Chapter 4
Residence Jurisdiction over Legal Entities

§ 4.01. Residence of Legal Entities

§ 4.01.1. Corporations

A corporation is identified as a "domestic" corporation under the Code if it was "created or organized in the United States or under the laws of the United States or of any state."[1] A foreign corporation is a corporation other than a domestic corporation.[2] Thus the organizers of a corporation can determine whether a corporation is subject to the residence jurisdiction of the United States by their choice of the place of incorporation. If a corporation is organized under the laws of the United States and also the laws of a foreign country, it is treated as a domestic corporation.[3]

The mechanical place-of-incorporation test for determining the tax status of a corporation provides a high degree of certainty, to the government and to taxpayers, in the case of corporations that are organized as such under local law. The public policy cost of obtaining that certainty is high, however, because the mechanical test gives taxpayers the power to control the reach of U.S. residence jurisdiction.[4]

To regain some control over its tax jurisdiction, Congress has enacted elaborate provisions under subpart F of the Code for taxing the profits of foreign corporations controlled by U.S. interests. In some sense, the subpart F rules can be understood as a refinement of the place-of-incorporation test.[5]

In recent years, some U.S. corporations have attempted to avoid subpart F and otherwise minimize their U.S. tax obligations by converting themselves into foreign corporations through a corporate reorganization. A transaction for expatriating a corporation is typically referred to as an "inversion" transaction. In a typical inversion transaction, the U.S. shareholders of a U.S. corporation exchange their shares in that corporation for shares in a foreign subsidiary of that corporation. The subsidiary is typically organized in a tax haven country, such as the Bermuda. After the inversion transaction, the U.S. residents formerly owning shares in the U.S. corporation become shareholders of the tax-haven corporation, and the tax-haven corporation becomes the parent of the U.S. corporation. Thus the former relationship between the two companies is inverted, with the former subsidiary becoming the parent and the former parent becoming a subsidiary. The parent corporation, however, is now a foreign corporation that is not subject to the subpart F rules and is not subject to U.S. residence jurisdiction.

Consider, for example, a U.S. corporation, SCo, that manufactures hammers and other tools in the United States. The stock of SCo is widely held by U.S. resident individuals. SCo establishes a foreign

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[1] IRC § 7701(a)(4). See Reg. § 301.7701-5 (2006). The term "U.S. corporation" is occasionally used in this book as a synonym for "domestic corporation." Under the stapled stock rule of IRC § 269B and the anti-inversion rule of IRC § 7874, certain foreign corporations may be treated as U.S. corporations.

[2] IRC § 7701(a)(5).

[3] Reg. § 301.7701-5(a) (2006).

[4] Some countries, such as Australia and the United Kingdom, use a place-of-management test for determining the residence status of a corporation. It is possible for a corporation to be a U.S. corporation under the place-of-incorporation test and to be, for example, a U.K. corporation under U.K. law.

[5] For discussion of the residence status of affiliated companies, see Michael J. McIntyre, "Determining the Residence of Members of a Corporate Group," 51/4 Canadian Tax Journal 1567-73 (2003).

subsidiary, BCo, under the laws of Bermuda. It arranges for its shareholders to exchange their shares in SCo for the same number of shares in BCo. Now the U.S. resident individuals are the owners of BCo, and BCo is the owner of SCo.

In the typical case, an inversion transaction is combined with various transactions designed to strip profits out of the United States. For example, SCo might arrange to make deductible payments to BCo for its use in the United States of intangible property owned by BCo. Those payments typically would be routed through a foreign corporation entitled to U.S. treaty benefits in order to avoid or minimize U.S. withholding taxes.

In 2004, Congress acted to limit the benefits of inversion transactions by adopting Code section 7874. Under that provision, the new foreign parent (the "surrogate foreign corporation") is treated as a U.S. corporation for all purposes of the code if at least 80 percent of the stock (by vote or value) of the entity is held by the former owners of the domestic corporation that was inverted.[6] If at least 60 percent of the stock is held by the former owners but less than 80 percent, Code section 7874 denies the use of some tax attributes to offset any gain that resulted from the inversion transaction.[7] A similar rule applies to inverted partnerships.[8]

An entity may be treated as a "corporation" for tax purposes even if it is not so treated under local law. Under the current and prior regulations dealing with the classification of entities, a juridical person that is taxed under the Code as a corporation is called an "association." Prior to the adoption of the check-the-box regulations, an entity characterized as a trust or partnership under local law would be treated as an "association" if it had most of the important legal characteristics of a corporation.[9] Under check-the-box, an unincorporated entity generally is treated as a corporation at the discretion of the taxpayer.

When an association is treated as a corporation for federal tax purposes but is not organized as a corporation under local law, the bright-line test—place-of incorporation—obviously is not applicable. Under such circumstances, the place of residence of the association depends on the locus of the various contractual arrangements that led to its creation or organization. The place of residence is often obvious under this test, but not always. For example, residency of an association may be difficult to determine if the contractual arrangements under which it was formed are governed by the laws of more than one country or if the associating parties did not enter into any formal contractual arrangements.

Assume, for example, that UCo, a U.S. corporation, enters into a joint venture with FCo, an unrelated company organized in Country F, to construct an airport facility in Country R. UCo and FCo do not incorporate their joint venture arrangement, but UCo elects to have that arrangement classified as a corporation under the check-the-box rules described below. The question arises as to where this ersatz corporation is resident. Some of the contractual arrangements for establishing the joint venture were made in Country F, some in the United States, and some in Country R. In addition, the parties have stipulated in

[6] IRC § 7874(b).

[7] IRC § 7874(a).

[8] IRC § 7874(a)(2)(A).

[9] Under the prior regulations, an association resembled a corporation to the extent it had the following characteristics: (1) associates, (2) an objective to carry on business and divide resulting profits, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of ownership interests. The last four characteristics were used to distinguish corporations from partnerships in that both partnerships and corporations always possessed the first two characteristics. An association was a corporation rather than a partnership under the prior regulations if it possessed three out of four of the last four characteristics. A common criticism of the prior regulations was that they gave equal weight to the last four characteristics instead of giving extra weight to characteristics five and six. An additional telling criticism of the prior regulations is that they frequently permitted the taxpayer in the international setting to repudiate for tax purposes the form of organization it had chosen for business purposes.

one of their agreements that disputes between the parties over the terms of the joint venture are to be resolved in accordance with the laws of Country N. Under these facts, the country of residence of the joint venture arrangement is unclear.

§ 4.01.2. Partnerships

The rules for determining the residence status of partnerships are roughly comparable to those for determining the status of associations and other entities treated as corporations. In general, a partnership created or organized under U.S. law is a domestic partnership, and all other partnerships are foreign.[10] The tax authorities are permitted to modify this rule by regulation in appropriate cases.[11]

A partnership often is organized exclusively under the local law of a particular country. In such a case, its country of residence typically is easy to determine. In other circumstances, however, the place of organization or creation is unclear, especially when the "partnership" is an informal association, not created by a specific legal act. In the example above of the joint venture between UCo and FCo, the same question of where that arrangement was resident would arise if UCo had elected to treat the arrangement as a partnership.

§ 4.01.3. Trusts

A trust is treated as a domestic trust if a court within the United States is able to exercise primary supervision over the administration of the trust (the "court" test), and one or more United States persons have the authority to control all substantial decisions of the trust (the "control" test).[12] In general, the rules defining the residence of trusts are biased toward foreign trust classification.[13]

The control test, set forth in the regulations, is met if one or more U.S. persons have the authority to control "all substantial decisions of the trust."[14] If a foreign person has the power to veto the substantial decisions of the U.S. person, the U.S. person will not be treated as controlling the trust.[15] Substantial decisions include, for example, decisions on (1) whether or when to distribute income or corpus, (2) the amount of such distributions, (3) the selection of beneficiaries, and (4) whether to remove, add, or replace a trustee.[16] U.S. persons are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust no longer to be controlled by U.S. persons.[17]

A safe-harbor rule allows certain individual retirement accounts (IRAs) and other tax-exempt trusts, including certain qualified pension plan trusts, to satisfy the control test even if the grantor or beneficiary of the trust is a foreign person. For that safe harbor rule to apply, United States fiduciaries must control all of the substantial decisions of the trust that are made by trust fiduciaries.[18] The safe harbor is important

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[10] IRC § 7701(a)(4) and (5).

[11] IRC § 7701(a)(4) (as amended by the 1997 tax act). Regulations have not been issued. The legislative history suggests that this authority might be used in the case of certain joint ventures but that the general rule would continue to apply in most cases.

[12] IRC § 7701(a)(30)(E).

[13] See T.D. 8813, 64 FR 4967-4975, Feb. 2, 1999.

[14] IRC § 7701(a)(30)(E)(ii); Reg. § 301.7701-7(a)(1)(ii) (2001).

[15] Reg. § 301.7701-7(d)(1)(ii) (2001).

[16] Reg. § 301.7701-7(d)(1)(ii) (2001).

[17] Reg. § 301.7701-7(d)(3) (2001).

[18] Reg. § 301.7701-7(d)(1)(iv) (2001).

because trusts established to hold retirement funds must be domestic trusts to have tax-exempt status under U.S. law.

For the court test to be satisfied, a U.S. court must be able "to exercise primary supervision over the administration of the trust."[19] That test is satisfied if (1) the trust instrument does not direct that the trust be administered outside of the United States, (2) the trust in fact is administered exclusively in the United States, and (3) the trust is not subject to an "automatic migration provision."[20] An automatic migratory provision is defined as a provision that would cause the trust to migrate from the United States—that is, become a foreign trust not subject to the jurisdiction of a U.S. court—if a U.S. court attempted to assert jurisdiction or otherwise to supervise the administration of the trust.[21] A U.S. court may have "primary supervision" over a trust even if a foreign court has jurisdiction over a trustee, a beneficiary, or some trust property.[22] In addition, the court test is met if both a foreign court and a U.S. court are able to exercise primary supervision over the administration of the trust.[23]

A safe-harbor rule provides that the court test is satisfied for a non-migrating trust in certain circumstances. Examples include: (1) a trust that is properly registered with a U.S. court under the Uniform Probate Code or a functional equivalent; (2) a testamentary trust that is probated within the United States if all fiduciaries of the trust have been qualified as trustees by a U.S. court; and (3) an *inter vivos* trust if the fiduciaries or beneficiaries cause the administration of the trust to be subject to the primary supervision of a U.S. court.[24]

Prior to a change in the Code adopted in 1996, a domestic trust was defined as a trust that was not taxable as a foreign trust, using the same circular definition that is currently applicable to estates. Taxpayers generally can create a foreign trust more easily under current law than they could under pre-1996 law. Creating a domestic trust, however, is often more difficult. As a transition measure, a trust that was treated as a domestic trust prior to August 20, 1996, may elect to continue to be treated as a domestic trust if a variety of conditions are met.[25]

If a U.S. person transfers property to a foreign trust with a U.S. beneficiary, the transferor may be treated as the owner of that property under Code section 679. In that event, the U.S. person is taxable on that portion of the income of the trust attributable to the transferred property, notwithstanding the status of the trust as a foreign person. Certain loopholes in section 679 were closed by amendments to that section in 2010.

For tax planning purposes, there are some advantages of being a foreign trust and some advantages of being a domestic trust. The grantor of a trust having one or more U.S. beneficiaries typically would prefer that the trust be treated as a domestic trust when it is initially established. This characterization generally allows the grantor to make transfers of property to the trust without the trust being characterized as a grantor trust. Once the property has been transferred to the trust, however, the grantor would prefer that the trust be characterized as a foreign trust so that its foreign source income would not be subject to U.S.

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[19] IRC § 7701(a)(30)(E)(ii); Reg. § 301.7701-7(a)(1)(i) (2001). A U.S. court is a court of one of the several states or the District of Columbia. A court of Puerto Rico or a U.S. territory is not a U.S. court for purposes of the court test. Reg. § 7701-7(c)(3)(ii) (1999).

[20] Reg. § 301.7701-7(c)(1) (2001).

[21] Reg. § 301.7701-7(c)(4)(ii) (2001).

[22] Reg. § 301.7701-7(c)(3)(iv) (2001).

[23] Reg. § 301.7701-7(c)(4)(i)(D) (2001).

[24] Reg. § 301.7701-7(c)(4)(i)(A)-(C) (2001).

[25] Reg. § 301.7701-7(f) (2001).

taxation. The rules defining a domestic trust are designed in part to prevent migration of domestic trusts—that is, the conversion of domestic trusts into foreign trusts.

Once a trust is determined to be a foreign trust, its taxable income is computed in the same manner as the taxable income of a nonresident alien individual who is not present in the United States at any time.[26] In general, the foreign trust is not taxable on its foreign source income but is taxable on income that is effectively connected with a U.S. business and on U.S. source periodical income. The residency rules of Code section 7701(b) are not applicable to foreign trusts.[27]

§ 4.01.4. Estates

In contrast to domestic corporations, partnerships, and trusts, domestic estates are defined as the residual category. That is, a domestic estate is any estate other than a foreign estate.

The Code definition of a foreign estate is circular. It provides that an estate is foreign if it is not subject to U.S. residence jurisdiction.[28] As noted above, that same definition was applicable to trusts under pre-1996 law. That circular definition of trusts and estates provoked considerable litigation, most of which related to the residency of trusts. Case law suggests that, in the absence of special circumstances, an estate is a foreign estate for federal income tax purposes if it is managed outside the United States, has its major assets located outside the United States, and is engaged in only minimal operations within the United States.

A Matter of Definition: "Foreign" and "Domestic" Taxpayers

2 *International Tax & Business Lawyer* 239-272, 258-266 (1984)

by David R. Tillinghast

Entities are not people. One needs to recognize this fundamental difference at the outset of any search for the most acceptable rule or rules for determining the domestic or foreign nature of legal entities. Both tax laws and tax lawyers tend to attach to these entities the same labels used to describe the connections between individuals and taxing jurisdictions. For instance, the English courts have struggled to analogize the residence of a company to that of an individual. There are common threads in the two situations, but each case is different and requires separate consideration. It is reasonable and appropriate for a country to tax a legal entity on income which originates within its borders. The question then is what kind of "ligatures," to use Ralf Dahrendorf's coinage,[29] between the entity and the country justify going beyond this simple rule to tax income of the entity which is conceded to have its source elsewhere. Each kind of entity must be considered separately, for on empirical and, perhaps, theoretical grounds there may be significant differences among them. The fact that a partnership is not a taxable entity whereas a corporation is a taxable entity may, for example, have an effect on the outcome. And the fact that an estate is intimately identified with the personal affairs of the decedent may suggest treatment different from that of a corporation, even if the corporation is owned by a single individual.

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[26] Reg. § 301.7701-7(a)(3) (2001).

[27] Id.

[28] IRC § 7701(a)(31)(A) ("The term "foreign estate" means an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A").

[29] R. Dahrendorf, Life Chances 30-39 (1979).

Corporations. Although the rationale for the "place of incorporation" test has seldom been articulated, the test seems to rely on the notion that a corporation is able to earn income by virtue of being a juridical entity, in that it derives its income-earning capacity from the granting of its charter. The jurisdiction granting the charter and investing the entity with the legal capacity to earn income then has the right to tax that income when it arises. Taxing a corporation based on its place of incorporation is analogous to taxing an individual on the basis of citizenship because both focus on the grant of legal status to the taxpayer by the taxing country. Broadly stated, the policy of existing law is to allow a corporation to freely choose domestic or foreign status, including the status of an existing subsidiary, but to impose a consistency requirement. After the first free chance, a mid-life shift in a corporation's status may be achieved only at the price of "killing" the old corporation and "creating" a new one, with consequent tax effects under such recognition provisions as Code sections 367, 1491, and 1248.

"Taxing a corporation based on its place of incorporation is analogous to taxing an individual on the basis of citizenship because both focus on the grant of legal status to the taxpayer by the taxing country."

The "place of incorporation" test has one distinct advantage and one serious drawback. Its advantage lies in the certainty which arises from its application. If the test is applied by reference solely to the jurisdiction in which the corporation's charter is filed and by whose laws, therefore, the relations among its shareholders are governed, there can be no doubt as to what is a domestic and what is a foreign corporation.[30] The drawback of the "place of incorporation" test is that a corporation is by nature androgynous; it can and does autonomously create progeny. In this characteristic lies the important difference between the corporation and the individual. While there are some factors which may strongly influence the decision to incorporate a business in the United States rather than abroad, it is unlikely that a business such as IBM would have been incorporated outside the United States under any circumstances. Once the decision to incorporate in the United States is made, there are tax restraints on changing the decision and re-incorporating abroad. There are far fewer restraints, however, on the ability of a U.S. corporation simply to incorporate a subsidiary abroad, thus creating another taxpayer having a different status.

There is little question that the place of incorporation is a crude, if not naive, criterion of domestic corporate status. The question really is whether there exists a more rational and workable alternative. Some of the alternative tests that have been devised seem workable, but they do not address the central problem of U.S.-connected entities deriving entirely foreign income. For example, the United States might provide, as is done in Pakistan, that any corporation which has more than half of its gross income for a requisite period effectively connected with the conduct of a trade or business in the United States is a U.S. corporation. Such a rule would accomplish relatively little, however, as the effectively connected income of even a foreign

[30] Even this long-revered axiom may no longer be wholly true. Under recently enacted amendments to the Delaware Corporation Law, a foreign corporation may domesticate itself by filing its charter in Delaware. Del. Code, ch. 1, tit. 8, §§388, 389. At least under the first of these provisions, which relates to a permanent rather than a temporary change in the corporation's domicile, domestication will occur regardless of the effect of the filing under the foreign law governing the corporation's affairs at the time of the filing. Thus, a corporation could be considered a Delaware corporation under Delaware law while still being treated under foreign law as organized under the law of a foreign country. The problem is aggravated by the fact that the Delaware law in such a case specifies that "the existence of the corporation shall be deemed to have commenced on the date the corporation commenced its existence in the jurisdiction in which the corporation was first formed, incorporated or otherwise came into being." *Id.* §388(d). *Quaere*: whether this means that the corporation should be deemed always to have been a U.S. corporation for any relevant federal income tax purpose?

corporation is already taxable under the Code. Thus, any increase in taxability under U.S. laws would be only on the remaining income of the corporation.

> "It is difficult to see why the United States should even consider adopting the central management and control test, with its attendant difficulties, if the effect is to base the tax status of a corporation on the geographical location of its Board of Directors meetings."

Moreover, a change of this kind could be made effectively only by overriding the provisions of existing income tax treaties. The reaction of trading partners to actions which depart this far from traditional international tax conceptions can be judged by the outcry over unitary taxation and the longer-standing resentment over the United States' "extra-territorial" imposition of the "secondary" dividend tax on certain distributions by foreign corporations. Here the gain does not seem worth the stakes. The same is true of similar rules which base the domestic status of a corporation on the conduct of business within the jurisdiction, in combination with other factors relating to ownership and control.

The obvious and more responsive possibility would be to fashion a test under which a corporation would be considered a U.S. person on the basis of what is popularly known as its "residence." The test might be cast in any of several ways, including reference to the place of the corporation's central management and control, the place of its effective management, or the place in which its business is principally transacted. Although the particular factors to be taken into account would vary according to the exact formulation of the test, the concept would be to identify, not the jurisdiction which gives the corporation its legal life, but rather the jurisdiction in which its economic life is centered, focusing on inputs such as the capital, technology, and management skills which give the corporation the economic ability to earn income. This jurisdiction may be easier to identify in concept than in practice, however.

England and the other Commonwealth countries provide a good example of the problems associated with the "residence" test. In these countries, the residence of a company is a matter of common law. The courts have for many years followed, or purported to follow, the landmark decision in the *de Beers* case.[31] De Beers enunciated the test that the residence of a company, while a question of fact, depends upon the location of the "central management and control" of the company. The most important factor in determining the location of the central management and control is the location at which the company's Board of Directors meets or otherwise discharges its functions. At least one leading case suggests that this factor is decisive and, in the broad range of cases, the law has in fact been so applied.

The English reports are littered, however, with more disturbing opinions. One case, for example, holds that an English company was resident in England although all of its Board of Directors meetings were held and its entire business was carried on in Sweden. Another case states that a company may be simultaneously resident in two countries because parts of its management process are carried on in each.[70] An opinion in this case further maintains that when a company engages in more than two businesses, each business may have a different place of management and control. Although the case did not specify this result, presumably

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[31] De Beers Consol. Mines, Ltd. v. Howe, 5 T.C. 198 (1905). [70] Unit Construction Co. v. Bullock, 1960 A.C. 351 (H.L).

this view requires either that the world-wide income of the company be taxed in full by both jurisdictions, or that the two businesses be separated and the separate income of each taxed by the country of its domicile.[71]

This uncertain state of affairs seems highly unsatisfactory for several reasons. First, even if the place where the Board of Directors discharges its functions is held to be decisive, in the modern world this location may not be easy to determine. Many corporations rotate their Board meetings from one country to another. Directors are often of differing residence and nationality. With increasing frequency, Board actions are taken by written consent or in telephonic meetings. Directors waive their participation or give proxies to other directors. Management functions of large corporations are, moreover, often shared by the Board and its committees, which may, of course, meet at different places or by different means. Even if this process is correctly stage-managed, companies are always at risk that a different finding will be made. Under the English practice, such factual findings are made by Commissioners, who are employees of the Inland Revenue and the courts have reviewed the findings of the Commissioners with the utmost deference.

Indeed, in recent years, the English Inland Revenue, apparently of the view that the "central management and control" test is too malleable, has sought a legislative definition of corporate residence based on the presence in England of a company's "principal office." Denied this legislative change, in 1983 the Inland Revenue issued a "Statement of Practice" designed to clarify the application of the existing common law test. The views expressed in it, if ultimately upheld by the courts, would move the English law far in the direction of the "principal place of business" rule. The Statement emphasizes that the place where a company's Board of Directors acts is not always determinative of the place where central management and control is exercised. It notes, for example, that central management and control may be exercised by a single individual, as in a case when a chairman or a managing director "exercises powers formally conferred [on the Board] by the company's Articles and the other board members are little more than cyphers. . . . "

It is difficult to see why the United States should even consider adopting the central management and control test, with its attendant difficulties, if the effect is to base the tax status of a corporation on the geographical location of its Board of Directors meetings. The only results of such a change would be a mild stimulus to the economies of Canada, Bermuda, or our Caribbean neighbors, inconvenience in the taking of timely Board actions, and a not insubstantial measure of unfairness to small enterprises which would find it more difficult or expensive to keep their overseas subsidiaries "foreign." Further, if the central management and control test is not as simple as looking to the place where the Directors act, it may present a wholly different set of more difficult problems. The test is, after all, a factual analysis, carrying with it a degree of uncertainty and administrative complexity, and uncertainty in the test for corporate residence may prove even less tolerable than similar uncertainty in the individual case simply because the stakes are so large and the facts often so complex.

The U.S. might pass over the "centralized management and control" test in favor of the OECD's formula, which places residence where the "effective management" of the corporation is carried out. Phrased, undoubtedly, to ignore legal formalities in favor of economic realities, the OECD test might produce clear answers in at least some straightforward cases.

For example: Bermuda Corporation X is wholly-owned by U.S. citizen and resident A. Corporation X engages in the business of purchasing and reselling petroleum and petroleum products, dealing entirely with unrelated parties. All of its everyday activities are carried on by a staff located in Hamilton, and its Board of Directors, consisting of A, his Bermuda lawyer, and his banker meets there. However, all policy decisions are

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[71] *See* Tillinghast, *Tax Aspects of International Transactions* § 1.2 (2d ed. 1984), 1 CAN. TAX REP. 2d (CCH) §§1120-26 (discussing Union Corp. Ltd. v. C.I.R., [1952] 1 All E.R. 646, [1952] T.R. 69, *aff'd*, [1953] 1 All E.R. 729 (H.L.), and Swedish Central Railway Co. v. Thompson, 1925 A.C. 495).

made by A from his apartment in New York. In this case, there would be a wide measure of agreement that the place of effective management of Corporation X is in the United States. The test still relies on an analysis of all the facts presented, however, and even if the rule works in a simple case such as this, there will be many other cases in which the result is not so clear.

For example: publicly-held U.S. Corporation A owns all of the stock of Corporation X, incorporated in Country X, and this corporation in turn owns all of the stock of Corporation Y, incorporated in Country Y. Corporation X serves not only as a holding company but as the European management center for the group of which Corporation A is the parent. Corporation Y, which engages in the manufacture of high-technology products, has its executive office in Country Y, fully staffed with qualified personnel. However, in each of its principal functions — technical, production, finance, and administration — its top line officer reports to a regional officer who is employed by Corporation X in Country X. In turn, each such officer reports to an officer of Corporation A, located in the United States, who has responsibility for the functional area to which he is assigned.

Employees of Corporation A and Corporation X constitute the Board of Directors of Corporation X and employees of all the corporations sit on the Board of Directors of Corporation Y. Under the corporate manual of approvals used by the Corporation A group, officers of Corporation Y are authorized to make certain decisions affecting production and sales without express approval from higher authority. Certain more important decisions can be made only with the concurrence of the appropriate officers of Corporation X. Major decisions — such as major capital expenditures or changes in products produced (switches of production to or from Corporation Y) — can be made only with the concurrence of the responsible officer of Corporation A. These decisions are, however, rare, and the actual commitment of funds or other action is always taken formally on behalf of Corporation Y by its Board of Directors.

In this situation, it is difficult to say where the "effective management" of Corporation X is located. It is clear that ultimate authority rests in Corporation A. On the other hand, the decisions actually made by Corporation A are those on which even a fully independent management might seek the views of its principal shareholder. From the U.S. point of view, of course, it is immaterial whether Corporation Y may be deemed to be effectively managed by officers of Corporation X in Country X.

> "Domestic or foreign status [for corporations] will remain in effect elective over a broad range of cases under any rule which is likely to be adopted."

These ambiguities in the determination of the place of effective management could be resolved in either of two ways. First a distinction could be made between shareholder or "stewardship" activities, which are not to be considered, and management functions, which are. This approach, however, creates other problems. Considering only management functions, the corporations in the above examples would clearly be treated as foreign corporations, unless the corporations have insufficient management staff abroad. Such a deficiency can be cured simply by increasing that staff, which raises questions of fairness as between large multinationals, which can afford to employ numerous management personnel to run their foreign enterprises, and small businesses, which do not enjoy this option. The protests of the small business community against the "foreign presence" requirement of the Reagan Administration's Foreign Sales Corporation initiative demonstrate the difficulties, real and political, which this kind of requirement would raise.

The second way of resolving the factual ambiguities of the "place of effective management" test would be to adopt the view that, in the end, the effective management of a corporation is lodged with its controlling shareholder or shareholders, regardless of where the directors meet or the officers work. This approach would lead to a definition based on the domestic ownership of a controlling stock interest in an otherwise foreign corporation. Such a "back-door" termination of the deferral of taxation on foreign subsidiary earnings is no more likely to succeed than more direct approaches, however. The policy trade-offs between capital import and capital export neutrality have given us Subpart F in its present form, and it is unreasonable to suppose that that compromise will be upset by toying with the Code's definitional structure. Moreover, even advocates of ending deferral may have serious reservations about taxing that portion of the foreign earnings of a less-than-wholly-owned controlled foreign corporation which accrues to the benefit of foreign shareholders.

Similar analyses could be made of the analogous tests which refer to the corporation's principal place of business. These tests either stumble in the face of factual ambiguity or resolve the ambiguities by resorting to tests which favor those (mainly large) companies which have a relatively high degree of flexibility in arranging the corporate pieces of the enterprise. Further, the place of incorporation test, or some substitute, would have to be retained as an alternative, lest all U.S. subsidiaries of foreign parents be treated as foreign.

The conclusion which emerges is that domestic or foreign status will remain in effect elective over a broad range of cases under any rule which is likely to be adopted. Big companies with a range of choices concerning the deployment of personnel and access to good legal advice will normally be able to qualify for foreign status, even under standards more stringent than the place of incorporation test. An attempt to impose more stringent standards is likely to weigh particularly heavily on smaller enterprises or those which for one reason or another do not have the range of flexibility that most multinationals have. Under these circumstances, the case seems persuasive for continuing the approach of current law, making domestic or foreign status effectively elective under the place of incorporation test and utilizing Subpart F to tax through to U.S. shareholders their shares of the income of foreign corporations whose activities are not sufficiently enmeshed in the economies of foreign countries to justify, in the Congress' view, tax deferral.

The logic of this conclusion leads to another view so radical that it has not even been whispered for twenty years, that U.S. persons might be given the election to treat a U.S. incorporated entity as a foreign one. Experience shows that few purchasers are willing to pay full federal income tax as the price for access to the law of Delaware as governing law and prefer, if it comes to that, the laws of Canada, Bermuda, or other jurisdictions whose prices for nearly identical goods are more reasonable. The object of allowing such an election would be the rationalization of this recognized electivity, and nothing more. The proposal is senseless if an attempt is made to attach conditions to such an election that do not attach to owning a foreign corporation. On the other hand, all of the effects of "foreignness," such as the application of Code sections 367 and 1248, as well as Subpart F, must flow from the election, lest unintended benefits arise.

§ 4.02. Classification of Juridical Persons

This section describes the rules governing the classification of a legal entity for federal tax purposes as a corporation, partnership, trust, or estate, or as an entity having no independent juridical status ("disregarded entity"). Under regulations initially issued in 1996, the tax authorities have granted broad discretion to the taxpayer to determine for itself whether it will be classified as a corporation, partnership, or disregarded entity for federal tax purposes. These regulations are popularly referred to as the check-the-box regulations to signify that taxpayers may elect the classification that best serves their tax planning goals simply by checking a box (metaphorically) on a tax form.[72] The classification of an entity as a trust or estate is not elective under those regulations.

The entity classification scheme adopted under the so-called check-the-box regulations in 1996 divides all entities subject to classification into two categories. The first category is business entities, and the second is non-business entities. Subject to some important limitations, taxpayers are permitted to elect the tax status to be given to legal entities in the first category. Section 4.02.1, below, sets forth the main features of this elective system.

Section 4.02.2, below, describes the rules for classifying non-business entities. Trusts and estates are the only two types of non-business entities recognized under the regulations. Some policy notes, critical of the check-the-box regulations, are presented in § 4.02.3.

In a press release dated May 4, 2009, the Obama administration signaled a limited assault on the check-the-box regulations. It stated as follows:

> ***Eliminating Loopholes for "Disappearing" Offshore Subsidiaries***: Traditionally, U.S. companies have been required to report certain income shifted from one foreign subsidiary to another as passive income subject to U.S. tax. But over the past decade, so-called "check-the-box" rules have allowed companies to make their foreign subsidiaries "disappear" for tax purposes—permitting them to legally shift income to tax havens and make the taxes they owe the United States disappear as well. The Obama administration proposes to reform these rules to require certain foreign subsidiaries to be considered as separate corporations for U.S. tax purposes. This provision would take effect in 2011, raising $86.5 billion from 2011 to 2019.

Time will tell whether the Obama administration will be successful in this endeavor. Supporters of tax reform in the House and Senate may attempt to expand the Obama initiative to mount a more extensive attack on check-the-box abuses. Opponents may try to derail the proposal.

§ 4.02.1. Business Entities

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 Internal Revenue Code."[73] The intended effect of the rule is to treat an entity used to conduct business as a business entity. A joint venture or other contractual arrangement may constitute a business entity.[74] Little positive guidance is given as to the conditions that must be met for a contractual arrangement or organizational structure to constitute an "entity." An arrangement does not need to have legal status in its country of residence to be considered an entity.[75] The tax authorities apparently intended that a branch or division of a corporation not be treated as an entity, although the regulations never actually make that point explicitly.[76]

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72 The election is made on Form 8832 (Entity Classification Election), and, indeed, that form provides some boxes to check.

73 Reg. § 301.7701-2(a) (2012).

74 Reg. § 301.7701-1(a)(2) (2011).

75 Reg. § 301.7701-3(a) (2006).

76 Reg. § 301.7701-1(a)(4) (2011) states that certain organizations having a single owner "can choose to be recognized or disregarded as entities separate from their owners." The use of the word "organizations" rather than "entities" is significant. Branches are treated as separate entities for some purposes under the Code. See, e.g., IRC §§ 954(d)(2) (branch rule under the anti-avoidance rules of subpart F) and 989(a) (qualified business unit under the foreign currency rules of subpart J). Those ersatz entities, however, are not "organizations." Obviously a regulatory definition of the term "organization" would have been useful in clarifying the regulatory intent.

The three types of business entities that are recognized under the check-the-box regulations are corporations, partnerships, and "disregarded entities." A disregarded entity is an entity that is not recognized as a distinct entity for federal tax purposes. A business entity with two or more members is either a corporation or a partnership,[77] and a business entity with only one member (single-member entity) is either a corporation or a disregarded entity.[78] A single-member entity is popularly called a "SME" (rhymes with glee). Many of the tax planning opportunities made available under the check-the-box regulations involve the classification of SMEs. Presumably, that is the reason that SMEs are the prime target of the Obama administration's proposed reform of check-the-box.

§ 4.02.1.1. Operative Rules

Subject to various restrictions, a taxpayer may elect to treat a business entity with two or more members as either a partnership or a corporation for federal tax purposes.[79] The taxpayer generally may elect to treat an entity with a single owner as a corporation or as a disregarded entity.[80] A disregarded entity is treated as a sole proprietorship when owned by an individual and as a branch or division when owned by a juridical person.[81] This classification election is available only to "eligible entities."[82] An eligible entity is a business entity that is not listed as an ineligible entity.

Ineligible Entities. An ineligible entity is a business entity that must be treated as a corporation under the regulations. All entities organized as a corporation under the law of a U.S. state or the District of Columbia or a Federal statute are ineligible entities.[83] That is, they are taxed as associations under the Code without regard to any election the taxpayer may wish to make. Entities organized as a limited liability company (LLC) under state law, however, are not listed as ineligible. Publicly traded partnerships generally are ineligible, as provided in Code section 7704. Insurance companies[84] and some domestic banks[85] are ineligible entities, but other financial services companies generally are eligible entities.

The list of ineligible entities includes some foreign entities. In general, the tax authorities have treated one type of entity in each of a long list of foreign countries as constituting a corporation. For example, in several countries, including Australia, India, Malta, and the United Kingdom, a "Public Limited Company" must be treated as a corporation; in several other countries, including France, Luxembourg, and Morocco, it is a "Societe Anonyme" that is ineligible for elective treatment; in Poland, it is a "Spolka Akcyjna."[86] A variance from the general rules is provided to certain taxpayers who had treated various listed entities under color of law as partnerships under the old regulations.[87] In general, the ineligible foreign entities are corporations that typically are not closely held and the shares of which can be traded on a securities exchange.

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[77] Reg. § 301.7701-2(a) (2012).

[78] Id.

[79] Reg. § 301.7701-3(a) (2006).

[80] Id.

[81] Reg. § 301.7701-2(a) (2012).

[82] Reg. § 301.7701-3(a) (2006).

[83] Reg. § 301.7701-2(b)(1) (2012). This rule includes corporations created under the laws of a federally recognized Indian tribe.

[84] Reg. § 301.7701-2(b)(4) (2012) and IRC § 7701(a)(3).

[85] Reg. § 301.7701-2(b)(5) (2012). To be ineligible, the bank must be chartered by a state and its deposits must be guaranteed by the Federal Deposit Insurance Act. Id. The various "plaque-on-the-door" banks are eligible entities.

[86] Reg. § 301.7701-2(d)(1) (2012).

[87] Reg. § 301.7701-2(b)(8)(ii) (2012).

Default Election. To simplify administration of the system, taxpayers that fail to file an election with respect to an eligible entity are treated under specified default rules.[88] The default rules generally reflect the best guess of the tax authorities as to the classification that would be preferred by the taxpayer. This favorable default system is part of an overall objective of the regulation writers to give taxpayers whatever outcome they might have been able to achieve through tax planning under the prior rules, but without the transactional costs.

Changing an Election. Some modest limitations are imposed on making and changing an election. In general, an entity is entitled to change an election only once in any 5-year period.[89] It may do so at will by transferring its business and assets to a new entity, but such a transfer may have adverse tax consequences.

An entity that has been treated as a corporation that elects to be treated as a partnership is treated as if it distributed its assets and liabilities to its shareholders in liquidation and the shareholders immediately contributed those assets and liabilities to a newly formed partnership.[90] Gain is recognized on the deemed liquidation, and the deemed basis of the partners is carried over to the partnership on the deemed contribution to the partnership.[91] Similarly, if an entity taxable as a partnership elects to be classified as a corporation, it is deemed to have contributed its assets and liabilities to the corporation in exchange for stock and to have distributed the stock to the partners on liquidation of the partnership.[92]

If a corporation elects to be treated as a disregarded entity, the owner is treated as having received the assets and liabilities of the corporation in liquidation.[93] Conversely, if a disregarded entity elects to be treated as a corporation, the owner of the organization is treated as having contributed all of the assets and liabilities of the organization to the corporation in exchange for its stock.[94]

If the membership of an eligible entity that has elected to be treated as a partnership is reduced to one, then the entity becomes a disregarded entity.[95] If the membership of a disregarded entity should become greater than one, then the entity is classified as a partnership unless the parties make an election to have the entity classified as a corporation.[96] For example, if A, the owner of a disregarded entity, sells a 50-percent interest in that entity to B, then the entity will be classified as a partnership.[97] A and B may elect, however, to have the entity classified as a corporation.[98]

The check-the-box regulations offer many tax planning opportunities to U.S. taxpayers in the international arena, as illustrated by the following example.

Example 4.1: Check-the-Box Regulations

UCo is a domestic corporation organized under the laws of Delaware. It conducts business in the United States at a profit. UCo owns all of the stock of MCo, a corporation organized under the laws of

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[88] Reg. § 301.7701-3(b) (2006).

[89] Reg. § 301.7701-3(c)(1)(iv) (2006).

[90] Reg. § 301.7701-3(g)(1)(ii) (2006).

[91] Reg. § 301.7701-3(g)(2) (2006).

[92] Reg. § 301.7701-3(g)(1)(i) (2006).

[93] Reg. § 301.7701-3(g)(1)(iii) (2006).

[94] Reg. § 301.7701-3(g)(1)(iv) (2006).

[95] Reg. § 301.7701-3(f)(2) (2006).

[96] Id.

[97] Reg. § 301.7701-3(f)(4) (2006).

[98] Id.

Country M that has been operating at a loss. To minimize U.S. tax on its U.S. source income, UCo elects under the check-the-box regulations to treat MCo as a branch. As a result of that election, the foreign losses incurred by MCo may be used to offset UCo's income earned in the United States.

Besides owning MCo, UCo also owns a six percent interest in RCo, a corporation organized under the laws of Country R. RCo was formed by a consortium of companies, mostly European, to construct oil-refining facilities in Country R. RCo pays substantial income taxes to Country R and pays substantial dividends to its shareholders. MCo cannot claim an indirect foreign tax credit for the Country R income taxes, however, because it fails to satisfy the 10-percent ownership test of Code section 902(a). It arranges, therefore, for RCo to elect to be treated as a partnership for U.S. tax purposes.[99] *As a deemed partner in RCo, UCo becomes eligible to claim a direct foreign tax credit under Code section 901. It is treated under that section as having paid its pro rata share of RCo's taxes.*

UCo also owns SCo, a holding company organized under the laws of Country S, a tax haven. SCo pays no taxes in Country S. SCo has three wholly owned European subsidiaries, FCo, GCo, and ICo, that operate, respectively, in Country F, Country G, and Country I. All of these affiliates operate at a profit. To take advantage of business opportunities that arise from time to time, UCo arranges for funds to be transferred from one of the affiliates to another. The transfers take place by having one of the affiliates pay a dividend to SCo and having SCo make a capital contribution to the affiliate in need of the funds.

Under the anti-avoidance rules of subpart F, a dividend from GCo, FCo, or ICo to SCo would be treated as "subpart F" income, currently taxable to UCo as a deemed dividend. To avoid that result, UCo arranges for the European affiliates to check the box to be treated as branches of SCo. As a result of that election, the dividends from the affiliates to SCo are treated for U.S. tax purposes as intra-company transfers with no U.S. tax consequences.

The check-the-box regulations increase the opportunities for avoiding foreign income taxes as well as U.S. taxes. To illustrate, assume that SCo, the holding company in the example above, owns a valuable trademark, which it makes available to GCo for a royalty. GCo deducts the royalty payment in computing its income taxes owed to Country G. Before the check-the-box regulations were adopted, the royalty payments from GCo to SCo would have constituted subpart F income, taxable currently to UCo as a deemed dividend. UCo would have little incentive, therefore, to cause SCo to inflate the royalty charge to GCo.

That result is changed under check-the-box. If GCo, in *Example 4.1*, above, checks the box to be treated as a branch of SCo, royalty payments between GCo and SCo are ignored for U.S. tax purposes and do not generate subpart F income. An inflated royalty, therefore, has become beneficial. Of course, Country G might prevent GCo from deducting an excessive royalty payment, assuming it has in place an effective set of transfer pricing rules. To do so, however, it must detect the misstatement of income and expend resources to correct it.

§ 4.02.1.2. Anti-Avoidance Measures

Some commentators and some governments profess to be unconcerned about the type of tax avoidance illustrated in *Example 4.1*, above. They insist that a country should be concerned only about the avoidance of its own taxes. It should not, they claim, be a tax policeman for the world.[100]

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[99] The assumption in the example is that the affiliates were not ineligible entities—that is, they were not organized as one of the listed foreign entities that *must* be treated as a corporation under the check-the-box regulations. *See* Reg. § 301.7701-2(b)(8)(i) (2012).

[100] Old-timers may recall that this argument was made against the adoption of the subpart F rules in the early 1960s.

From the government perspective, this solipsistic approach to international taxation is grand folly. The United States, and indeed all major industrial countries, have a major stake in buttressing the tax systems of their trading partners. The relationship between source taxation and residence taxation is symbiotic. Source countries are dependent on residence countries to mitigate the competitive pressures that tend to undermine their ability to tax income from moveable capital. Residence countries are likewise dependent on source countries, for only the source country can reduce the potential profit from tax avoidance and evasion by collecting taxes through withholding or by providing the residence country with regular and accurate information on the income flows of its residents.

The U.S. tax authorities belatedly acknowledged that the check-the-box rules they championed were allowing taxpayers to sidestep the anti-avoidance rules of subpart F and otherwise were wrecking havoc with the international tax regime that the United States had constructed over the past four decades.[101] On January 16, 1998, it issued Notice 98-11,[102] announcing that regulations were forthcoming that would restrict the use of hybrid entities—entities treated as one type of entity under check-the-box and as another type of entity under foreign law. The promised regulations, temporary and proposed, were issued on March 23, 1998. On June 19, 1998, in response to a firestorm of protests from multinational companies and the threat of Congressional action to roll back the regulations,[103] the tax authorities withdrew the regulations and announced an intent to issue new regulations that would be effective after a lengthy transition period.[104] Companies that had set up hybrid entities prior to June 19, 1998, were promised that they would be permanently exempt from the anti-avoidance rules contained in the new regulations.[105] The new proposed regulations, based on the March 23, 1999, temporary regulations that were withdrawn, were issued on July 9, 1999. They are to be effective no sooner than July 1, 2005—indicating that many of the tax avoidance

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[101] The U.S. tax authorities have been reluctant to acknowledge that check-the-box, from the government's perspective, has been an abysmal failure. This reluctance is understandable, as the tax authorities developed and promoted the check-the-box concept. The tax avoidance opportunities available under check-the-box were explained in detail in the first edition of this book, long before Notice 98-11 was under consideration by the Service. For a primer on international tax avoidance under check-the-box, see John B. Magee, F. Scott Farmer, and Robert A. Katcher, "Branching Out – Reexamining Branch Rules in the Context of Check-the-Box," 15/25 *Tax Notes Int'l* 1951-1972 (Dec. 15, 1997). See also Henry J. Lischer, Jr., "Elective Tax Classification for Qualifying Foreign and Domestic Business Entities Under the Final Check-the-Box Regulations," 51 *Southern Methodist University Law Review* 99 (1997) (providing an excellent analysis and description of the check-the-box rules); Victor E. Fleischer, Note, "'If It Looks Like a Duck': Corporate Resemblance and Check-the-Box Elective Tax Classification," 96 *Columbia Law Review* 518 (1996); Thomas M. Hayes, Note, "Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect on Entity Classification," 54 *Washington & Lee Law Review* 1147 (1997).

[102] Notice 98-11, 1998-6 I.R.B. 13 (Jan. 16, 1998). See also Lee Sheppard, "U.S. Cross-Border Tax Arbitrage, 'Hybridity,' Mules, and Hinnies," 16/8 *Tax Notes Int'l* 579-585 (Feb. 23, 1998).

[103] See Staff of Joint Committee on Taxation, *Description of Additional Modifications to Senate Finance Committee Chairman's Mark Relating to Reform And Restructuring of The Internal Revenue Service And Tax Technical Correction Provisions* (JCX-23-98), March 31, 1998 (stating that it is the sense of the Finance Committee that the regulations contemplated by Notice 98-11 should not be implemented for at least 6 months).

[104] Notice 98-35, 1998-27 I.R.B. 35 (June 19, 1998). For discussion of the political difficulties that forced the Treasury Department to withdraw the regulations, see Leslie Wayne, "U.S. Corporate Giants Save a Tax Loophole," *New York Times* p. 17 (July 12, 1998) (describing the "intense lobbying campaign" by U.S.-based multinationals and the big accounting firms that had aggressively marketed tax avoidance schemes based on check-the-box). Multinational companies stand to reduce their annual tax bill by many billions of dollars, notwithstanding the low-ball estimate by the Joint Committee on Taxation that the revenue cost of rolling back the regulations would amount to only $1.8 billion over ten years. That estimate does not take account of the huge tax savings that U.S.-based multinationals would enjoy from avoiding foreign taxes and the likely retaliatory responses of U.S. trading partners to the U.S.-sponsored avoidance of their taxes. For additional discussion of the IRS retreat on Notice 98-11, see Dave Benson, Hal Hicks, Margie Rollinson, and Vickie Kraay, "U.S. IRS Notice 98-35 Withdraws Regulations on Hybrid Branch Payments," 16/26 *Tax Notes Int'l* 2033-2036 (June 29, 1998); Lee Sheppard, "U.S. Notice 98-11 Withdrawn: Who Won?," 17/1 *Tax Notes Int'l* 57 (July 6, 1998).

[105] Notice 98-35, 1998-27 I.R.B. 35 (June 19, 1998).

opportunities derived from the use of hybrid entities will be available for at least another six years.[106] In fact, they never went into effect.

Although the U.S. tax authorities in the Clinton administration were forced by political concerns to surrender on the hybrid-entity issue, they had indicated a willingness to continue to oppose other perceived abuses of the check-the-box rules. On November 29, 1999, they issued proposed regulations that would prevent a taxpayer in some circumstances from using check-the-box to characterize a foreign subsidiary as a disregarded entity when it sells the stock in that entity.[107] A typical taxpayer purpose for having the subsidiary treated as an disregarded entity would be to convert, for U.S. tax purposes, the sale of stock in a foreign affiliate—which typically would generate U.S. source income[108] or subpart F income[109]—into a sale of its assets.[110]

In the preamble to the November 29, 1999, proposed regulations, the U.S. tax authorities indicated a concern that abuse of check-the-box was undermining some important U.S. tax policies and that its proposed solution is to void the effect of a check-the-box election in some cases. The preamble states:

> These regulations [modifying the check-the-box rules] are intended to address inappropriate Federal tax consequences that would otherwise result from certain of these transactions under a number of international provisions of the Code. These provisions include the rules governing source of income under sections 861 through 865, foreign tax credit limitation categories under section 904, the disposition of ownership interests under Subpart F (sections 951-964), and outbound transfers under section 367. . . .

The IRS and Treasury considered several responses to these transactions and determined that a special rule completely revoking the entity's classification as a disregarded entity was the most equitable and administrable approach. Of the responses considered, the IRS and Treasury believe that this approach also gives the greatest certainty to all parties involved in the transactions covered by this rule.[111]

The proposed regulations signaled a change in strategy by the U.S. tax authorities. Rather than attacking perceived abuses by amending the substantive tax rules that check-the-box has undermined, the U.S. tax authorities in the Clinton administration apparently were prepared to curtail certain perceived abuses by amending the check-the-box regulations. The advantage of this latter approach, from the perspective of the tax authorities, is that they appear to have plenary power to revise the check-the-box regulations, having usurped the power to issue the regulations in the first place.[112] In fact, however, nothing

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[106] For discussion, see David Benson & Margaret O'Connor, "U.S. Treasury Backs Off Its Attack on Hybrid Branches, Withdraws Notice 98-35 and Temporary Regulations," 19/4 *Tax Notes Int'l* 389 (July 26, 1999).

[107] Prop. Reg. § 301.7701-3(h) (1999).

[108] Compare IRC §§ 865(a) (setting forth general rule that the source of income from sale of personal property, including stock, is country of residence of the seller), 865(c) (sale of depreciable property used outside the United States produces foreign source income), and 865(d) (sale of certain intangible property used outside the United States produces foreign-source income).

[109] See IRC § 954(c)(1)(B) (classifying gain sale of stock as foreign personal holding company income subpart F income).

[110] For discussion of the proposed regulations, see Thomas R. May, "Warning: Hybrid Entities—Proceed With Caution," 19/25 *Tax Notes Int'l* 2357 (December 20, 1999).

[111] REG. 110385-99, 64 F.R. 66591 (Nov. 29, 1999).

[112] The creation of an elective system would appear to go beyond the authority of the tax authorities to interpret statutory terms such as "partnership" and "corporation," especially when the system routinely results in the same types of entities being classified differently for similarly situated taxpayers. The possible illegality of the regulations is discussed in Staff of the Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* (JCS-6-97), April 8, 1997, at 13-16; see also W. McKee, W. Nelson and R. Whitmire, *Federal Taxation of Partnerships and Partners*, 3-102 (3d ed. 1997), para. 3.08; New York State Bar Association Tax Section, "Report on the 'Check the Box' Entity Classification System Proposed in Notice 95-14," Aug. 30, 1995.

much was done, by the Clinton administration or the subsequent Bush administration. The Obama administration indicated some willingness to restrict certain perceived abuses of check-the-box, but, as of August of 2012, no legislative changes have been adopted..

The importance of the check-the-box rules for international tax planning is hard to overstate. A recent assessment of those rules in the international field reported that the application of the rules to foreign entities is "complex and difficult to administer, and is revenue reducing as a result of potentially inefficient tax planning activity that is contrary to the objectives of the Code provisions for taxing foreign income".[113] According to IRS figures, a total of 97,922 elections were made under the check-the-box rules by foreign entities from 1997 to 2007. Of that number, 68,218 such elections were made to classify entities as disregarded (SMEs).[114]

§ 4.02.2. Trusts and Estates

In general, trusts and estates are classified under the check-the-box regulations according to their actual legal characteristics. That is, they are not part of the elective system described in § 4.02.1, above.

In general, an organization that is treated under the check-the-box regulations as a separate entity for federal tax purposes is either a "trust" or a "business entity."[115] A trust is an entity that does not have associates or an objective to carry on business for profit.[116]

A trust is typically created by will or *inter vivos* declaration. Under the trust arrangement, the trustees typically hold title to property contributed to the trust and preserve or conserve the property for the beneficiaries of the trust. In general, the beneficiaries may not share the management responsibilities of the trustees. Consequently, they are "not associates in a joint enterprise for the conduct of business for profit."[117]

An entity will not be classified as a trust for federal tax purposes simply because it is referred to as a trust or has a trustee who holds legal title to contributed property. The general rule is that if the entity carries on business for profit, it will not be a trust, notwithstanding its name.[118]

No guidance is given in the Code or the regulations as to when an entity might be classified as an estate for purposes of entity classification. In this context, however, an estate is simply a special kind of trust. The "grantor" of that trust is the decedent, and the beneficiaries are the persons entitled to receive the property of the estate pursuant to a will or to the applicable laws of descent and distribution. The fiduciary of this special trust is the executor or administrator of the estate.

Viewed as a type of trust, an estate would not be classified as a business entity if it does not have associates or an objective to carry on business for profit.[119] Its defining characteristics would be that it came into being as a result of the death of the decedent, that its property is held in a fiduciary capacity by the administrator or executor, that the primary responsibility of that fiduciary is to preserve and conserve the estate for its beneficiaries, and that the beneficiaries do not share in the discharge of that responsibility. By

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[113] See Heather M. Field, "Checking in on 'Check-the-Box,'" 42 LOYOLA L.A. LAW REV. 451, 490 (2009).

[114] Id. at n. 205.

[115] Reg. § 301.7701-2(a) (2012).

[116] Reg. §§ 301.7701-1(b) (2011) and 301.7701-4(a) (1996).

[117] Reg. § 301.7701-4(a) (1996).

[118] Reg. § 301.7701-4(b) (1996)

[119] By classifying all entities that are not business entities as "trusts," Reg. § 301.7701-2(a) (2012) has implicitly treated an estate as a type of trust. Yet Reg. § 301.7701-4 (1996) distinguishes sharply between trusts and estates.

analogy to the trust rules, it appears that an estate that is used to conduct business or to manage investments for persons who are not beneficiaries would be treated as a business entity under the regulations.

§ 4.02.3. Policy Notes on Check-the-Box

The check-the-box system for classifying business entities violates the basic principle that tax policy should be made by the government acting for the citizenry as a whole, not by individual taxpayers acting in their own self interest. As illustrated by *Example 4.2*, above, check-the-box permits taxpayers to defeat freely some of the fundamental policy goals of the corporate income tax. For example, by utilizing the check-the-box regulations, a U.S. corporation that wants to take losses incurred by a foreign affiliate can do so by electing to have the foreign affiliate treated as its foreign branch. Similarly, U.S. taxpayers can defeat the anti-avoidance rules of subpart F in many cases by electing to have their foreign controlled corporations treated as branches. As the U.S. tax authorities acknowledged in the preamble to proposed regulations issued on November 29, 1999, check-the-box is being used to defeat U.S. source rules, U.S. rules on expatriation of assets, U.S. credit limitation rules, subpart F rules, and many other major rules. Surely, check-the-box is a sign that U.S. international income tax policy is in disarray.

Defenders of check-the-box contend that the system it replaced was “insane.” Not only was it insane in terms of policy results, but it also imposed high administrative costs on the government and forced taxpayers to pay extravagant legal fees.[120] Check-the-box is better, they assert, because it achieves about the same results as the old insane system at substantially reduced costs.[121]

Members of the tax bar, and particularly the international tax bar, have responded euphorically to check-the-box.[122] Their euphoria cannot be explained entirely by the prospect that they will be losing extravagant legal fees. At least in part, the euphoria is due to the dramatic new opportunities for tax avoidance that check-the-box offers.[123]

Check-the-box has surely simplified the law relating to the classification of foreign entities. Some of the simplification gains, however, may be short lived. Check-the-box is not grounded on tax policy principles. It is an ad hoc response to the problems created by the unprincipled, perhaps insane, classification system that it replaced. All legal rules, including the extensive rules in the check-the-box regulations, require interpretation. In a principled system, the underlying principles give guidance on how interpretive lines ought to be

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[120] The characterization of the old classification rules as insane comes from Gerald T. Ball and Michael A. Siegel, “Current Developments in Foreign Entity Classification—Stop the Insanity,” 9 *Tax Notes Int’l* 759-767 (Sept. 5, 1994).

[121] See, e.g., David A. Weisbach, “Line Drawing, Doctrine, and Efficiency in the Tax Law,” 84 Cornell Law Review 1627-1681 (1999) (praising check-the-box on efficiency grounds without noting the enormous efficiency costs that almost certainly result from allowing taxpayers to engage in cross-border tax arbitrage through the use of hybrid entities).

[122] See, e.g., Daniel M. Shefter, “Check the Box Partnership Classification: A Legitimate Exercise in Tax Simplification,” 67 *Tax Notes* 279 (April 10, 1995) (suggesting that the proposed check-the-box system “almost sounds too good to be true”). Some academics were also enthusiastic. See, e.g., Reuven S. Avi-Yonah, “To End Deferral As We Know It: Simplification Potential of Check-the-Box,” 74 *Tax Notes* 219 (January 13, 1997) (“check-the-box makes it possible for taxpayers to avoid transaction costs, without putting the IRS in a significantly worse position than it was under prior law, and also reduces the likelihood that classification issues will be the subject of litigation, which is costly for both taxpayers and the IRS”).

[123] For a useful description of the check-the-box regulations and a discussion of the tax planning opportunities they present, see Joni L. Walser and Robert E. Culbertson, “Encore Une Fois: Check-the-Box on the International Stage,” 15 *Tax Notes Int’l* 53-74 (July 7, 1997). In describing the importance of check-the-box to tax planners, those authors observe:

> The regulations . . . are said to have merely made *de jure* an elective classification scheme that already existed *de facto* under prior law. But [the fact of the matter] is that electivity could only be achieved at significant expense and *with significant uncertainty*—and not at all in some cases—while elective classification is now cheap, certain, and available in all but a few well defined cases. Thus, the regulations will *substantially broaden* the practical utility of U.S. classification as an international tax planning tool. (Emphasis added.)

Id. at 55.

drawn. Unprincipled systems tend to get complex because the line drawing cannot be accomplished without creating a host of new anomalies. The one operative principle under check-the-box—that no taxpayer should be worse off than under the old rules—is not a useful principle for maintaining a coherent system of taxation.[124]

The check-the-box regulations, in the international arena, do not appear to serve any public purpose, unless undermining the international tax regime of the United States and its trading partners is viewed as a public purpose. As one commentator has noted:

> [I]t is difficult to believe that the original purpose for which the [check-the-box] regulations were issued has been accomplished to any significant degree. That purpose was to reduce the total amount of time Treasury must spend addressing issues relating to entity classification. Instead, it seems that nowadays Treasury wastes much more time in attacking the use (or misuse) of hybrid entities in international tax planning than it ever did on domestic and foreign entity classification.[125]

Given the lack of apparent public purpose, the case on tax policy grounds for retaining the check-the-box regulations in their present form apparently does not exist. The political obstacles to fundamental reform of the regulations, however, appear to be formidable.

Reform cannot come without the development of some new system for classifying foreign entities. The old system of looking at "corporate attributes" was flawed conceptually, and in practice it worked out as an expensive, albeit limited, version of check-the-box. That system was designed primarily to deal with the issue of whether income earned through an entity of questionable status should be taxable both at the corporate level and at the individual level. In the international arena, virtually all of the entities of questionable status are owned by corporations. The individual shareholders of these corporations are not going to be taxed directly (*i.e.,* on a pass-through basis) on income earned through those entities however the classification issue is resolved. The primary issue in the international arena is whether corporations should be allowed to use inconsistencies among countries in the classification of their controlled entities to minimize their taxes. The old system allowed that type of tax planning, but only at some cost in administrative fees and some risk. Check-the-box, as initially implemented, made it inexpensive and virtually risk free. The Treasury's anti-avoidance campaign, however, is likely to increase both the costs and the risks.

A reformed classification system in the international arena would have two important characteristics—certainty and consistency. Certainty would be advanced by identifying the status of an entity once and for all, based on ascertainable historical facts. For example, certainty would be advanced by preventing taxpayers from treating an entity as a "disregarded entity" if they have organized it as a corporation under local law.

Consistency is achieved if an entity that is treated as a corporation, branch, or partnership in one country is given that same treatment in all other countries in which the entity conducts significant business activities. In a world replete with tax havens, full consistency is impossible to achieve. It would be advanced, however, if the major taxing countries agreed to give nearly determinative weight, in classifying an entity, to the classification given to it under the laws of the member state in which it was organized.

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[124] The point made in the text might have been controversial when initially written—soon after publication of the check-the-box regulations. At the time, tax practitioners and Internal Revenue officials were still expecting to garner major simplification gains from check-the-box. It is now clear, however, that those gains did not materialize.

[125] Thomas R. May, "Warning: Hybrid Entities—Proceed With Caution," 19/25 *Tax Notes Int'l* 2357 (December 20, 1999).

Like the sack of Rome by Alaric and his Visigoths in the early fifth century, the adoption of check-the-box punctuated and finalized a decline and fall that had occurred through many small steps over a very long time.[126] The unruly and undisciplined check-the-box system that replaced it, however, is far worse than the old regime, for the only rule of law that now applies is the law asserted by the taxpayer as ruler of its private domain. Reform of check-the-box should be high on America's tax reform agenda, for that unwise and possibly illegal system is undermining its international tax policies and the tax polices of its major trading partners.

[126] Those steps would include (1) the original classification regulations (*Kintner* regulations), adopted in 1960, which placed heavy emphasis on formal attributes under control of the taxpayer and were improperly weighted in favor of conduit treatment; (2) the *per se* treatment of a limited partnership as a conduit entity (the rule that launched a million tax shelters); (3) the general treatment of a partnership with a corporate general partner as a conduit; (4) the treatment of very large partnerships with centralized management, such as American Express, as conduits; and, most recently, (5) the treatment of limited liability companies (LLCs) as conduits.