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Memorandum

Re; Entity Classification

In today's global society, businesses now operate across borders. Entities organized and established in foreign jurisdictions are now entering into lines of business in the United States. With the movement of labor and capital, foreign business owners are moving to the United States. The classification of a foreign entity as a corporation, a partnership, or disregarded entity, potentially affects many aspects of U.S. taxation.

The classification of a foreign entity as a corporation, a partnership, or disregarded entity, potentially affects many aspects of U.S. taxation. Entity classification affects the extent to which, or whether an entity is subject to U.S. tax. A U.S. corporation pays U.S. tax on its worldwide income while a foreign corporation generally pays U.S. tax only on its income effectively connected with a U.S. trade or business. The entity classification regulations under IRC § 7701 ("the check-the-box regulations") allow certain business entities to choose their classification for Federal tax purposes under an elective regime.

A business entity is any entity recognized for federal tax purposes that is not properly classified as a trust or otherwise subject to special treatment under the IRC. Certain business entities are by definition classified as corporations under Treas. Reg. § 301.7701–2(b). Per Se" corporations are statutory corporation and are not allowed to choose their classification. Treas. Reg. § 301.7701–2(b)(8) contains a list of these foreign entities.

A business entity that is not necessarily classified as a corporation under Treas. Reg. § 301.7701–2(b), (i.e., an "eligible entity") can elect its classification for federal tax purposes under the rules of Treas. Reg. § 301.7701–3. Those rules provide that an eligible entity with at least two members can be classified as either a partnership or an association taxable as a corporation. An eligible entity with a single member can be classified as an association or "disregarded as an entity separate from its owner (a "disregarded entity").

The check-the-box classification regulations provide a default rule for an eligible entity that does not elect its classification. An election is necessary only when an eligible entity chooses to be classified initially other than under the default rule, or when the entity chooses to change its classification. The default rules are different for foreign and domestic entities

Generally, a foreign eligible entity is an eligible entity that is not created or organized in the U.S. The key for the default classification for foreign entities is whether or not the members have limited liability. A foreign eligible entity is an association taxable as a corporation if all of its members have limited liability. A foreign eligible entity is a partnership if it has two or more members and at least one member does not have limited liability. The entity is a disregarded entity if it has a single owner and that owner does not have limited liability with respect to that entity.

An entity whose initial classification is determined by default retains that classification (without regard to changes in the members' liability) until the entity makes an election to change its classification.

An eligible entity may affirmatively elect its classification by filing Form 8832, *Entity Classification Election*. The election is effective on the date specified on Form 8832, or if no date is specified, on the filing date. If, however, an election specifies an effective date more than seventy-five (75) days prior to the date on which the election is filed, it will be effective only seventy-five (75) days prior to the date it was filed. Additionally if an election specifies an effective date more than twelve (12) months following the date on which the election is filed, it will be effective 12 months after the date it was filed. The election must be signed by each member of the entity under penalties of perjury. A retroactive election must also be signed by every person who was an owner during the period of retroactivity, but is not an owner at the time the election is filed. A change of classification may constitute a recognition event for U.S. tax purposes.

A taxpayer that makes an entity classification election generally cannot change its classification by election during the sixty (60) months following the effective date of the election. However, if within that time more than fifty (50) percent of the ownership has changed since the filing date or effective date of the election, the Commissioner may permit a change.

Example

Foreign national ("FN") living in the U.S. owns a 9.8226% interest in a Dutch CV which FN received as a gift. None of the owners of the Dutch CV are U.S. nationals. A check-the-box election has not been filed for the entity.

The primary issues here are how the Dutch CV is treated under the entity classification rules and what are the owner's U.S. reporting requirements as a result.

Treas. Reg. § 301.7701- 2(b)(8)(ii) lists foreign business entities which under U.S. law are considered to be per se corporations. A Dutch CV is not among those listed. A business entity that is not necessarily classified as a corporation under Treas. Reg. § 301.7701–2(b), an "eligible entity", can elect its classification for federal tax purposes under the rules of Treas. Reg. § 301.7701–3. No such election was filed. Consequently the default rules for foreign entities apply. The key for foreign entities is whether the members have limited liability. A foreign eligible entity is an association and thus a corporation if all of its members have limited liability. A foreign eligible entity is a partnership if it has two or more members and at least one member does not have limited liability. Dutch CV's are typically partnerships in which one of the partners has general liability and the other partner(s) have limited liability. Therefore, assuming this is a typical Dutch CV, this entity would be considered a foreign partnership for U.S. tax purposes under the entity classification rules.

A U.S. person holding an interest in a Dutch CV (or other foreign entity treated as a partnership) must complete Form 8865 *Return of U.S Persons with Respect to Certain Foreign Partnerships* if any of the following apply:

- A U.S. person who controlled the foreign partnership at any time during the foreign partnership's tax year. Control of a partnership is ownership of more than 50% interest in the partnership.
- A U.S. person who at any time during the tax year of the foreign partnership owned a 10% or greater interest in the partnership while the partnership was controlled by US persons each owning at least 10% interests.
- A U.S person who contributed property to the partnership or who had reportable events under I.R.C. § 6046A during that person's taxable year.

FN is not required to file Form 8865 but will be required to report her pro rata share of the Dutch CV's income determined under U.S. principles on FN's 2012 tax return if she is treated as a resident alien for tax purposes. Additional reporting obligations may arise from having received the interest as a gift, and ownership of a foreign asset.