REPORT #882

TAX SECTION

New York State Bar Association

Report on the Proposed “Check the Box” Regulations

August 23, 1996

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Hon. Donald C. Lubick,
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson,
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Report on the Proposed "Check the Box" Regulations

Dear Secretary Lubick and Commissioner Richardson:

I am pleased to submit the enclosed report dealing with recently-proposed "check the box" regulations. This report was prepared by an ad hoc committee of the New York State Bar Association Tax Section; the principal drafters were Reuven S. Avi-Yonah, Andrew N. Berg and William B. Brannan.

As discussed in the report, we strongly support the adoption of the proposed regulations. We find that the regulations generally reflect appropriate and thoughtful policy decisions and that they will, when finalized, result in a major simplification of the tax law. However, we do have a number of specific technical comments and recommendations, including the following:

1. The standard for determining when a domestic entity is "incorporated" should be clarified;

2. A person that is treated as a member of an entity under local law and that has any economic interest in the entity should be respected as a member for classification purposes, regardless of the size of that interest;

3. There should be guidance as to the deemed mechanics associated with an elective classification change;

4. The regulations should explain the criteria for inclusion of foreign entities on the per se corporation list and indicate the intentions of the Treasury regarding future updates of the list;

5. A special partnership default rule should be provided for constructive entities; and

6. Certain aspects of the transition and grandfathering rules should be clarified.

Please let me know if we can be of further assistance in helping to finalize the "check the box" regulations.

Respectfully Submitted

Richard L. Reinhold
Chair

Encl.

Tax Report #882

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON PARTNERSHIPS

COMMITTEE ON U.S. ACTIVITIES OF FOREIGN TAXPAYERS

Report on the Proposed “Check the Box” Regulations

August 23, 1996

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON PARTNERSHIPS
COMMITTEE ON U.S. ACTIVITIES OF FOREIGN TAXPAYERS [1]/

Report on the Proposed "Check the Box" Regulations

1. Introduction

This report comments on recently-issued Proposed Regulations that would revise the entity classification rules under Treasury Regulation §§ 301.7701-1 through 301.7701-3 (the "Proposed Regulations"). [2]/

The Proposed Regulations would eliminate the existing four-factor classification test set forth in Treasury Regulation § 301.7701-2 and replace it with a purely elective entity classification system, commonly referred to as "check the box". In April 1995, the Treasury Department and the Service published Notice 95-14 [3]/ indicating that they were considering elective entity classification and soliciting public comment on that concept. In August 1995, the Tax Section submitted a detailed report (the "1995 Report") commenting on Notice 95-14, which report strongly endorsed the "check the box" concept and made a

[1]/ This report was prepared by an *ad hoc* committee (the "Committee") consisting of certain members from each of the Committee on Partnerships and the Committee on U.S. Activities of Foreign Taxpayers. The principal authors of the report were Reuven S. Avi-Yonah, Andrew N. Berg and William B. Brannan. Helpful comments were received from Nancy D; Browne, William L. Burke, Benjamin J. Cohen, Richard G. Cohen, Lori S. Hoberman, Carolyn Joy Lee, Richard O. Loengard, Jr., David Miller, Stephen L. Millman, Yaron Z. Reich, Richard L. Reinhold, Robert H. Scarborough, Michael L. Schler, Daniel Shefter, Robert J. Staffaroni and Eugene L. Vogel.

[2]/ 61 Fed. Reg. 21,989 (May 3, 1996).

[3]/ 1995-14 I.R.B. 7.

number of specific suggestions. [4]/

A. Summary of the Proposed Regulations

The Proposed Regulations would automatically classify as corporations all ordinary corporations organized under domestic law, certain specialized types of entities (e.g., banks) and certain foreign entities identified on an extensive list contained in the Proposed Regulations (the "per se corporation list"). All other entities, referred to herein as "unincorporated entities", would be subject to a new elective classification system. Unincorporated entities with two or more members would be eligible to elect to be treated either as a partnership or as a corporation; unincorporated single-member entities may elect to be treated either as a corporation or to be disregarded for Federal income tax purposes.

An entity would make a classification election by filing with the Service an election form that is signed by each member of the entity or by any officer, manager or member authorized to make the election. The election generally would be effective on the date specified in the election, provided that such date is not more than 75 days prior to the date on which the election is filed. An entity would be able to change its classification by filing a new election, but such an entity could not again change its classification by election within sixty months.

A newly-formed unincorporated U.S. entity that does not make an affirmative classification election would automatically be classified as a partnership (or disregarded if it has only one

[4]/ New York State Bar Association Tax Section, Report on the "Check the Box" Entity Classification System Proposed in Notice 95-14 (Aug. 30, 1995), reproduced in Highlights & Documents (Sept. 6, 1995) at 2929-56.

owner). A newly-formed foreign unincorporated entity that does not file an election would be classified as a partnership (or disregarded if it has only one owner) so long as some member has unlimited personal liability under local law for the debts of the entity; otherwise it would be classified as a corporation.

Existing entities would be subject to elective entity classification on a prospective basis. Existing entities that do not make an affirmative classification election would be classified in a manner consistent with the classification position they had previously claimed. Moreover, the Service would not challenge an existing entity's classification for periods ending before the effective date of the final regulations if the entity had a "reasonable basis" for its claimed classification, it had filed consistently for all prior periods and it had not had its classification position challenged by the Service on audit. In addition, a special grandfather rule is provided for foreign entities on the per se corporation list that were in existence prior to May 9, 1996, and that had previously claimed partnership treatment. Such an entity would continue its classification as a partnership if the entity had a reasonable basis for claiming partnership classification, that classification had not been challenged by the Service on audit and the entity's classification was relevant to any person for U.S. Federal income tax purposes.

The Proposed Regulations implement two of the major recommendations made in the 1995 Report by extending the elective entity classification system to foreign entities and to single-member entities. The Proposed Regulations also include other changes that address a number of other concerns expressed in the 1995 Report, including relaxing the unanimous consent requirement by permitting the election to be made by an authorized person, eliminating the automatic corporate default rule in the foreign context, imposing a special partnership default rule following a termination under Section 708(b)(1)(B) [5]/ and permitting elections to be made up to 75 days after their intended effective date. Certain recommendations made in the 1995 Report were not followed, including a recommendation that the default rule in the foreign context be the current four- factor test and a recommendation that partnerships electing to be classified as corporations be permitted to elect a particular form of incorporation.

B. Overview of the Committee's Comments

The Proposed Regulations generally reflect appropriate and thoughtful policy decisions by the Treasury and Service in light of the comments received by them, including the 1995 Report. Accordingly, the Committee strongly supports adoption of the Proposed Regulations. When finalized, the Proposed Regulations should result in a major simplification of the tax law.

The Committee commends the Treasury and the Service for promptly moving from the conceptual stage reflected in Notice 95-14 to actual proposed regulations. The Committee urges the Treasury and the Service to maintain their momentum and to issue final regulations as soon as possible. Hopefully the regulations can be finalized by the end of this year, so that they will be effective for all of calendar year 1997.

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[5]/ All “Section” references herein are to the Internal Revenue Code of 1986, as amended to date.

The Committee has a number of specific technical comments and recommendations regarding the Proposed Regulations. As set forth in more detail below, the Committee's principal recommendations are the following:

(1) The standard for determining when a domestic entity is “incorporated” should be clarified.

(2) A member treated as such under local law that has any economic interest in the entity should be respected as a member for purposes of the classification regulations, regardless of the size of that interest.

(3) The treatment of certain transactions involving single member entities, including the admission of a second member, should be further clarified.

(4) There should be guidance as to the deemed mechanics associated with an elective classification change.

(5) The regulations should explain the criteria for inclusion of foreign entities on the per se corporation list and indicate the intentions of the Treasury and the Service concerning future updates of the list.

(6) A special partnership default rule should be included for constructive entities.

(7) The regulations should state that in determining whether a member of a foreign entity has personal liability for the debts of the entity, it is not necessary to look through members that are themselves single-member entities that have elected to be disregarded for Federal income tax purposes.

(8) Certain aspects of the transition and grandfathering rules should be clarified.

II. General Comments

A. Meaning of "Incorporated"

By stripping away the current four-factor entity classification test, the Proposed Regulations would leave only two substantive partnership classification issues for most entities: (i) whether the entity is "incorporated" within the meaning of Proposed Regulation § 301.7701-2(b)(1) and (ii) whether the entity is "publicly traded" within the meaning of Section 7704. While there are elaborate regulations dealing with the issue of whether an entity is "publicly traded", [6]/ the Proposed Regulations devote only a few words to the question of whether an entity is incorporated.

Proposed Regulation § 301.7701-2(b)(1) seems to adopt a formalistic test in determining whether an entity is incorporated, since it simply refers to whether "the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic". [7]/ Thus, the Proposed Regulations apparently adopt a "check the box" approach on this specific issue, with the election being made by

[6]/ Treas. Reg. § 1.7704-1. An important subsidiary issue that arises for entities that are publicly traded is whether the entity satisfies the "qualifying income" exception in Section 7704(c). There is relatively little

[7]/ It is conceivable that the approach of the Proposed Regulations is more than formalistic, since state "corporation" statutes may confer a greater level of certainty regarding limited liability than non-corporate statutes because "corporation" statutes, being more ubiquitous and familiar, may involve less choice of law risk. See Bishop and Kleinberger, Limited Liability Companies, § 6.08 (1994).

legislators using the appropriate terminology in the governing statute. [8]/ That approach would make academic the existing body of law regarding what it means to be incorporated. [9]/ However, for some reason, that result is not expressly acknowledged in the preamble or the Proposed Regulations themselves.

The Committee recommends that Proposed Regulation § 301.7701-2(b)(1) make clear the standard to be applied in determining whether an entity is incorporated. The elective approach that seems to be intended would eliminate controversies about an issue as to which there is little clear authority and that ultimately seems to have little policy significance. However, by discarding the existing law on what it means to be incorporated, the elective approach apparently opens the door to domestic “partnership” statutes becoming corporate-like in all substantive respects. [10]/ The Committee makes no substantive

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[8]/ By deferring to the terminology used by the legislature in the governing statute, the Proposed Regulations put pressure on the need for legislators to use or avoid certain key words. It is possible, for example, that there might be a state LLC statute that refers to the entity as a “body politic”, although the Committee is not aware of any specific problem in this regard. Presumably a court's use of the term “corporation”, “body corporate” or “body politic” in describing a statute would not be relevant for this purpose.

[9]/ See, e.g., O'Neill v. United States, 410 F.2d 888, 895-98 (6th Cir. 1969); PLR 7921084 (Feb. 27, 1979); and PLR 8426031 (Mar. 26, 1984), all of which apply the old common law definition of “corporation” based upon Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat) 518 (1819). That definition, which is somewhat amorphous, takes into account factors such as whether the entity exists separate and apart from its members with the power to carry on business and whether it has permanent life.

[10]/ Indeed, if the elective approach is taken on this issue, the next logical question would be whether there should be a “check the box” entity classification system for ordinary corporations (although adoption of that system would require a statutory change). It also should be noted that the elective approach results in an asymmetry between the domestic arena and the foreign arena, since the concept of the *per se* corporation based upon substantive characteristics would exist only in the foreign arena. See Part III.A below.

recommendation on this issue, but does urge that the regulations be clarified, perhaps through the addition of an example or commentary in the preamble.

B. De Minimis Interests

An issue that arises with some frequency in the classification context and other areas is whether a partner whose interest is very small may be disregarded as a partner for Federal income tax purposes. The best illustration of that issue in the classification context under current law is the minimum interest requirement for the general partner of a limited partnership in Revenue Procedure 89-12. [11]/ Similar concerns can arise with respect to an interest that represents an interest in profits but not capital.

This issue arises in two different contexts under the Proposed Regulations: (i) determining whether a two-member entity really is a one-member entity for Federal income tax purposes where one of the member's interest is very small and (ii) determining whether a foreign entity has a member with personal liability for Federal income tax purposes where the member whose personal liability is being relied upon has a very small interest.

The *de minimis* interest issue is a classic illustration of the type of issue that the “check the box” approach is intended to sweep away:it frequently arises in practice, there is very little authority on point, it poses a trap for the unwary and there does not seem to be any strong policy concern at

[11]/ *See* Rev. Proc. 89-12, 1989-1 C.B. 798, section 4.

stake. The Committee appreciates that certain differences between partnership and branch treatment can be material [12]/ and for that reason considered whether there was a policy concern about the potential ability to "elect" single or multi-member treatment through use of de minimis interests. However, taxpayers can virtually always insure the presence of a second member, albeit at some cost, and it would frustrate the simplification goals of the Proposed Regulations to establish law and engage in the factual inquiry necessary to make the fine (and ultimately arbitrary) distinction between a sufficient and an insufficient interest in a partnership. Accordingly, the Committee recommends that the final regulations provide that a member of an entity that is treated as such for purposes of the law under which the entity is organized will be treated as a member for Federal income tax purposes so long as the member holds some economic interest in the entity, regardless of the size of such member's interest and regardless of whether it represents an interest in partnership capital. [13]/

C. Single-Member Entities

As reflected in the 1995 Report, the Committee strongly supports the extension of the elective entity classification rules to single-member entities. The Proposed Regulations provide that "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of

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[12]/ See, e.g., Schler, "Initial Thoughts of the Proposed 'Check The Box' Regulations," 71 Tax Notes 1679, 82-84 (June 17, 1996).

[13]/ The Committee does not propose the converse, i.e, that the failure of a person to be treated as a "member" under local law should preclude the Service from treating that person as a member for tax purposes in appropriate circumstances.

of the owner". [14]/ The consequences of "disregarding" an entity will raise issues under substantive tax law that will need to be considered outside the scope of "check the box". [15]/ The Committee believes "check the box" should not be delayed on account of these considerations, which can be addressed on a case-by-case basis. The Committee does believe, however, that two matters, discussed below, ought to be addressed in the final regulations.

First, as a procedural matter, the Proposed Regulations do not specifically state whether a single-member entity electing to be disregarded needs to have its own employer identification number. [16]/ It is also not clear what type of tax return, if any, a single-member entity should file. [17]/ It would seem appropriate

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[14]/ Proposed Regulation § 301.7701-2(a).

[15]/ Certain issues arising in the treaty context are discussed in Section III.C.1. Consideration should be given to providing one or two simple substantive examples in the final regulations if doing so would not delay issuance of the regulations. For example, it would seem to follow from the Proposed Regulations that if the owner of a single-member limited liability company ("LLC") electing to be disregarded exchanged its entire LLC interest for property which was of a like kind as that held by the LLC, such exchange should qualify under Section 1031. As another example, questions may arise upon the merger of a domestic corporation into an LLC that has a domestic corporate owner and has elected to be disregarded, such as whether the transaction is a reorganization (assuming stock of the domestic corporate parent is the acquisition consideration) and, if so, whether it is a "A" reorganization or a "C" reorganization. See Treas. Reg. § 1.368-2(b)(1) (an A reorganization must be effected through a merger pursuant to the "corporation laws" of the United States or a state).

[16]/ Paragraph III.C.1 of the preamble to the Proposed Regulations provides that if a single-member entity elects to be disregarded, the employer identification number of the owner should be displayed on the election form. That rule is consistent with the conclusion that the entity itself does not have an employer identification number.

[17]/ The Committee understands, based upon its experience with returns filed by single-member entities under current law, that the Service normally will reject a Form 1065 filed by a "partnership" where only one partner is listed.

to clarify these points in the final regulations.[18]/

Second, the Committee recommends that the final regulations address the tax consequences of adding a second member to a single-member entity. For example, assume that A, the sole owner of an LLC that has elected to be disregarded, transfers part of his interest in the LLC to B for cash and the LLC thereafter either elects or defaults to partnership classification. There are at least three ways to characterize the mechanics of that transaction: (i) a sale of assets by A to B, followed by the organization of a partnership by both A and B, (ii) the organization of a new partnership by A and B, with A contributing all of the assets of the LLC and B contributing cash, followed by the distribution of the cash to A, and (iii) the organization of the partnership by A, immediately followed by the sale of an interest in that partnership to B. [19]/ The tax treatment of each of these transactions is different. [20]/

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[18]/ We note that similar issues arise with respect to grantor trusts, which issues were addressed in regulations that were finalized earlier this year. Treas. Reg. § 1.671-4.

[19]/ While A technically could not organize a partnership by itself as a matter of state law, this technicality could simply be ignored, since it exists for only a brief moment. Cf. Prop. Treas. Reg. § 1.708-1(b)(1)(iv). Alternatively, A could be deemed to have organized the partnership with an affiliate, who immediately withdrew after B's admission.

[20]/ The transaction described in (i) above would be governed by Sections 704(c) and 721. Since there would be no disparity between the fair market value and the basis of assets deemed purchased by B, Section 704(c) would not apply to the contribution of those assets. Section 704(c) would apply, however, to the assets deemed contributed by A, and B would have a first call upon the depreciation with respect to those assets, subject to potential ceiling rule limitations. See Treas. Reg. § 1.704-3(b)(1). In the joint contribution scenario described in (ii) above, the transaction would presumably be treated as a “disguised sale” under Section 707(a)(2)(B), with tax consequences similar to those in (i) above. In scenario (iii) above, there would be no step-up in the basis of the assets at the partnership level, but B could get the benefit of any basis step-up through a Section 754 election. There may also be collateral differences in tax treatment among the three alternatives, such as under Section 168 or Section 197. The Committee notes that the transaction described scenario (iii) is analogous to the treatment of a “qualified REIT subsidiary” within the meaning of Section 856 (i) that ceases to qualify as such. See Section 856 (i)(3).

if they had gone to the trouble of structuring additional steps in the transaction. [21]/

The foregoing recommendation is similar to a recommendation made in the 1995 Report that specific guidance be provided concerning the tax treatment when a partnership elects to be taxed as a corporation. [22]/ The Committee believes that the need for guidance concerning the admission of a second member to a single member entity is even more compelling. As noted above, there can be significant differences in the tax treatment of such an admission, depending mainly upon the form of the transaction. Accordingly, failure to provide guidance in this area would create uncertainty and would motivate well- advised taxpayers to engage in the sort of nonproductive tax engineering that is contrary to the spirit of the Proposed Regulations.

D. Changes in Classification

The Committee has two comments regarding elective changes in entity classification.

First, the Committee objects to the five-year prohibition on a second classification change in Proposed Regulation § 301.7701-3(c)(1)(ii). While it would be unusual in practice for an entity to seek to change its tax classification twice within a five-year period, there appears to be no

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[21]/ For example, A might have liquidated the LLC and then entered into any one of the three described transactions. As a practical matter, there might be contractual limitations on the ability of A and B to liquidate the LLC and engage in these transactions and there may be state income, sales or transfer tax implications as well. Nonetheless, these would not seem sufficient reasons to deny A and B the Federal income tax consequences of any one of these three alternatives.

[22]/ See the 1995 Report, Part IV.B.2. See also Part II.D below, which reiterates those recommendations.

legitimate policy reason to impose such an artificial time limitation, particularly given that it is inconsistent with the policies behind the "check the box" system. [23]/ The suggestion in the preamble that a second classification change could be effected through an actual transfer of assets to a new entity with the desired classification is not persuasive, since there is no policy reason to impose on taxpayers the transaction costs, third-party consent requirements and other difficulties that may be associated with an actual conversion transaction. Another difficulty with the five-year limitation is that it may make it impossible for a purchaser of an interest in an entity that seeks to have the entity make a new election to change its classification (or even to confirm an old election) to have certainty that the new election will be effective. Accordingly, the Committee recommends the elimination of the five-year prohibition.

Second, the final regulations should address in greater detail the deemed mechanics associated with an elective classification change. As discussed in detail in the 1995 Report, [24]/ the need for guidance concerning the deemed mechanics associated with a partnership-to-corporation classification change is especially important, since under current law a taxpayer is free to choose any one of three different ways to incorporate a partnership, and the taxpayer's choice of form will be respected in determining the tax consequences. [25]/

[23]/ The Committee observes that the prohibition on a second elective change within five years is superficially analogous to the restriction contained in Section 1362(g) on re-electing S status after an S election termination. The situations are quite different however. Electing in and out of S status has no immediate tax consequence. In contrast, changes in classification are potentially taxable events and such changes can readily be accomplished through means other than the filing of an election.

[24]/ The 1995 Report, Part IV.B.2.

[25]/ See Rev. Rul. 84-111, 1984-2 C.B. 88.

The Committee believes the need for this guidance continues and that the final regulations are the appropriate place for it. The Committee also believes comparable guidance should be provided concerning the deemed mechanics of a corporation- to-partnership conversion.

The 1995 Report recommended that taxpayers be permitted to freely select among any of the three alternative ways to incorporate a partnership. The 1995 Report further recommended that if the foregoing recommendation were not adopted, or if it were adopted but the entity failed to select among the three alternatives, that the transaction be treated as a transfer of all of the partnership's assets to a newly formed corporation in exchange for the corporation's stock followed by a liquidation of the partnership. [26]/ Since the Proposed Regulations do not address such issues, the Committee urges that its prior comments be reconsidered.

With respect to corporate-to-partnership conversions, while the Proposed Regulations themselves contain no specific guidance concerning the deemed mechanics, Part III.C.3 of the preamble indicates that upon such, an election owners must recognize gain if any under the rules applicable to actual corporate liquidations. [27]/ The Committee believes that it would be appropriate to provide taxpayers the flexibility to elect the deemed mechanics of a corporate-to-partnership conversion in a manner analogous to the three ways to effect a

[26]/ The Committee notes that this suggested form is analogous to the deemed mechanics for a Section 708(b)(1)(B) termination contained in proposed regulations under Section 708. See Prop. Reg. § 1.708-1(b)(1)(iv).

[27]/ This conclusion is consistent with Rev. Rul. 63¬107, 1963-1 C.B. 71. Neither the preamble nor the revenue ruling, however, spells out the deemed mechanics of the liquidation of the corporation and the constitution of the partnership.

partnership-to-corporate conversion. Specifically, taxpayers should be permitted to elect to treat the conversion as (i) a liquidation of the corporation through an in-kind distribution of its assets followed by a transfer of its assets to a new partnership; (ii) the transfer by the corporation of its assets to a newly organized partnership followed by a liquidation of the corporation, or (iii) the contribution of the shares of the corporation to a newly organized partnership followed by a liquidation of the corporation. The Committee recognizes that each of those forms of conversion may have somewhat different tax consequences due to the limitations of Section 751 and other factors and that an elective system may be inconsistent with certain rulings involving corporation-to-partnership classification changes that assume that the conversion mechanics involve an asset distribution as described in (i) above. [28]/ However, the Committee believes that the "check the box" regulations should acknowledge the practical reality that taxpayers currently have the flexibility to orchestrate actual conversion transactions with the desired mechanics and they will continue to do so if they are not permitted to elect to be treated as if they had.

Consistent with the recommendation on partnership-to-corporation conversions, the Committee recommends that if the foregoing recommendation on corporation-to-partnership conversions is not adopted, or if it is adopted but the entity fails to select among the three alternatives, that the transaction be treated as a transfer of all of the corporation's assets to a newly formed partnership followed by a liquidation of the corporation.

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[28]/ See, e.g., Tech. Adv. Mem. 9618003 (Jan. 17, 1996) (situations 1 and 2); and Priv. Let. Rul. 9401014 (Oct. 7, 1993). Other rulings involving such classification changes are less clear as to the deemed mechanics, but seem to contemplate asset distributions. See, e.g., Rev. Rul. 63-107, 1963-1 C.B. 71.

III. Application in the Foreign Context

The Committee strongly endorses the decision to extend the “check the box” system to foreign entities. Given the taxpayers' ability to achieve elective classification for foreign entities under current law, the extension of the “check the box” system to foreign entities should substantially further the simplification goals that the Proposed Regulations were designed to achieve.

The Committee also applauds the decision to permit authorized representatives to make an election under Proposed Regulation § 301.7701-3(c)(2)(ii) as a reasonable compromise between the need to avoid adverse consequences for foreign members of an entity that elects to be treated as a partnership and is engaged in a U.S. trade or business, and the need to avoid giving each member of a foreign entity unlimited veto power.

The following comments address three specific issues arising in the foreign area which should be clarified: (1) the *per se* corporation rule; (2) treatment of constructive entities; and (3) treatment of single-member entities.

A. Per Se Corporations

Proposed Regulation § 301.7701-2(b)(8) sets forth a list of foreign entities that will be automatically treated as corporations for Federal income tax purposes, without regard to the terms of their organizational documents. The Committee supports the Treasury's decision to publish a list of *per se* foreign corporations. [29]/ However, as noted in the 1995 Report, that approach will necessitate that the Treasury and the Service monitor the law applicable to foreign entities to determine whether new entities should be added or existing entities deleted. [30]/

In its current form, the *per se* corporation list is something of a "black box", since the Proposed Regulations do not discuss how the list was compiled. The *per se* corporation list is all the more mysterious given that the concept of a *per se* corporation in the domestic context now appears to turn entirely on the statutory nomenclature, rather than substantive characteristics. [31]/ To better inform taxpayers regarding the *per se* corporation list, it would be helpful for the Treasury to state its criteria in deciding whether to include an entity on the list. In addition, it would be useful if the Treasury could indicate whether the list is comprehensive as of the date on

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[29]/ The 1995 Report summarized certain advantages and disadvantages of the *per se* corporation list approach, but questioned whether the establishment and maintenance of a comprehensive list was an efficient allocation of government resources given that it does not seem to be required by law and would not prevent abuses. The 1995 Report suggested that the benefits of a short list dealing with major treaty partners and common tax havens might be worth the expenditure of effort. *See* the 1995 Report, Part V.C. In a prior report, the Tax Section endorsed the establishment of a *per se* corporation list. *See* New York State Bar Association Tax Section, *Report on Foreign Entity Characterization for Federal Income Tax Purposes*, 35 *Tax L. Rev*. 167, 209-11 and 214 (1980).

[30]/ It will only be a matter of time before a country with an entity on the *per se* corporation list modifies its statute to attempt to get the entity off the list, perhaps simply by providing for elective personal liability for one or more members or elective lack of continuity of life. Alternatively, a country might be tempted to "clone" its statute, subject to minimal changes intended to avoid *per se* corporation status for the new entity.

[31]/ *See* Part II.A above. As discussed earlier, the domestic concept of the *per se* corporation was based upon the old common law standard of the meaning of "incorporated", whereas the *per se* corporation list in the Proposed Regulations presumably is based upon the current four-factor entity classification test, which is somewhat different.

which the list is promulgated and indicate its intentions concerning updating the list. The Treasury also should consider setting forth specific transition rules for future additions to the list. [32]/

It should be noted that the Committee has not attempted to analyze all the entities on the per se corporation list to determine whether any such entities should not be on the list, nor has the Committee attempted to analyze other types of entities to determine whether they should be on the list. If the criteria for inclusion on the list are made clear, the Committee may have additional comments on the specific entities on the list.

B. Constructive Entities

When the Service determines on audit that a contractual or other arrangement between taxpayers is a separate entity for Federal income tax purposes, special concerns may arise in foreign contexts. In particular, since such a constructive entity [33]/ obviously will not have made an affirmative classification election under the Proposed Regulations, its default classification becomes the critical issue.

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[32]/ The Committee observes that the Service currently takes the position that a change in the statute pursuant to which an entity is formed cannot, by itself, result in a classification change. See Rev. Rul. 63-107, 1963-1 C. B. 71. Presumably that rule would not apply to a change in classification caused by an entity being added to the per se corporation list.

[33]/ The term “constructive entity”, as used herein, means an arrangement which, for Federal income tax purposes constitutes a separate entity, even though it is not an entity under local law. For this purpose, an arrangement is considered an entity under local law if it constitutes a juridical entity with an identity separate from its owners. Indicia of such an entity would be the right to hold property and to sue or be sued in its own name. The Committee is aware of certain business arrangements involving profit sharing in the foreign area that are governed by provisions of local law that do not rise to the level of a juridical entity. If any of these arrangements were found to constitute an entity for U.S. purposes, such an entity would be a constructive entity.

As a threshold matter, it is unclear whether the constructive entity is foreign or domestic for purposes of determining the applicable default rule under the Proposed Regulations. The Proposed Regulations provide that an entity is domestic if it is “created or organized in the United States”. [34]/ However, since the entity will not have been organized under an identified statute, it is unclear what criteria should apply in making that determination. The possibilities include the law governing the contractual arrangements of the participants, the place where the contractual arrangements were negotiated and executed, the nature of the participants themselves and the place where the underlying business activities are conducted.

Even where it is established that the constructive entity is foreign, there can be additional uncertainties. Since the members of a constructive entity have not availed themselves of the statutory protection of a limited liability entity, they generally would have personal liability for debts arising in connection with the arrangement and, therefore, partnership treatment ought to apply by default. There remains nonetheless a question whether that liability satisfies the requirements of the Proposed Regulation, given the difficulty of determining exactly what are the “debts” of the entity [35]/ and that there may be no single participant with liability (whether direct or vicarious) for all the debts of the entity.

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[34]/ Proposed Regulation § 301.7701-1 (d).

[35]/ For example, assume that a constructive partnership is found to exist by reason of a leasing arrangement where the lessor receives a percentage of the lessee's profits. Are the “debts” of the entity for this purpose the debts related to the leasing operations, for which the lessee is presumably liable but possibly not the lessor?

Two additional problems can arise. The first is a technical issue arising because the determination whether any member has personal liability for debts of the entity is to be made "based solely on the statute or law pursuant to which the entity is organized." [36]/ Since a constructive entity is not organized pursuant to any statute or law in the ordinary sense, under a literal reading of the Proposed Regulations it would be classified as an association even if the participants had personal liability under applicable law. The second issue arises where the participants are single-member entities that have elected branch treatment, since it is not clear how to determine whether the members have personal liability for this purpose. [37]/

The technical infirmity with respect to the first issue was surely not intended. In the case of a constructive entity, the parties to the arrangement would expect pass-through treatment, since they chose not to operate through a separate legal entity. This problem could be resolved either by addressing the specific issues discussed above or by simply providing a special partnership default rule for constructive entities. [38]/ We recommend the latter approach, because it avoids having to provide definitive guidance in the classification context regarding whether a constructive entity is domestic or foreign, which is a difficult issue that has significance outside the classification area. [39]/

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[36]/ Proposed Regulation § 301.7701-3 (b)(2)(ii).

[37]/ See Part III.C.2 below.

[38]/ See the 1995 Report, Part V.E.3.

[39]/ See, e.g., Section 1491.

C. Single-Member Entities

1. Application of Treaties to Single-Member Entities. In the preamble to the Proposed Regulations, the Treasury expresses its concern that the use of partnerships in the international context will have to be carefully monitored to prevent results that are inconsistent with U.S. tax policy and with tax treaties.

The Committee notes that the special concerns regarding hybrid entities in the treaty context also will arise with respect to one-member entities that are treated as branches. For example, suppose corporation A is a resident of jurisdiction X, which has a tax treaty with the United States that eliminates U.S. withholding on interest payments to residents of X. If A had a U.S. subsidiary and lent it money, there would be no U.S. withholding on interest payments from the subsidiary to A, but A would pay income tax to X on its interest income. If, however, X did not tax A on income earned by its subsidiaries under a Subpart F-type regime, A could set up an intermediate subsidiary B in a tax haven, elect to treat B as a branch for U.S. tax purposes and provide funds to B to be lent to the U.S. subsidiary. In that case, absent any rule to the contrary, neither X {because the earnings of B are not imputed to A) nor the U.S. (because the interest paid to B is treated as paid to A and, therefore, is exempt under the treaty) would tax the interest. [40]/ Similarly, dividends paid by the U.S. subsidiary to B arguably would be subject to the reduced treaty withholding rate, even though such dividends may not be subject to X income tax on a current basis.

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[40]/ See the 1995 Report, Part V.B.4.

As with multi-member hybrid entities, such results may be inappropriate, since the purpose of a tax treaty is to eliminate double taxation, not to create opportunities to avoid taxation altogether. [41]/ The Committee assumes that the Treasury's concern in this area is reflected in the recently proposed withholding regulations, which would prevent the application of reduced U.S. withholding rates under a treaty to foreign hybrid entities unless the income involved is currently taxable by the other treaty partner. [42]/ These proposed regulations would significantly reduce the potential for abuse associated with foreign entities that are treated as partnerships for U.S. tax purposes but as corporations for foreign tax purposes. However, since the use of hybrid entities in international transactions is possible under current law, the Committee does not believe these concerns warrant delay of the final “check the box” regulations.

2. Existence of Personal Liability. As indicated above, the “default” classification for a foreign entity is partnership treatment (or, if applicable, branch treatment) if at least one member has “unlimited liability”. [43]/ The Proposed Regulations specify that “unlimited liability” exists if a member has personal liability for the debts of the entity “by reason of being a member, based solely on the statute or law pursuant to which the entity is organized”. [44]/ The preamble indicates that

[41]/ Note that the same problem would arise under current law if B were treated as a corporation by X but as a partnership by the U.S. under the four-factor test. B could even be a U.S. entity (such as an LLC), as long as X treated it as a corporation, the U.S. treated it as a partnership and it avoided being engaged in a U.S. trade or business.

[42]/ Prop. Treas. Reg. §§ 1.1441-1(c)(6)(ii)(B) and 1.1441-6(b)(4)(i). The Tax Section expects to submit a report on these proposed regulations in the near future.

[43]/ Proposed Regulation § 301.7701-3(b)(2)(i).

[44]/ Proposed Regulation § 301.7701-3(b)(2)(ii).

this determination is to be made without regard to the financial capacity of the member to satisfy its liability.

A unique problem in determining the applicability of the partnership default rule arises in the context of an entity that has as one of its members a single-member entity that has elected branch treatment. In that case, the single-member entity may have personal liability for the debts of the underlying entity as a matter of local law. However, it is not clear whether that represents personal liability of the “member” for this purpose, since the “member” in the eye of the Federal tax law is the parent of the deemed branch and that person normally would not have personal liability for the obligations of the underlying entity. Even if the single-member entity had some assets in addition to its interest in the underlying entity, the liability of the parent would be limited to the value of such assets, and the preamble suggests that limited personal liability is not sufficient.

The Committee urges that this issue be clarified. Because the Proposed Regulations do not require that a multi-member entity (or, indeed, even a single-member entity that does not elect branch treatment) have substance for its personal liability to be relevant, a single-member entity should be classified as a branch in the same manner, i.e., that personal liability would be found if the single-member entity had personal liability for the obligations of the underlying entity under local law. That approach also has the virtue of avoiding the question of whether personal liability could exist with respect to a single-member branch that had a significant amount of other assets (and how significant those assets would need to be).

IV. Transition Rule Issues

A. Existing Unincorporated Entities

Under Proposed Regulation § 301.7701-3(b)(3), an unincorporated entity in existence prior to the effective date of the regulations will be deemed to have elected to be classified in the same manner as the entity claimed under prior law, unless the entity files an affirmative election to the contrary. In the case of a foreign entity, this rule would apply only if the entity's classification was “relevant” to any person for Federal income tax purposes prior to the effective date of the regulations. This rule raises two issues that require further clarification in the final regulations.

First, the regulations should make clear what it means for an entity to have “claimed” a particular type of classification. The Committee recommends that the regulations state expressly that an entity will be treated as having “claimed” a classification position for this purpose if it was clearly reflected in a tax return or other form filed with the Service (or other U.S. taxing authority applying similar standards) or, in the case of an entity not required to file tax returns or forms that would reflect a U.S. tax classification position, in a written communication sent to substantially all its members subject to U.S. taxing jurisdiction, in the entity's organizational document or in an offering memorandum pursuant to which interests in the entity were sold. [45]/ Any such “claimed” classification position, regardless of when made, should govern unless it has been superseded by a subsequent document of the same type clearly reflecting a contrary classification position and the entity itself and its members have filed their tax returns on a basis consistent with the claimed change in classification. Moreover, the regulations should make clear that a classification position taken by a direct or indirect member of the entity generally does not satisfy the requirement that the entity claim a classification position. While we do not find that rule altogether satisfactory in cases where the members have taken clear and consistent classification positions, it avoids the many difficult issues that would arise if member positions were relevant. [46]/ The one exception to the foregoing recommendation regarding the relevance of member positions would be the case of the one-member entity that has been treated as a “nothing” for Federal income tax purposes; in that event, the entity presumably would have had no need to file a return of its own and, therefore, the position taken by the member should be sufficient.

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[45]/ The Committee observes that entities formed shortly before the effective date of the final regulations generally will not have filed a tax return or report reflecting a classification position before that date. (For example, if the regulations are effective as of January 1, 1997, entities formed during 1996 generally will not have filed a return or report prior to that date, except possibly an estimated tax payment voucher.) However, the final regulations should clarify that a classification position claimed by such a newly-formed entity after the effective date that relates to the pre-effective date period would be sufficient for purposes of the prospective treatment of the entity.

[46]/ In that event, it would be necessary to decide (i) how direct and significant an interest an owner must have before its own treatment of the entity provides a basis for grandfathering the entity, (ii) what happens if the owners have taken inconsistent classification positions and (iii) what evidentiary standards are to be applied in verifying owner classification positions.

Second, the final regulations should clarify what it means for the classification of a foreign entity to be “relevant” to any person. In the case of any entity not engaged in a trade or business in the United States, it should be sufficient that the classification of the entity is relevant to any U.S. person with a direct or indirect ownership interest in the entity, whether for purposes of direct U.S. taxation of such U.S. person pursuant to Subchapter K or for purposes of indirect effects under Section 901 or 902, Subpart F, FIRPTA or other provisions of the Code.

B. Safe Harbor for Prior Periods

Under Proposed Regulation § 301.7701-3(e)(2), an existing entity's claimed classification will be respected for all periods prior to the effective date of the Proposed Regulations if it (i) claimed that classification for all prior periods, (ii) had a reasonable basis for its claim, and (iii) has not been notified in writing on or before May 8, 1996, that its classification is under examination by the Service. This rule applies not only to entities in existence before May 8, 1996, but also to entities newly formed thereafter but before the promulgation of the final regulations.

This safe harbor rule raises several issues. First, as with the rule described in the preceding section, it is unclear what is meant by the entity's having “claimed” partnership classification for all prior periods. The Committee recommends that the clarifications discussed in the preceding section apply in this context as well.

Second, clarification should be provided concerning the proper interpretation of the consistency requirement. For example, an entity should not be viewed as having reported inconsistently if its charter had been amended in a way that resulted in a change to its classification under the four factor test and the entity's tax reporting properly reflected that change. In other words, the final regulations should permit the safe harbor rule to apply where partnership classification was not claimed in all prior periods if any change in the entity's position resulted from a material change in circumstances.

C. Grandfathering Rule for Preexisting Per Se Corporations

Under Proposed Regulation § 301.7701-2(d), a foreign *per se* corporation will nevertheless be classified as a partnership if (i) it was in existence and claimed to be a partnership on May 8, 1996, and for all prior periods, (ii) the classification was relevant for Federal tax purposes at any time during the period that includes May 8, 1996, (iii) the entity had a reasonable basis for claiming partnership classification and (iv) neither the entity nor any member had been notified in writing that the entity's classification was under examination by the Service.

The Committee notes that the Proposed Regulation is unclear concerning the classification of a grandfathered foreign entity on the *per se* corporation list which is classified as a partnership if such entity undergoes a termination under Section 708(b)(1)(B). Since a termination results in the creation of a new entity for tax purposes, [47]/ the newly created entity might not be grandfathered since it was not technically in

[47]/ *See* Treas. Reg. § 1.708-1(b)(1)(iv).

existence prior to May 9, 1996. In such case there appear to be two conflicting rules in the Proposed Regulations. The per se corporation rule would seem to mandate that the entity automatically be classified as a corporation. [48]/ However, the Committee notes that the Proposed Regulations also provide that when a partnership undergoes a termination under Section 708(b)(1)(B) "the resulting entity created by such termination is a partnership."[49]/

The Committee believes the Proposed Regulation should be clarified concerning the status of grandfathered entities on the per se corporation list that undergo a termination under Section 708(b)(1)(B). The Committee expresses no view on whether such entities should lose their grandfathered status. The Committee considered that preservation of grandfathering potentially might facilitate abusive trafficking in grandfathered entities. However, the Committee notes that, unlike the publicly traded partnership grandfather rules, [50]/ the foreign per se corporation grandfathering continues even if the entity experiences organic changes, such as the addition of a substantial new line of business. In addition, the Committee believes there may not be a sufficient number of grandfathered entities to warrant terminating grandfather status upon a Section 708(b)(1)(B) termination. The Committee is also concerned that there might be disastrous tax consequences from inadvertent Section 708(b)(1)(B) terminations of grandfathered per se corporations.

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[48]/ Proposed Regulation § 301.7701-2(b)(8).

[49]/ Proposed Regulation § 301.7701-3(d).

[50]/ Partnerships that were grandfathered under the publicly traded partnership rules lose their grandfathering when there is the addition of a substantial new line of business. Treas. Reg. § 1.7704-2(b)(2). This regulation implements the effective date provision of the legislation. See Pub. Law No. 100-203, § 10211(c). Treas. Reg. § 1.7704-1(e) provides a separate regulatory grandfathering rule, also subject to a substantial new line of business provision.

This grandfather rule also raises a number of other issues, which should be addressed by the final regulations. First, it is unclear whether the entity had to have taken an affirmative classification position, or whether a position taken by a member is sufficient. The Committee recommends that the clarification discussed in Part IV.A above apply in this context as well.

Second, as suggested above, the consistency requirement should be viewed as having been satisfied if any change in the classification position taken by an entity was the result of a material event occurring before May 8, 1996.

Third, the Proposed Regulations literally seem to require the entity to be treated as a partnership forever, since there is no reference in Proposed Regulation § 301.7701-2(d) to the ability of the entity to elect corporate treatment. Presumably being grandfathered should not prevent the entity from electing corporate status in the future. [51]/

Fourth, the rule that the status of the entity must be relevant for U.S. tax purposes should be clarified to include cases in which the status becomes relevant after May 8, 1996. Clarification concerning the determination of "relevance" should be provided in manner similar to that suggestion in Part V.A, above.

Finally, the grandfather rule should apply to a single member entity whose owner treated it as a branch (rather than a partnership) for all prior periods.

August 23, 1996

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[51]/ Compare Proposed Regulation §301.7701-3(b)(3) relating to "eligible existing entities", which expressly states that the previously claimed treatment continues "unless the entity elects otherwise".