of a partnership for this purpose (although such administrative concerns could still be implicated).

The foregoing discussion illustrates that the extent to which hybrid entities present a potential for U.S. tax abuse is often unclear. Indeed, with the exceptions of the Abbott Laboratories and Cayman Islands corporation examples, there are good arguments that they do not present any real U.S. tax abuse potential. However, while the examples discussed above reflect the Committee's own knowledge and experience, it is possible that taxpayers have devised (or will devise) other uses for hybrid entities that

could be considered to be abusive. Against that backdrop, the question arises as to what role, if any, general entity classification law should play in addressing any abuses involving hybrid entities.

(ii) Addressing the Hybrid Issue. The Treasury could address any concerns it may have with respect to hybrid entities either through the general entity classification law (such as, for example, by not extending the "check the box" system to foreign entities) or through specific rules designed to deal with the particular abuses involved. 117/ Obviously, the Treasury's decision as to which option to choose will be influenced by the effectiveness of each option to deal with those concerns.

Simply deciding not to extend the "check the box" classification system to foreign entities would do virtually nothing to address any potential issues presented by hybrid entities, since hybrid entities would continue to exist as they do today. Likewise, extending the "check the box" system to foreign entities should not materially enhance any abuse potential, since, as discussed above, entity

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117/ We note with approval the recent formation by the Service of a working group to examine the use of pass-through entities in international transactions. See Highlights and Documents (May 17, 1995) at 2375.

classification with respect to foreign entities is already elective to a substantial degree. 118/

Alternatively, the Treasury could address the hybrid entity issue by promulgating entity classification regulations requiring that the U.S. tax classification of a foreign entity be consistent with the entity's classification in the relevant foreign jurisdiction. However, identifying the relevant jurisdiction to which to conform may be difficult. 119/ Moreover, the Committee strongly believes that it would not be sound tax policy for the U.S. to cede control over entity classification determinations to foreign jurisdictions. Furthermore, such an inflexible rule could create unintended tax consequences, in some cases

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118/ As indicated earlier, the Committee believes that the degree of electivity is probably greatest with respect to foreign entities employed by investors in tax-motivated transactions, which would include many hybrid situations.

119/ In the case of an abuse of treaty benefits, the relevant jurisdiction(s) would be the jurisdiction(s) whose treaty benefits are being claimed, which often would be a manageable determination. In other cases, identifying the relevant jurisdiction might not be so easy, particularly where the entity does substantial amounts of business in multiple jurisdictions or it has investors located in multiple jurisdictions. In all such cases, the relevant jurisdictions could, of course, change over time.

adver e to taxpayers and in some cases adverse to the government. 120/

A more flexible approach would be to extend the "check the box" system to all foreign entities and then address any perceived abuses with reforms targeted to the specific types of transactions involved. 121/ One situation that clearly should be addressed under that approach is the Abbott Laboratories case. 122/ The alternatives to address that fact pattern would include providing in the "check the box" regulations that, if corporate classification is elected, the investors will be deemed to have consented to

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120/ As discussed in connection with the Abbott Laboratories case, the same transaction may be abusive on one set of facts and nonabusive on another, making an inflexible rule particularly arbitrary.

121/ We note that the Service has used the transactional approach with great success recently. See, e.g., Notice 94-93, 1994-41 I.R.B. 8 (relating to corporate inversion transactions); Rev. Proc. 94-76, 1994-52 I.R.B. 30 (relating to downstream mergers); Notice 94-46, 1994-1 C.B. 356 (relating to Section 367(a) transactions); and Rev. Rul. 94-28, 1994-1 C.B. 86 (relating to the dividends-received deduction).

122/ Extension of the "check the box" system may broaden the number of situations in which the taxpayer's position in Abbott Laboratories could be taken. That is due to the fact that it may be difficult under current law to obtain corporate classification for Federal income tax purposes with respect to an entity that is classified as a partnership in a foreign jurisdiction. But see Rev. Rul. 76-435, 1976-2 C.B. 490. The "check the box" system would eliminate any substantive barriers to achieving that result.

the application of Section 902, and not Section 901, with respect to the creditability of the foreign taxes paid with respect to the income of the entity. A second alternative would be to promulgate Section 901 and 902 regulations expressly adopting the result in the Abbott Laboratories case. 123/

To address any abuses involving withholding tax benefits under treaties, the Service could consider modifying the new anti-conduit regulations. 124/ Such a modification could provide the District Director with the authority to require that, not only will certain intermediate corporate entities be viewed as transparent for purposes of determining the appropriate withholding rate on payments to those entities (as under the current anti-conduit regulations), but, in addition, that certain intermediate entities that otherwise would be classified as partnerships will be viewed as nontransparent for these same

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123/ A third alternative would be to not permit a corporate election for entities that are classified as partnerships under the relevant foreign law. That alternative would be less desirable because of its inconsistency with the simplification goals of the "check the box" proposal and because of the complexities in determining the relevant foreign law where multiple jurisdictions are involved. See supra note 119.

124/ See T.D. 8611 (Aug. 10, 1995), modifying or adding Treas. Reg. §§ 1.871-1, 1.881-0, 1.881-3, 1.881-4, 1.1441-3, 1.1441-7, 1.6038-2, 1.6038A-2, 1.6038A-3, 1.7701(l)-1.

purposes. That approach would have some drawbacks, such as creating uncertainties for taxpayers and introducing the potential for inconsistent treatment among Internal Revenue Districts for the same types of entities. The potential for inconsistent treatment would be reduced, however, if the District Director's discretion were narrowly circumscribed by the regulations and made subject to National Office oversight. 125/

Alternatively, the Treasury could address any hybrid entity abuses involving treaties through the treaty process. That would be the most closely tailored approach, because it would be specific treaty provisions that are being abused. Moreover, that approach could enable the U.S. to obtain reciprocal agreements in appropriate cases. 126/ Treaty solutions would not be appropriate in all cases, however. Moreover, it may take a significant amount of time to renegotiate treaties due to the limited resources

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125/ Such an approach has been taken with respect to transfer pricing penalties under Section 6662(e)(1)(B) by the establishment of a transfer pricing penalty oversight committee. See Richardson Outlines Progress in International Tax Issues, Highlights and Documents (Dec. 15, 1994) at 3329.

126/ For example, the U.S. might obtain Canadian recognition of U.S. LLCs as partnerships. However, to the extent that such recognition were properly viewed as an increase in the tax burden on Canadian residents, it could violate Article XXIX(1) of the U.S.-Canada treaty.

available to the Treasury. Any approach to treaty issues should, however, be handled in a way that does not ignore the treaty provisions themselves or the legitimate concerns of the other party to the treaty.

Finally, the Service could retain the authority to publish rulings excepting specified foreign entities from the "check the box" system if necessary to deal with any treaty abuses. While that approach would raise the administrability problems discussed in Part V.C.2 below and conceivably could put some pressure on the authority issue in the foreign context (because it would result in similar entities being classified differently), it may nonetheless be an appropriate method for targeting a specific known abuse.

(c) Conclusion Regarding Hybrid Entities. In the hybrid area the real abuses appear to be limited to the Abbott Laboratories-type situation and to obtaining treaty benefits without income inclusion. It is clear that if the "check the box" system were extended to the foreign area, any existing obstacles to such potential abuse (such as local law limitations or co-investor constraints on entity selection or design) would be reduced or disappear altogether. Opportunities for abuse exist under present law, however, and the generally sophisticated taxpayers who

utilize hybrid entities are usually able to obtain the desired classification results under the current regulations. Accordingly, the Committee believes that extending the "check the box" system to foreign entities would not significantly expand the potential for the abusive use of the partnership form. Furthermore, there are more specific and effective methods to address abuses involving hybrid entities 127/ than denying all foreign entities an elective classification system. Thus, the Committee firmly believes that the hybrid entity issue should not preclude the extension of the "check the box" system to foreign entities.

5. Conclusion

The Committee believes that the purposes of the "check the box" entity classification system would be furthered substantially if that system were to apply in the foreign context. The Committee believes that entity classification in the foreign context is generally elective today, and that the extension of the elective classification system to foreign entities would therefore achieve a substantial simplification in the tax law without materially

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127/ As indicated earlier, the Committee believes that there definitely should be some specific reform to address Abbott Laboratories-type situation. See, notes 121-3 and the accompanying text, supra. However, we would urge that any such remedies be effective only on a prospective basis.

changing the substantive classification results under current law. The Committee does not believe that the extension of the "check the box" system to foreign entities would exacerbate abuse potential to any significant extent. Moreover, the Committee believes that the most appropriate way to deal with any abuses that do arise is not by denying elective classification to foreign entities, but instead by adopting specific reforms that address the particular abuses involved. Therefore, the Committee recommends that the "check the box system" be extended to all foreign entities. 128/

128/ It also has been suggested that the failure to extend the "check the box" system to foreign entities might create a discrimination problem under our tax treaties. While the Committee believes that these concerns should be considered by the Treasury, it does not appear that nondiscrimination concerns should control the decision of whether or not to extend the "check the box" system to foreign entities. First, if only U.S. owners were treated less favorably because of the classification of a foreign entity, it does not appear that a colorable non-discrimination claim could even arise. Second, as described in the following footnote, except for a narrow class of U.S. business ventures (such as foreign law firms engaged in business in the United States), foreign owners of the entity will typically bear the same U.S. tax burden whether the entity is classified as a partnership or a corporation. Finally, even assuming that a foreign owner of a foreign entity doing business in the U.S. were taxed less favorably because of the entity's classification than he would have been had he been allowed to choose the entity's classification (because, for example, a less beneficial treaty, or no treaty, applies), it is at best unclear whether such foreign owner would be viewed as having shown the requisite discrimination, since it would be his use of a foreign entity, not his status as a foreign national, that

C. Per Se Corporations

Another question that arises in considering whether to extend the "check the box" system to foreign entities is whether certain types of foreign entities should be classified as corporations per se, as is the case with domestic incorporated entities.

1. Substantive Issues

Retaining the current classification rule that domestic state law corporations are per se corporations for tax purposes creates an arbitrariness in the distinction between entities taxable as corporations and entities classified as partnerships. Preservation of the automatic corporate classification for entities organized as state law corporations, however, has long been required by the law and presumably helps preserve the corporate tax base. By contrast, in the foreign context, an automatic classification rule analogous to that for state law corporations does not appear to be required by the Code and the establishment of a class of entities analogous to state law corporations probably would not significantly increase the corporate tax

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would be the basis for the different treatment. See generally Goldberg and Glicklich, Treaty-Based Nondiscrimination: Now You See It Now You Don't, 1 Fla. Tax Rev. 51 (1992).

base. 129/ Moreover, there has been no clear pattern under which certain foreign entities have been classified per se as corporations under the common law definition of "incorporated" or any other test. Indeed, the Service's current view is that even the most corporate-like of foreign entities must be tested under the four-factor test. 130/

It might be argued that establishment of a class of foreign entities analogous to state law corporations would serve to reinforce a notion that the corporate income tax (and the related provisions applicable to corporations) should be applied to entities that have essential "corporateness." However, to the extent that this has ever

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129/ In general, the Treasury is unlikely to collect significantly less revenue due to the fact that a U.S. business is conducted through a foreign partnership rather than a foreign corporation. If the entity is owned by foreign corporations, the U.S. business generally would be taxed as a branch of a foreign corporation in either case. If the entity is a partnership owned by foreign individuals, the higher marginal individual rates would apply, although if rates become inverted, with individuals in brackets below the 35% corporate rate, or if the branch tax otherwise would apply to the entity but not to its individual members, partnership status could produce a U.S. tax benefit for that narrow class of U.S. businesses conducted by foreign individuals. Also, U.S. taxpayers can benefit from using foreign partnerships (as discussed in Part V.B.3 above) and from the elimination of a layer of tax if the foreign entity is engaged in a U.S. business. In any event, as discussed in Part V.B.2 above, the Committee believes that the use of partnerships is currently unfettered, so that extending the "check the box" system to foreign entities would not erode the corporate tax base for that reason.

130/ See note 10 and the accompanying text, supra.

been an objective, the Committee believes that the time has come to abandon it.

2. Administrative Issues

As discussed above, the principal purpose of the "check the box" proposal is to save the considerable resources expended by taxpayers and the government in the entity classification exercise. Also, as discussed above, greater resources generally are required in dealing with the classification of a foreign entity, as opposed to a domestic entity.

In order to compile a list of per se corporations in the foreign context, the Service would be required to go through a very burdensome exercise, examining each foreign country's laws for the creation of business entities (presumably with extensive involvement by foreign counsel) and determining whether each particular entity sufficiently resembled a domestic corporation, and was sufficiently inflexible as to its ability to defeat the four corporate factors, that it should be treated as a corporation per se. 131/ It goes without saying that such a list would have

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131/ In this regard, it is unclear whether such corporate resemblance should be determined under the four-factor test or some other standard. For example, limited liability could be a "super-factor", or the existence of a juridical entity could mandate corporate classification. See also note 136 infra, for a standard using some of the old common law factors.

to be constantly updated as changes are enacted in the myriad foreign laws governing the foreign entities. Monitoring and responding to such changes would impose substantial additional burdens on the Service. Yet, in the view of the Committee, any such exercise by the Service would not significantly reduce any potential abuses of the "check the box" system, as most foreign entities would likely be determined to be sufficiently flexible that they should not be viewed as per se corporations (at least under the four-factor test) 132/ and in any event taxpayers could shift to other forms of legal entities to achieve the desired tax results.

If the Service were to decide that it should attempt to compile a list of per se corporations, it could limit its analysis to the corporate-like entities commonly used by residents of our major treaty partners and commonly

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132/ When the Internal Revenue Manual contained a listing of certain foreign entities and their classifications, it included the following important caveat: "[The Internal Revenue Manual entity classification listing] is to be viewed as a source of information but not as evidence on which to base a Service position. The final determination of the form of business organization depends on the circumstances of each case. The form of organization may not be in fact what it appears to be from generally accepted terminology. Therefore, it is important for an examiner to carefully consider the facts. . . . Accordingly, the classifications in [the I.R.M.] should never be construed as the position of the Service." I.R.M. 4233, Exhibit 500-4 (prior to withdrawal).

used in tax havens as a way to significantly reduce the amount of resources that would be required as compared to a more comprehensive analysis. Such a list could provide taxpayers with significantly enhanced certainty and simplicity in the foreign entity classification area (although, as suggested in the preceding paragraph, such a list would not reduce any potential abuses). Therefore, the Service might reasonably decide that the benefits of establishing a short list of per se corporations (or even per se corporations and per se partnerships) would justify that effort. 133/

3. Conclusion as to Per Se Corporations

The Committee believes that the principal reasons for the retention of a class of per se corporations in the domestic context are not present in the foreign context. Moreover, the Committee believes that it would require a major expenditure of resources by the Service to establish a list of per se entities, with a reasonable likelihood that such a list would become inaccurate over time. However, if a short list of per se entities were developed and

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133/ The Tax Section previously endorsed the establishment of such a short list. See Report on Foreign Entity Characterization for Federal Income Tax Purposes, 35 Tax L. Rev. 167, 209-11 and 214 (1980).

maintained, the benefits of enhanced taxpayer certainty and simplicity might outweigh these considerations.

D. Default Classification

If the "check the box" system is adopted in the foreign context, a decision must be made regarding the default classification for foreign entities with respect to which no election is made. As discussed earlier, the default classification for domestic entities is classification as a partnership. Notice 95-14 states that this default classification was chosen because the Service believes that domestic unincorporated business entities typically are formed to obtain partnership classification, a conclusion with which we concur. Notice 95-14 properly recognizes, however, that the desired classification for foreign entities is much less uniform, which means that there is no single default classification choice in the foreign area that would clearly coincide with experience and expectations in the preponderance of cases. Notice 95-14 proposes to treat any foreign entity that fails to make an election as a corporation, which proposal reflects the assumption that corporate classification is generally preferable in view of the compliance requirements and excise tax provisions that apply to foreign partnerships and their partners.

In our view, there are several possible default classification options for foreign entities:

1. Default classification on a case-by-case basis analyzing:

    a. The four factors that are examined under current law;

    b. How the entity is classified under the law of the jurisdiction(s) in which it is organized or operating;

    c. Other factors that may more appropriately indicate whether an entity-level tax should be imposed; 134/ or

2. Automatic default classification as:

    a. A partnership; or

    b. A corporation.

The merits of an automatic default classification are obvious. Even though that approach could not be justified based upon experience and expectations in the foreign area, the policy objectives of Notice 95-14 would be best served if case-by-case determinations were eliminated completely. However, there are drawbacks to either possible default classification choice.

With automatic default classification as a partnership, foreign investors might inadvertently be required to file U.S. tax returns and pay U.S. taxes, which

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134/ See, e.g., the factors summarized in note 136, infra.

could be a significant disincentive to inbound investment. Moreover, as illustrated in Parts V.B.3 and V.B.4 above, the compliance requirements and excise tax provisions are but two of the adverse consequences that could befall foreign entities (and their owners) if such entities were inadvertently classified as partnerships. Therefore, the Committee agrees that automatic default classification as a partnership is not appropriate.

The Committee also believes, however, that automatic default classification of a foreign entity as a corporation would be problematic. That approach could give rise to unduly harsh results where the owners of a foreign entity generally desire to structure the entity as a partnership, but they cannot obtain the agreement of all the owners to file an election with the Service. That situation undoubtedly would arise frequently in practice, particularly if there is a strict unanimous owner consent requirement (as discussed in Part V.E.1 below). The harsh tax consequences could include the loss of a flow through of tax losses and the imposition of a second layer of tax in the form of the branch profits tax. In addition, the application of treaty provisions to an unincorporated entity that is classified by the U.S. as a corporation may become even more confusing if

increasing numbers of entities are classified as corporations by default.

The Committee therefore believes that serious consideration must be given to a default classification approach that requires case-by-case determinations. The most obvious case-by-case approach would be classification based upon the current four-factor test. That approach would permit the owners of a foreign entity to achieve their tax planning objectives by making appropriate changes to the organizational documents for the entity as they do today in the same manner and with the same flexibility, without having to deal with any burdensome U.S. classification election procedure requiring unanimous owner consent. Furthermore, that approach would be more consistent with expectations based upon current practice than would automatic default classification as a corporation (or any other approach). As discussed later, it also would help bolster the position that the Treasury has the authority to issue "check the box" regulations in the foreign area. 135/ For these reasons, the Committee recommends that default classification in the foreign area be based upon a case-by-case analysis under the four-factor test.

135/ See Part V.E.2, infra.

The Committee is aware that this approach would be, in part, inconsistent with the simplification goal of the "check the box" proposal and would perpetuate (hopefully only in a minor way) a system requiring an analysis of factors which often bear no clear relationship to whether an entity should be treated as a corporation. Therefore, the Committee considered whether less arbitrary standards could be derived and, in cases where no affirmative election is made, whether the regulations should require an analysis of those standards. 136/ On balance, however, we do not think

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136/ It has been suggested that some more relevant hallmarks of corporate status would include: (i) whether the entity is required to file a legal charter or certificate pursuant to which the entity itself (separate from its owners) consents to be governed by the laws of a given state; (ii) whether the foreign law imposes minimum capitalization requirements at the entity level; (iii) whether the foreign law imposes procedural requirements upon the governance of the entity (e.g., a provision for shareholder/owner meetings and the election of a board of directors or managers by such owners); (iv) whether the entity's powers are conferred upon it by statute (rather than by private agreement of its owners); (v) whether procedures exist for maintaining the entity in good standing, irrespective of the composition of its shareholder/owners from time to time; and (vi) provision of state-mandated dissolution procedures, usually requiring the surrender of the entity's charter and powers. See Letter from Kimberly S. Blanchard to the Service dated June 12, 1995 (available on Lexis at 95 TNT 113-53). Cf. Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819). It has been suggested that these hallmarks recognize the entity as a separate juridical person created by the statute, possessed of its own powers and having its own "life" and "death", separate and apart from its members, in contrast to a partnership, which is a creature of contract whose powers and "life" and "death" are closely

that any benefit that might be derived from any greater theoretical accuracy (assuming that it could be achieved) would be significant enough to warrant the effort.

The Committee also considered the extent to which the legitimate expectations of foreign owners should be taken into account. Such expectations might best be served if the Federal income tax classification of foreign entities followed the classification in the relevant foreign jurisdiction. The Committee also rejected that approach because, although to some extent it serves the purposes of resource conservation and simplicity, as discussed above the Committee does not believe that the United States should effectively cede control over the entity classification determination to a foreign jurisdiction. 137/ Moreover, such an approach appears to be especially inappropriate when not undertaken to address a potential abuse.

In sum, the Committee recommends that foreign entities with respect to which no election has been made be classified based upon the result under the current four-factor test. Although such an approach is at odds with certain objectives of the "check the box" proposal, it allows the Treasury to implement the "check the box" system

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linked with its owners.

137/ See Part V.B.4, supra.

with the least disruption to the current entity classification regime and the taxpayer practices that are based upon it. 138/

E. Other Issues

1. Unanimous Consent Requirement

One of the most difficult issues associated with extending the "check the box" system to foreign entities is determining which persons should be required to make the election. Two considerations come to mind. First, U.S. owners of a foreign entity will want the Treasury to preserve their current flexibility to achieve partnership status, without having to face an increased possibility that foreign owners could veto the U.S. owners' classification choice (especially in cases where the foreign owners have nothing at stake). Second, there undoubtedly will be situations where unanimous consent cannot be obtained even when the parties have the best of intentions due to (i) the unwillingness of a foreign person to sign a form that will be filed with the Service or (ii) the sheer impracticality

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138/ It should be noted that the Committee recommends two minor exceptions to the default classification rule in Part V.E.3 below. Those exceptions would be applicable whether the default classification is the result under the four-factor test or automatic corporate classification.

of obtaining the consent of every single owner (particularly in the case of a widely held entity). 139/

The Committee believes that if the default classification in the foreign context is the current four-factor test, as recommended above, U.S. persons could adequately protect themselves from a foreign holdout through the same means as are available today, i.e., by choosing a suitable foreign entity and including appropriate provisions in its organizational documents. Thus, if the Committee's foreign default classification recommendation is accepted, the Committee would not object to the proposed unanimous consent requirement in the foreign context (assuming that it may be satisfied in the same manner as the Committee recommended in Part IV.B.1 above for domestic entities). Should the Committee's foreign default recommendation not be accepted, the Committee believes some relief from the unanimous consent requirement would be appropriate, as discussed below.

For purposes of analysis, one can begin by considering the possibility that only the U.S. owners would

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139/ It may be possible to deal with the first problem by forming the entity with only U.S. owners (and/or foreign owners that are willing to sign the form), at which time the election would be made, and then later admitting the other foreign owners, but that procedure would seem to be unnecessarily formalistic and cumbersome.

be required to join in the election. Such a regime would preserve the U.S. owners' flexibility to achieve partnership status for U.S. tax purposes without increasing the chances that the foreign owners would veto that choice. However, that regime would allow the U.S. owners to elect partnership status for a foreign entity that is engaged in a U.S. trade or business, with the result that any foreign owner not otherwise subject to U.S. tax would be made subject to U.S. tax without its consent. 140/

140/ One might argue that such a foreign owner could choose to invest only upon obtaining assurances that no partnership election would be made (or, if the default classification is partnership treatment, that a corporate classification election would be made). It should be noted, however, that (i) a foreign owner might be poorly advised as to the U.S. tax consequences of investing in a foreign entity (and might not even think to ask about such matters), (ii) even if such an owner is well advised, he may have little leverage to require assurance of corporate classification and (iii) any breach of any such assurance by the U.S. owners may have little cost to such owners because it may result in little or no direct financial damage to the foreign owner.

Additionally, one might argue that such a foreign owner is subject to the same risks today, since the U.S. owners may draft the organizational documents in such a way as to create partnership status for U.S. purposes. Typically, however, the substantive provisions bearing on entity classification under current law are subject to negotiation (even if the foreign owners do not fully appreciate the U.S. tax significance of them), whereas providing U.S. owners with the sole right to make the election can be viewed as depriving a foreign owner of its right to participate in the decision in any way.

A solution to that conundrum would be to provide U.S. owners of a foreign entity with the sole right to make the election if the entity is not required to file a U.S. tax or information return, 141/ and to require the consent of all the owners if the entity is required to file a U.S. tax or information return. 142/ That approach would achieve

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141/ We are assuming for this purpose that the filing requirement of Treas. Reg. § 1.6031-1(d)(1) applies so that no return is required absent a U.S. trade or business or U.S.-source income. But see TEFRA § 404 (filing required if there is a U.S. partner); and Prop. Treas. Reg. § 1.6031-1(d)(2) (filing required if 25% or more of any item allocable to U.S. persons). We note that the contours of this requirement differ depending on whether the entity is classified as a corporation or a partnership, making the analysis somewhat circular. See Treas. Reg. § 1.6012-2(g)(2)(i)(a) (even if corporation has U.S. source income, it need not file a U.S. tax return if its tax liability is wholly satisfied through withholding at the source). Therefore, the Service should consider whether the "return filing" test suggested in the text should instead be an "engaged in a U.S. trade or business" test.

Where such an election is made with respect to a pre-existing entity for the first year in which it has a U.S. owner, the tax consequences (i.e., under Sections 367 and 1491) should flow from the classification selected by the U.S. owner and the manner in which it acquired its interest (i.e., contribution or purchase). Where such an election is made with respect to a preexisting entity for a later year, the consequences should be the same as under current law for conversion from corporate to partnership status or vice versa, as appropriate.

142/ The Committee notes that foreign owners could be affected by U.S. entity classification even in circumstances in which the foreign entity is not required to file a U.S. tax or information return. For example, the treaty consequences to a foreign recipient of a U.S. source dividend or interest payment could differ depending on whether the entity is classified as a corporation or

a reasonable accommodation between the aforementioned interests of U.S. owners and non-U.S. owners. Moreover, it finds precedent in other areas of the tax law. 143/ If that approach is taken, consideration should be given to excluding foreign owners from the consent process only in circumstances where U.S. ownership is significant and/or where the entity itself consents to the election, in order to avoid the possibility that a relatively small group of U.S. owners (who may have very little at stake) could permanently determine the U.S. characterization of the entity.

The Committee is aware that the foregoing approach would depend on potentially controversial factual questions that might not be finally determined until years after the

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partnership. Similarly, if the foreign entity owns raw land in the U.S., the tax consequences of a disposition of that land under Section 897, and the tax consequences of a disposition of an interest in the entity, normally would differ depending on whether the entity is classified as a corporation or a partnership. However, the administrative difficulties associated with broadening the class of foreign persons that must consent would seem to outweigh the benefit of theoretical purity that would be achieved by addressing those less immediate or more attenuated U.S. tax effects.

143/ See, e.g., Treas. Reg. § 1.338-1(g) (foreign purchasing corporation need not file a Section 338 election statement with respect to a foreign target before the earlier of three years after the acquisition date and 180 days after the close of the taxable year within which the purchasing corporation or any member of its affiliated group becomes "subject to United States tax", as defined).

election year. For example, the entity might be found on audit to have been engaged in a U.S. trade or business from inception. Where an entity in good faith takes the position that it is not engaged in a U.S. trade or business, however, the Service should allow the entity to make its election retroactive to the time as of which the Service makes a finding that it was engaged in a U.S. trade or business. If the foreign owners veto the U.S. owners' desired classification, by inaction or otherwise, the result would be the default classification. 144/

In the case of an entity not engaged in a U.S. trade or business that has previously made a valid election to be classified as a partnership with the consent of all its U.S. owners, the Committee believes that the election should remain valid even if the entity subsequently becomes engaged in a U.S. trade or business. That is essentially the same result as under current law. Where a foreign person is a member of an entity classified as a partnership for U.S. tax purposes under current law (which may be the result of tax engineering by the U.S. owners without any concern on the part of the foreign person), the foreign person runs the risk of becoming subject to U.S. tax as a

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144/ This discussion highlights the importance of considering the default classification in conjunction with the unanimous election requirement.

result of changes in the business activities of the entity. 145/ Under current law, the foreign person may be in a position to change the tax classification of the entity by modifying the characteristics of the entity that are relevant under the four factor test, but there is similar flexibility under the "check the box" system in that the foreign person may be able to convince the parties to make a new classification election.

One other issue raised by any nonunanimous consent approach is the estate tax consequence to a foreign owner of a foreign entity. If a foreign entity was not required to file a U.S. tax return, or, under an alternative standard, was not engaged in a U.S. trade or business, partnership treatment could be elected by the U.S. owners under our recommended approach, potentially making the foreign owners

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145/ An issue to be considered in connection with this approach is whether persons that are not U.S. persons, but whose tax situations affect U.S. persons, should be allowed to veto the election with respect to an entity that is not required to file a U.S. tax or information return. For example, should a controlled foreign corporation be considered to be a U.S. person for this purpose (and, if so, how should its U.S. owners be allowed to participate in the election)? How should a foreign partnership owner with U.S. partners be treated for this purpose? What about foreign corporations that are 10% U.S. owned and whose ownership of a foreign entity could affect the treatment of the U.S. owners under Section 902? The Committee believes that allowing any of these entities or their affected U.S. owners an election right would add unnecessary complexity to a regime the objective of which is simplicity.

subject to U.S. estate tax. If that result is viewed as not being appropriate, it could be addressed by limiting the scope of the "check the box" system so that a foreign partnership interest would be treated as a non-U.S. situs asset solely for estate and gift tax purposes if a partnership election were made for the entity without the consent of the foreign owner (or his predecessor in interest). 146/

2. Authority in the Foreign Context

The Committee believes that there is authority for extending the "check the box" classification system to the foreign context for the reasons discussed in Part III.A. above with respect to the domestic context. Indeed, as the foregoing discussion indicates, the policy objectives of simplifying the law and providing greater certainty are stronger in the foreign context, thereby enhancing the reasonableness of extending the "check the box" system to the foreign context. In addition, the Committee believes that its recommendation that the default classification in the foreign context be the result that under the four-factor test would, if accepted, strengthen the authority argument

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146/ For this purpose, the unanimity requirement would apply even where the entity's organizational documents permit the entity to act by less than unanimous action or some other deemed consent procedure is adopted in accordance with our recommendation above or otherwise.

in the foreign context. 147/ In that event, the classification system for foreign entities effectively would be the same as it is today, with the addition of an election to be classified differently than the result under the four-factor test if the required owner consents are obtained.

3. Other Technical Comments

The Committee's technical comments on the application of the "check the box" system in the domestic context (as set forth in Part IV above) also apply in the foreign context. However, the Committee believes two specific situations merit special consideration. First, for any foreign entity that had previously elected to be treated as a partnership but that experiences a technical termination under Section 708 (as discussed in Part IV.B.3

147/ As observed earlier, the authority issue is more likely to be raised in situations where the "check the box" system produces a result different from the four-factor test. See Part III.C, supra. Accordingly, the authority issue should not arise with respect to an entity that failed to file an election if the Committee's recommendation is accepted. In the case where an entity files an election, the unanimity requirement would seem to put any subsequent claim of lack of authority on weak ground (even if such claim were made by a transferee that had not participated in the classification election). However, a challenge could arise if, for example, an entity were not engaged in a U.S. trade or business and the U.S. owners made a partnership election which was binding on the entity and the election subsequently adversely affected a foreign owner, e.g., because, as a result of the entity becoming engaged in a U.S. business, the foreigner unexpectedly found himself a U.S. taxpayer.

above), the default classification of the new entity should be as a partnership. In this case, the expectations of the parties are so clear (and the burden of the owner consent requirement is potentially so serious), that default classification as a partnership is clearly more appropriate than either corporate classification or classification under the four-factor test. Second, for any arrangement that does not involve a separate legal entity but is treated as a separate entity for Federal income tax purposes by the Service on audit (as discussed in Part IV.B.4 above), consideration should be given to applying a partnership default rule. In this context, it again seems more appropriate to treat the separate entity constructed under U.S. tax law as a partnership, rather than applying either a corporate default rule or the four-factor test.

August 30, 1995