



What to do when your client didn't “Check the Box”?

San Diego County Bar Association
Taxation Section

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- I. “Check the Box Regulations” - Domestic vs. Foreign Entities
- II. What happens if Tax Returns are filed in contradiction to the “Default Rules”
- III. “Relief” under Treas. Reg. Section 301.9100-3 and Rev. Proc. 2002-59
- IV. International Tax Planning Opportunities



“Check the Box” Rules Provide More Certainty

- “Devils in the Details” Validity of Election ?
 - Procedural Requirements - Coordinating with Accountants
 - All of the information required by the Form 8832 must be provided Treas. Reg. Section 301.7701-3(c)(1)(i)
 - Form 8832 must be attached to federal tax or informational return of entity making election or any direct or indirect owner. Treas. Reg. Section 301.7701-3(c)(1)(ii)



“Check the Box” Rules Provide More Certainty

- “Devils in the Details” Validity of Election ?
 - Procedural Requirements - Coordinating with Accountants
 - Authorized signatures - (A) each member owner at the time of election, or (B) any officer member or member authorized under local law - Treas. Reg. Section 301.7701-3(c)(2)(i)(A) and (B)
 - “Relevance” is required for foreign eligible entities to make an election?
 - Treas. Reg. Section 301.7701-3(d)(1)
 - Classification is no longer relevant - 60 consecutive month rule. 301.7701-3(d)(2)



Default Rules are Simple Right?

- U.S. Entity Rules are Different from Foreign Entity Rules
 - Corporations - “Simple” Default Rules
 - Domestic - Treas. Reg. § 301.7701-2(b)(1)-(7)
 - Formed in U.S. as “incorporated”, “joint stock company,” Insurance Company, Owned by a Foreign Government, etc.
 - Foreign - “Per Se Corporations” – Sociedad
 - Treas. Reg. § 301.7701-2(b)(8)
 - » Exceptions - Canadian - Nova Scotia Unlimited Liability Company
 - » India and a Malaysian Sendirian Berhad.



U.S. Entity Rules are Different from Foreign Entity Rules

- Partnerships vs. Corporations
 - Two Member+/Owner Entities
 - Domestic Partnerships - Simple Default Rule
 - Treas. Reg. § 301.7701-2(c)(1) - Any 2 member business entity that is not a corporation
 - » Irrespective of liability of members
 - Foreign Partnerships - Tricky Rules
 - “Grandfather” Old “Kintner” Rules Apply to Foreign Entities - Must also meet a 6 Part Test
 - Fall out of “Grandfather” Rules - if there is a 708(b)(1)(B) sale or exchange of 50% or more of ownership or a division under 708(b)(2)(B)



Foreign “Partnerships” - Confusion

- Not Same Default Rule as Domestic
 - Two Member/Owner Entities
 - “Foreign LLCs” are NOT Defaulted Foreign Partnerships
 - Election Must be Made - Treas. Reg. § 301.7701-3(b)(2)(i)(B) –
 - Only Foreign “General Partnerships” are defaulted into Foreign Partnership Treatment
 - At least one member has unlimited liability - Treas. Reg. § 301.7701-3(b)(2)(i)(A) –
 - Foreign Legal Analysis of “Limited Liability” must be Undertaken - Legal Opinion from Foreign Legal Counsel
 - PRACTICAL CONCLUSION - “Check the Box” Election is Almost Always Required/Recommended for Foreign “Partnership” Entities



Single Member Entities

- Domestic vs. Foreign Entities - Different Rules
 - Domestic Entity - Simple Default Rule
 - Disregarded Entity - Treas. Reg. § 301.7701-3(b)(1)(2) - E.g., single member LLC
 - Foreign Entity - Tricky Different Rule
 - Disregarded Entity - Only if Unlimited Liability to Owner - Treas. Reg. § 301.7701-3(b)(2)(i)(c)
 - Foreign Legal Analysis of “Limited Liability” must be Undertaken - Legal Opinion from Foreign Legal Counsel
 - PRACTICAL CONCLUSION - “Check the Box” Election is Almost Always Required/Recommended for Foreign Single Member Entities



What happens if Tax Returns are filed in contradiction to the “Default Rules”

- Can you just file a “late” election to rectify the problem?
 - “No” . . . Not without “9100” Relief or Rev. Proc. 2002-59 Relief (more later)
 - Outbound - Late election can cause a liquidation of a foreign corporation thus causing a taxable event to the U.S. owner.
 - Inbound - Late election can cause a deemed 351 transaction (in context of single member U.S. entity)
 - If U.S. real estate ownership - then taxation of under Section 897 (absent an 897(i) election - assuming a Tax Treaty Country availability)



What happens if Tax Returns are filed in contradiction to the “Default Rules”

- “Parade of Horribles” - Outbound Scenario
- U.S. owned, foreign entities where foreign partnership or disregarded tax treatment is desired (the "out-bound" scenario);
 - Application of IRC Section 367(a)(1) - Taxation on Transfer of Assets to Foreign Corporation
 - \$10,000 Penalty Exposure under IRC Section 6038 (Failure to File IRS Form 5471)
 - Disallowing foreign net operating losses on U.S. “partners” U.S. tax returns (federal and State)



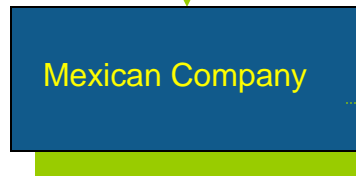
What happens if Tax Returns are filed in contradiction to the “Default Rules”

- Outbound Scenario - Late Election Filed
- U.S. owned, foreign entities where foreign partnership or disregarded tax treatment is desired:
 - Deemed distribution of all assets and liabilities to shareholders in liquidation and immediate contribution of the distributed assets and liabilities to newly formed partnership. Treas. Reg. 301.7701-3(g)
 - Section 336(a) application to Corporation’s deemed liquidation
 - Sections 1001(a) and 334(a) to Shareholders
 - \$10,000 Penalty Exposure under IRC Sections §6046A and IRC §6038, Form 8865 -

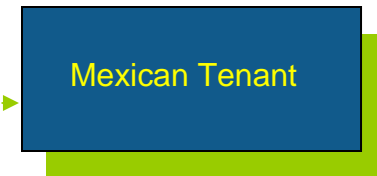


Comparison Taxes from Foreign Operation

- Mexican Withholding Tax on “Dividend” Distributions
- Article 10 - 10% Max Rate
- Current Rate of Zero



Lease



U.S. Tax Impact

- Foreign Tax Credit?
 - Foreign Corporation -S.A. de C.V.
 - No FTC if U.S. Individual SH
 - Indirect FTC if U.S. Corporate SH
 - Foreign Partnership -S.R.L.
 - FTC for Mexican Income Taxes and Withholding Taxes
 - Must Make “Check the Box Election”

- Mexican Income Tax of 35% on Net Income
- Mexican Value Added Tax -15% of Buildings/Structures



“Parade of Horribles” - Outbound Scenario - Continued

- U.S. owned, foreign entities where foreign partnership or disregarded tax treatment is desired (the "out-bound" scenario)
 - No Foreign Tax Credit? –
 - U.S. Individual Shareholder
 - U.S. Partnership Shareholder
 - U.S. Corporation - If Indirect FTC is Not Available
 - Deemed Paid Credit - Section 902(a))
 - Dividend Taxation of Income on otherwise Non-Taxable (from U.S. perspective) distributions from “foreign partnership” -

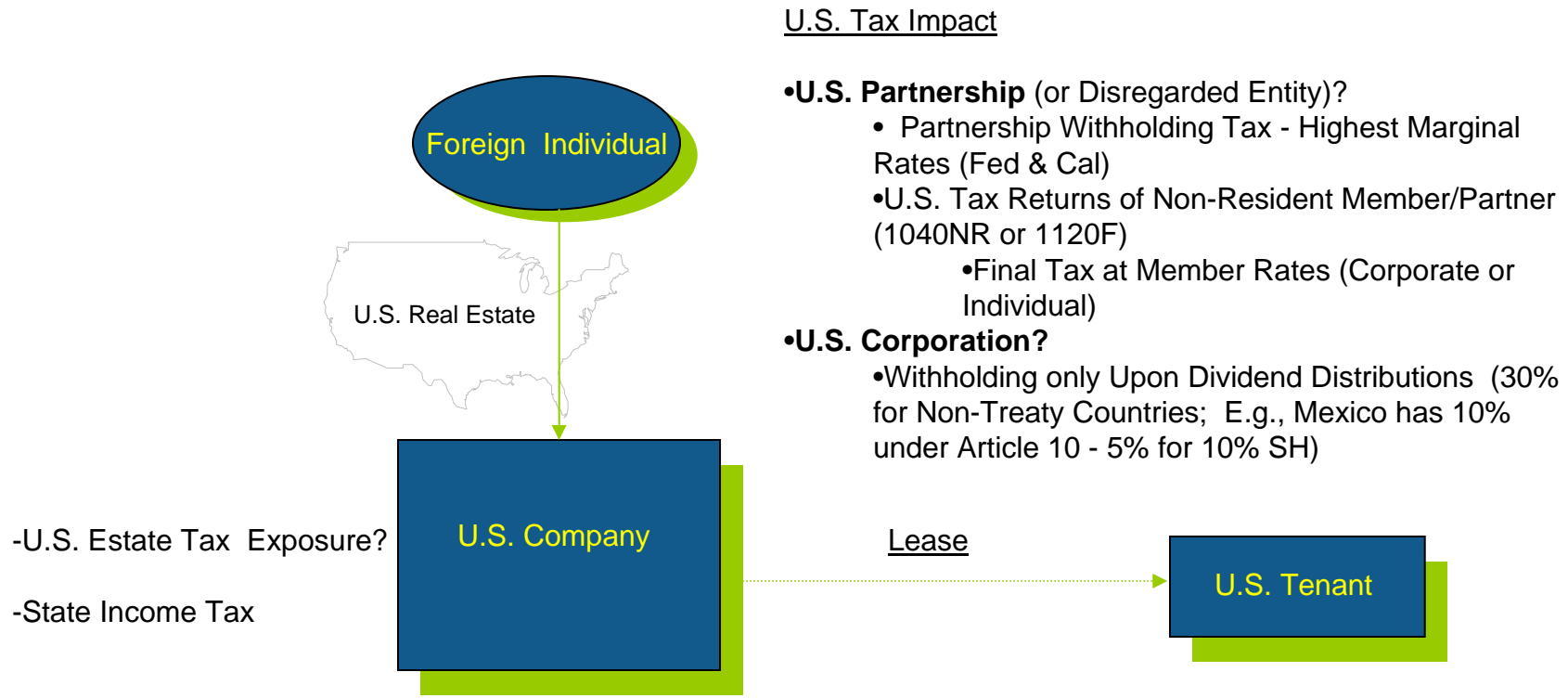


“Parade of Horribles” - Inbound Scenario

- Foreign owned, single member domestic entities where U.S. corporate tax treatment is desired
 - If U.S. Trade or Business
 - Foreign Owner becomes subject to the direct jurisdiction of IRS - no indirect jurisdiction per IRC Section 6038A(e) - deemed agent
 - Foreign owner must file U.S. income tax return (e.g., 1120F, 1040NR, etc.)
 - Foreign taxpayer to Pay U.S. Income tax on Gross Income (without deductions) for failure to properly file income tax return - arbitrary “18 Month Regulatory Rule” - “
 - “Nuclear Winter” precluded from receiving the benefits of any deductions that it might have otherwise been entitled to claim pursuant to section 882(c)(1)(A) had it filed a timely, true, and accurate return pursuant to section 882(c)(2), Treas. Reg. Section 1.882-4



U.S. Taxes from Real Estate Lease Transaction



U.S. Tax Impact

- **U.S. Partnership** (or Disregarded Entity)?
 - Partnership Withholding Tax - Highest Marginal Rates (Fed & Cal)
 - U.S. Tax Returns of Non-Resident Member/Partner (1040NR or 1120F)
 - Final Tax at Member Rates (Corporate or Individual)
- **U.S. Corporation?**
 - Withholding only Upon Dividend Distributions (30% for Non-Treaty Countries; E.g., Mexico has 10% under Article 10 - 5% for 10% SH)



“Parade of Horribles” - Inbound Scenario

- Foreign owned, foreign entities where foreign corporate tax treatment is desired (another "in-bound" scenario), especially for U.S. estate and gift tax consequences when underlying U.S. investments are held.
- U.S. Situs Assets (Estate Taxes)- The following properties are treated as situated in the U.S. as defined in Treas. Reg. §20.2104-1(a) to include:
 - Foreign Disregarded Entity? - All real estate located in the U.S. (Treas. Reg. §20.2104-1(a)(1))
 - “Intangible personal property the written evidence of which is not treated as being the property itself, if it is issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit” (Treas. Reg. §20.21041(a)(4))
 - Shares of stock of a domestic corporation, regardless of the location of the stock in a closely held corporation (Treas. Reg. §20.21041(a)(5))



“Relief” under Treas. Reg. Section 301.9100-1/3 or Rev. Proc. 2002-59

- When required?
 - If 75 Day filing deadline was not satisfied (Treas. Reg. 301.7701-3(c)(1)(iii); and
 - Want to avoid re-characterization of an existing entity (e.g., corporate liquidation)
 - What if no appreciated assets in entity?
 - Worth the User Fee of US\$ 6,000 - Rev. Proc. 2003-1



“Relief” under Rev. Proc. 2002-59

- “Relief” under Rev. Proc. 2002-59 (Preferred) - but limited
 - No user fee
- Requirements
 - the entity must be newly formed - and failed to obtain its desired classification for failure to timely file IRS Form 8832;
 - the due date for the tax return (excluding extensions) has not passed (even if no return required); and
 - the entity has reasonable cause for its failure to timely make the initial entity classification election on or before the due date of the first federal tax return (excluding extensions) of the entity's desired classification, the newly formed entity must file with the applicable service center (determined in accordance with the instructions to Form 8832) a completed Form 8832, signed in accordance with section 301.7701-3(c)(2).



“Relief” under Rev. Proc. 2002-59

(Superseded Rev. Proc. 2002-15)

- Procedural Requirements
 - The Form 8832 must state at the top of the document "FILED PURSUANT TO REV. PROC. 2002-59."
 - Attached to the Form 8832 must be a statement explaining the reason for the failure to file a timely initial classification election.



“Relief” under Treas. Reg 301.9100-1/3

- Private Letter Ruling Must Be with User Fee of US\$ 6,000 - Rev. Proc. 2003-1
 - Reduced \$500 user fee for taxpayers with income of less than \$250K
- Detailed procedural requirements and factual disclosure to be made to IRS
 - Taxpayer must provide evidence to establish that it
 - (i) acted reasonably and in good faith, and
 - (ii) that granting relief will not prejudice the interests of the Government. Section 301.9100-3(a).



“Relief” under Treas. Reg 301.9100-1/3

- Under Section 301.9100-3(b), a taxpayer is deemed to have acted reasonably and in good faith if (only the applicable provisions are included):
 - the taxpayer failed to make the election because he unaware of the necessity of the election;
 - the taxpayer failed to make the election because he reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election (Section 301.9100-3(b)(1)(v)); and the tax professionals were competent to render the advice of the regulatory election and were aware of all the facts (Section 301.9100-3(b)(2)(i) and (ii));



“Relief” under Treas. Reg 301.9100-1/3

- A taxpayer is not deemed to have acted reasonably or in good faith if:
 - the taxpayer seeks to alter a position for which an accuracy related penalty has or could be imposed under Section 6662 at the time the taxpayer requests relief
 - the taxpayer was informed of the requirement to file an election and did not do so; or
 - the taxpayer uses hindsight in requesting relief when the facts of his situation have changed where making the election is more advantageous for the taxpayer



Unanswered Questions?

- Is a foreign entity eligible to make an election if it has no U.S. owners, no U.S. tax return filing requirements? 62 F.R. 55768 (Oct. 28, 1997)
- Do Federal income tax principles and the Code apply to parties and transactions where there are no U.S. taxpayers, no U.S. events or no U.S. transactions?
 - Can Sections 351, 336, 1031, or similar provisions apply to the foreign taxpayers (entity and its owners) when there is no jurisdiction in the U.S. and all events occur outside the United States?
 - See U.S. v. Goodyear Tire and Rubber Co. 493 U.S. 132, 145 (1989), reh'g denied, 493 U.S. 1095 (1990); Biddle v. Comm'r, 302 U.S. 573, 578 (1938); RR 64-158



International Tax Planning Opportunities under “Check the Box”

- Now Limited ? - Proposed Anti-Abuse Rules –
 - APPLIES TO OUTBOUND TRANSACTIONS ONLY - WHERE AN EXTRAORDINARY TRANSACTION FOLLOWS
 - Prop. Treas. Reg. 301-7701-3(h)(3)
 - PROPOSED RULE: Apply - to foreign eligible entity (FEE) classified as disregarded entity if –
 - 10% or more of the FEE is sold within 12 months (before or after) the change in classification to disregarded entity
 - the FEE was originally classified as a corporation with 12 months (before or after)



International Tax Planning Opportunities under “Check the Box”

- OUTBOUND SCENARIOS –
 - FTC
 - Individual and Non-Corporate Owners Especially (No Indirect FTC)
 - Utilize Foreign Net Operating Losses to Offset U.S. Source Taxable Income (Subject to IRC Section 469)
 - Utilize Foreign Losses to Offset other Foreign Losses from Separate Business Enterprise (“Consolidated Foreign Partnership Operations)
 - Avoid U.S. Corporate “Double Taxation” on Foreign Operations



International Tax Planning Opportunities under “Check the Box”

- OUTBOUND SCENARIOS (cont.) –
 - Avoid Application of Section 482
 - Avoid U.S. Withholding Tax (1441 and 1442) on FDAP income from Use of U.S. Source Assets (e.g., IP royalty income) from U.S. Owner to Foreign Entity
 - Avoid Application of Section 367 (when assets are to be used in offshore/non-U.S. operations)
 - Avoid Application of Dual Consolidated Loss Rules - 1503(d) -
 - Disregarded Treatment - Obtain Foreign Currency losses - 987 & 989 - Functional Currency of U.S. Dollars vs. Local Currency



International Tax Planning Opportunities under “Check the Box”

- INBOUND SCENARIOS –
 - Single Member U.S. Eligible Entity - Elect U.S. Corporate Treatment
 - Avoid U.S. Trade or Business Attributed to Foreign Owner
 - Avoid U.S. tax return filing requirements by foreign owner
 - preclude application of Treas. Reg. Section 1.882-4 to receive the benefits of any deductions that it might have otherwise been entitled to claim pursuant to section 882(c)(1)(A)
 - Avoid Branch Profits Tax –
 - Obtain U.S. Tax Treaty Benefits - especially for corporate dividend distributions (U.S. sub foreign parent)



International Tax Planning Opportunities under “Check the Box”

- INBOUND SCENARIOS (cont.) –
 - Single Member U.S. Eligible Entity - Elect U.S. Corporate Treatment
 - Enable Future Sale of “Stock” of U.S. Sub free from U.S. income taxation (versus taxable sale of U.S. assets)
 - Avoid application of FIRPTA for U.S. real estate (e.g., commercial real estate investments) –
 - What if 897(I) election is available?



International Tax Planning Opportunities under “Check the Box”

- INBOUND SCENARIOS (cont.) –
 - Foreign Eligible Entity - Elects Corporate Treatment
 - Avoid property subject to estate taxation under IRC Section 2104 - for Foreign Individual Owners
 - E.g., underlying U.S. real estate, U.S. located personal property, etc.
 - Enable 897(i) election where tax treaty available –
 - to avoid application of FIRPTA for U.S. real estate held by FEE



International Tax Planning Opportunities under “Check the Box”

- INBOUND SCENARIOS (cont.) –
 - Foreign Eligible Entity - or Disregarded Entity
 - Obtain Tax Treaty Benefits (notwithstanding application of IRC 894(a), when all of the three requirement DO NOT apply
 - foreign treaty country does not treat income as an item of income of the foreign person for its taxation purposes; and
 - treaty does not contain provision regarding income derived through a partnership; and
 - foreign treaty country does not impose taxation on a distribution of income item by the entity to the foreign person

