by Leslie A. Share

Identifying and Reporting the Proper Taxpayer in International Structures

One of the most basic issues in U.S. tax law is the determination of the appropriate person or entity subject to tax and the accompanying compliance obligations with regard to a particular payment or other income item. When a non-U.S. entity appears to be the taxpayer in question, its classification for U.S. tax purposes is often crucial, especially when its status may not be obvious from its name or governing documents. In addition, especially in the international context, the actual recipient, titleholder, or beneficiary of the item in question is not always necessarily the "real" taxpayer in question. The IRS and U.S. courts on many occasions have dissected complex income streams and planning structures in the attempt to identify the actual responsible reporting party. Because offshore transactions and inbound and outbound tax planning activities are often highly scrutinized by the IRS, international tax practitioners will need to be extremely careful in providing advice in connection with U.S. tax-related responsibilities.

U.S. Tax Classification of Selected Offshore Entities

Offshore entities labeled as corporations, partnerships, trusts, and limited liability companies under local law, which are not per se corporations, may generally choose their U.S. tax status by filing a "check-the-box election" on Form 8832. On the other hand, the default status of many potentially eligible non-U.S. entities is not always clear because some of them arguably have no exact comparable match under U.S. law. If a foreign corporation, which is a foreign-eligible entity, elects treatment as a disregarded entity or a partnership for U.S. tax purposes, the U.S. shareholders of the corporation will be subject to U.S. tax on the entity's income in the year the income is earned, regardless of whether the earnings are distributed. U.S. investors, however, are generally allowed to claim a foreign tax credit against their U.S. federal income tax liability for their pro rata share of any income taxes paid by the foreign entity to the local tax authorities. The possibility of obtaining such a credit is often of paramount importance to individual shareholders of a foreign entity located in a high-tax jurisdiction because they would otherwise be subject to double taxation, first at the corporate level, and then in the U.S. at the shareholder level. In addition, to the extent that the foreign entity incurs losses, individual or corporate U.S. shareholders may be able to reduce their U.S. taxable income using such losses.

These pass-through attributes should be compared to the possibility of deferral if "corporation" treatment is instead elected on Form 8832 or accepted as the likely U.S. default treatment of the entity, or a per se corporation is the chosen investment or business vehicle. Pass-through treatment may also avoid the application of the U.S. branch profits tax with regard to certain effectively connected earnings and profits of the foreign entity, limit the imposition of income taxes to a single level, and enable the potential availability of long-term capital gains treatment in appropriate cases. If the foreign entity is either located in a low- or no-tax jurisdiction, its earnings will be distributed to its owners on an annual or more frequent basis, or it will predominately earn income of one or more types not eligible for deferral under U.S. tax law. Electing pass-through treatment or maintaining it as the entity's default classification may be the most overall advantageous planning tool for U.S. owners of the entity.

Foreign Partnerships

Many foreign "partnership" type entities with at least two owners arguably should default as such for U.S. tax purposes without the need to file a check-the-box election. On the other hand, if ultimately advantageous from a U.S. tax collection standpoint, the IRS may instead attempt to classify the entity as a corporation or disregard it entirely for U.S. tax purposes. Under the latter circumstances, "piercing the veil" in this manner could for example increase the likelihood of the estate of a non-U.S. person individual partner being subject to U.S. estate tax upon his or her share of the entity's U.S.-situs assets.

One potential partnership-type entity "piercing" method could be that an entity has only one actual "owner" because all the owners are commonly controlled or all but one such owner has a "de minimis" interest, thereby deeming the entity assets owned directly by a single owner. For example, in Rev. Rul. 77-214,[1] a pre-check-the-box election regulation ruling, the IRS treated a German GmbH that was jointly owned by two U.S. corporations with a common U.S. parent company as a corporation for U.S. tax purposes because the U.S. parent corporation

was, in substance, the entity's sole beneficial owner. Although the IRS later modified this ruling and declared it to be obsolete, it could still potentially use similar reasoning to claim that when one person or entity owns most of a partnership, with the other partners being effectively controlled by the first partner or having no or miniscule partnership economic interests, the other partners' interests should be disregarded. Under this theory, any otherwise applicable U.S. estate tax protection of the partnership for the partner in question may disappear. On the other hand, in a practical sense, it could be difficult for the IRS to take such a position if the other partners each have at least a one percent interest acquired with their own funds that they did not receive by gift or loan from the majority partner.

Foreign Trusts

Significantly, there is no "box" on Form 8832 for a domestic or foreign entity to elect "trust" status for U.S. tax purposes. In addition, unlike other entities, there is no default status to treat an entity as a trust for such purposes. As a result, trust-type entities must take such a position using other consistent means, such as formation documents, operations and management governance, and U.S. tax and compliance filings. At least in theory, such an entity could elect treatment as an "association taxable as a corporation," which may prove useful in certain circumstances. For example, one such entity could be a foreign revocable trust that directly owns U.S.-situs assets, such as U.S.-based tangible personal property, stock of a domestic corporation, or U.S. real estate.[2] These assets would generally be subject to U.S. estate tax upon the death of a settlor who is neither domiciled in the U.S. nor a U.S. citizen.[3] However, the foreign entity may be able to potentially shield such property from this tax by electing corporation status with an effective date during the settlor's lifetime. In appropriate circumstances, it may be possible to file this election after the settlor's death under Rev. Proc. 2009-41[4] with sufficient retroactive effect to achieve the desired planning result.

Civil Law Foundations

Many foreign jurisdictions provide for civil law foundations that, in effect, act as substitutes for a common law trust. The structure and governance of civil law foundations vary depending on the governing jurisdiction. In lieu of fiduciary management by trustees, in general, an appointed board manages foundations in accordance with formal articles. Unlike most trusts, foundations are registered in the public records of certain countries. U.S. and foreign practitioners have debated for many years whether trusts or foundations are superior from a U.S. tax, wealth preservation, and estate planning standpoint, but there appears to be no clear answer.[5]

In general, depending upon various factors, civil law foundations may default as either a trust or a corporation for such purposes.[6] This delineation can have a significant effect for U.S. estate planning purposes. For example, as in the case of the foreign trust discussed above, upon the death of a founder who is not a U.S. person for U.S. estate tax purposes, a foreign foundation's U.S.-situs assets could be subject to U.S. estate tax upon the founder's death if the foundation is most akin to either a revocable trust or an irrevocable trust if the founder retained certain powers over the entity.[7] Depending in part upon whether the entity is engaged in active business activities, a reasonable related U.S. tax reporting position would likely be classified either as a trust or a corporation, preferably being memorialized on Form 8832. As a bottom line, if the founder or any board member or beneficiary of a civil law foundation is a U.S. citizen or income tax resident, such individual should be prepared to report the foundation's assets and income from a U.S. compliance standpoint as may be required.

Limitada

A limitada (an S.R.L., S. de R.L., or similar) is roughly the civil law equivalent of a domestic limited liability company. For check-the-box election purposes, taxpayers may generally treat a limitada as either a single-member disregarded entity (in certain circumstances when there is only one beneficial owner), a corporation or a partnership. Because laws vary from country to country in connection with whether a limitada member may be liable for one or more obligations of the entity, the default U.S. tax classification of a limitada may not be universally certain. On a practical basis, especially when the check-the-box election can be effective as of the limitada's date of formation, the safest route for U.S. planning purposes could be to file Form 8832 to establish formally its classification rather than presume its applicable default treatment.

Comandita

This type of "limited silent partnership" entity exists in civil law countries, such as Argentina, Brazil, Chile, Colombia, Mexico, Portugal, Spain, and Venezuela. For U.S. tax purposes, U.S. tax law should treat a comandita as if it were either a corporation or a pass-through entity, provided that it so elects through the check-the-box election. Without the check-the-box election, its default U.S. tax treatment

is not entirely certain, although partnership treatment should apply.

Fideicomiso

A fideicomiso is a contractual arrangement that arguably creates a relationship falling somewhere between a trust and a custodial agreement. Many U.S. persons use these entities for the development and acquisition of real property in areas of Mexico in which foreign investment is either restricted or limited. In such instances, a foreigner may acquire an interest in the fideicomiso itself rather than taking title to the underlying property.[8] In 2011, the IRS Office of the Chief Counsel took the position that as "general information only," any U.S. person who transfers property to or who has an interest in a Mexican fideicomiso must treat the entity as a foreign trust for purposes of filing Forms 3520 and 3520-A.[9] However, in Rev. Rul. 2013-14,[10] the IRS apparently switched positions in determining that 1) the fideicomiso in question was not a trust for U.S. compliance purposes; and 2) the U.S. beneficial owner was the tax owner of the real estate for U.S. tax purposes, regardless of whether he or she directly held the fideicomiso interest or through a disregarded single-member domestic limited liability company. Although Rev. Rul. 2013-14 supports the general U.S. reporting position traditionally maintained by many U.S. practitioners that a fideicomiso is more akin to a custodial or nominee arrangement than a trust, caution should be exercised in terms of determining whether a taxpayer's particular situation falls within its facts and circumstances prior to making a related compliance decision.

Nominees, Agents, and Shams

As discussed above, under certain circumstances the IRS may in effect "sham" an entity's existence for U.S. tax purposes and treat the entity as a conduit, agent, or nominee of the entity's owners.[11] For example, the IRS used this type of argument in the international area against the perceived improper utilization of the U.S. tax treaty network.[12] Based upon this historical precedent, the IRS took such positions in the recent offshore voluntary disclosure initiatives and the U.S. government's related escalated prosecutions of individuals with unreported offshore income and accounts. In contrast, it has generally been extremely difficult for a taxpayer to effectively sham its own structure; in other words, proving that an entity that is not otherwise treated as a pass-through for U.S. tax purposes should in fact be ignored as being separate, distinct, and viable from a U.S. tax standpoint. If under the facts presented, a foreign corporation is truly an agent or nominee of another taxpayer (*e.g.*, a nongrantor trust that owns the foreign entity), such taxpayer should be deemed the actual "owner" of the nominee's assets, income, and gains and must accordingly account for them in its financial reports and records. In this regard, U.S. case law indicates that a corporation may be deemed a nominee for the true beneficial owner of assets held in the corporation's name for U.S. tax purposes under appropriate facts and circumstances.

In *National Carbide Corp. v Commissioner*, 336 U.S. 422 (1949), the U.S. Supreme Court determined that six factors exist to determine if a corporation is acting as an agent for a principal for U.S. tax law purposes: 1) whether the corporation operates in the name and account for the principal; 2) whether the principal was bound by the actions of the alleged corporate agent; 3) whether the corporate agent transmitted money received to the principal; 4) whether the receipt of income was attributable to assets or employees of the principal; 5) whether the relationship of the corporate agent was dependent on the fact that it was owned and controlled by the principal; and 6) whether the activities of the corporate agent were consistent with the normal duties of an agent. [13]

With regard to the fourth *National Carbide* factor, a principal-agent relationship must not merely be an attempt at an assignment of income. Income received by an agent is taxable to a principal at the time of receipt by the agent, rather than at the time of payment by the agent to the principal.[14] As for the next ownership level, reporting of any and all income by the actual beneficial owner of stock supports the testimony of a nominee titleholder that the stock was not his or hers for U.S. tax purposes.[15] The fifth *National Carbide* factor requires that an additional three-part test be applied to determine if a controlled corporation will be treated as an agent: 1) whether a written agreement set forth that the corporation acted as agent for its shareholders with respect to a particular asset; 2) the corporation functioned as agent and not as the principal with respect to the asset for all purposes; and 3) the corporation was held out as the agent and not the principal in all dealings with third parties relating to the asset.[16]

Although written documentation is apparently not an absolute requirement to prove the existence of a corporate agency agreement, it provides the most preferable means of supportive proof of the alleged facts and circumstances.[17] In *Commissioner v. Bollinger*, 88-1 USTC ¶9233 (S. Ct. 1988), the U.S. Supreme Court upheld written nominee/agency agreements in part because they specified that a corporation acted in said capacity on behalf of a particular partnership. However, a purported agency relationship was considered to be a sham when the written document was never effective; the actions of the parties were inconsistent; the testimony of the parties was unreliable; and "supportive" documents were created currently to document prior actions only after the IRS had requested copies of them after previously being told by the taxpayer that they did not exist.[18] In addition, stock certificates and other written evidence of ownership are not necessarily the controlling factor.[19] Although an oral agreement may be sufficient to establish a nominee arrangement under certain circumstances, a written agreement confirming the interested parties' mutual understanding of the existence of the nominee/agency relationship is undoubtedly far more convincing proof.

Although not for the faint of heart, intentional foreign nominee planning can have related U.S. tax benefits. For example, in the case of a foreign corporation with one or more U.S. person shareholders, if supported by the facts and circumstances, the successful nominee or agent treatment of

the entity could alleviate the potential negative U.S. tax and compliance effects that otherwise could result from corporation tax treatment. The principal and agent relationship of the parties in question is generally determined under local law.[20] Therefore, taxpayers taking such a position should ideally obtain a supportive written opinion of counsel in the jurisdiction in question, noting that there are never any absolute guarantees that either the IRS or a court of law would ultimately agree with such a position in a particular case.

IRS Enforcement Activity Against Sham Entities

In an attempt to shield their assets from scrutiny, many U.S. persons established supposed "blocker" offshore structures using foreign corporations and foundations to hold non-U.S. financial accounts and other assets. In any event, regardless of the debatable correctness of the Form W-8BEN submitted on behalf of the foreign entity, U.S. taxpayers were nevertheless generally required under U.S. law to report their relationship to the entity and the underlying assets, income, and gains but failed to do so. The U.S. government has recently been very successful in treating offshore "blocking" entities as "shams" for U.S. tax purposes and prosecuting their U.S. owners.

Consistent with this litigating position on numerous alleged "sham" or "nominee" foreign structures, under the 2009, 2011, and 2012 versions of the Offshore Voluntary Compliance Initiative (OVDI), the IRS has informally permitted taxpayers admitted to the program to disregard their own foreign entities so long as the U.S. beneficial owner reports all of the foreign entity's underlying assets, income, and gains accordingly, and the entity is formally dissolved prior to finalizing the related closing agreements. In this regard, 2012 OVDI Frequently Asked Questions #29 in effect continues the recent OVDI policy of permitting taxpayers to "sham" their own foreign entities through the execution of a statement on dissolved entities under penalties of perjury during the OVDI process. The form statement supplied by the IRS on its website requires confirmation under penalties of perjury that during the tax years in question, the taxpayer 1) used the named entities for the purpose of holding foreign accounts and/or assets to act as nominee or alter ego in holding the financial accounts and/or assets; 2) treated the financial accounts and/or assets of the entities as personal assets and accounts at all times after the formation of the offshore entities; 3) the financial accounts and/or assets held in the names of the entities were his or her assets; 4) he or she was responsible for filing the related foreign entity information returns; and 5) the entities had no business purpose other than to act as nominees. In accordance with these extraordinary written admissions of guilt, the taxpayer also acknowledges that the IRS will waive the requirement to file such delinquent information returns as a condition of resolving the voluntary disclosure, and confirms that he or she will instead dissolve or terminate these entities prior to entering into a specific matters OVDI closing agreement and provide any requested information about their dissolution or termination upon request. Although neither the 2012 OVDI FAQs nor this statement so indicate, it appears most likely that the IRS will treat the foreign entities so disclosed as disregarded entities for all other U.S. tax purposes.

Conclusion

The classification of foreign entities for U.S. tax purposes is often not a simple process. Although the relatively generous check-the-box election rules in effect provide for great flexibility for offshore entities not on the per se corporation list, there are numerous U.S. tax and estate planning considerations that must be considered prior to creating or modifying a foreign investment or business structure where U.S. persons may be involved.❑

[1] 1977-1 C.B. 408, modified and superseded by REV. RUL. 93-4, 1993-1 C.B. 225 (which itself was declared obsolete by REV. RUL. 98-37, 1998-32 I.R.B. 5).

[2] *See* TREAS. REG. §20.2104-1.

[3] *See* I.R.C. §2038.

[4] I.R.B. 2009-39 (9/28/2009).

[5] *See generally* L.A. Basha, *Trusts Versus Foundations: The Clash of the Titans or Two Structures Achieving the Same End Game?*, 100 DAILY TAX REPORT J-1 (May 26, 2010).

[6] *See, e.g.* IRS Advance Memorandum 2009-012 (Chief Counsel Advice), issued by the IRS Associate Chief Counsel (Passthroughs & Special Industries).

[7] *See, e.g.,* I.R.C. §2036.

[8] For an interesting case demonstrating the potential traps for a U.S. indirect investor (a Nevada LLC) in a Mexican fideicomiso from a Mexican tax standpoint, *see Gale v. Carnrite*, 559 F.3d 359 (5th Cir. 2009).

[9] Info 2011-0052, dated November 17, 2010, and released on June 24, 2011.

[10] I.R.B. 2013-26, dated June 24, 2013.

[11] *See, e.g., Fillman v. U.S.*, 355 F.2d 632 (Ct. Cl. 1966), and *Bigio v. Commissioner*, 62 T.C.M. 119 (1991), *aff'd*, 981 F.2d 1263 (11th Cir. 1992) (footnote no. 2).

[12] *See, e.g., Aiken Industries, Inc.*, 56 T.C. 925 (1971).

[13] *National Carbide*, 336 U.S. 422.

[14] *See Gerling International Insurance Co.*, 87 T.C. 679 (1986).

[15] *See, e.g., Berthold v. Commissioner*, 12 BTA 1306 (1928).

[16] *See also Commissioner v. Bollinger*, 88-1 USTC ¶9233 (S. Ct. 1988).

[17] *See, e.g., Advance Homes, Inc.*, 59 TCM 906 (1990), and IRS Private Letter Ruling 199947006.

[18] *Ghidoni v. Commissioner*, 61 TCM 2993 (1991). *See also* REV. RUL. 70-469, 1970-2 C.B. 179, REV. RUL. 70-615, 1970-2 C.B. 169, and REV. RUL. 75-261, 1975-2 C.B. 350.

[19] *See, e.g., Jacob S. Kamborian*, 56 T.C. 847 (1971), *affirmed sub nom, Estate of Jacob S. Kamborian v. Commissioner*, 469 F.2d 219 (1st Cir. 1972). *See also National Bellas Hess, Inc.*, 20 T.C. 636 (1953), *acq. in part*, 1953-2 C.B. 5, *affirmed*, 220 F.2d 415 (8th Cir. 1955), *rehearing denied*, 225 F.2d 340 (8th Cir. 1955) (voting trust shares were deemed held and controlled by the trust's beneficiaries, not the voting trustee); *Griswold Co.*, 33 B.T.A. 537 (1935), *acq.*, XV-1 C.B. 10 (shares held by an executor are owned by, and in the control of, the estate's beneficiaries); *Ridgewood Cemetery Co.*, 26 B.T.A. 626 (1932) (shares held by a corporate nominee for real estate were owned and controlled by the beneficial owner, not the nominee); REV. RUL. 84-79, 1984-1 C.B. 190.

[20] *See, e.g., Estate of Robert L. Allen*, 56 TCM 1494 (1989); *Estate of Larch M. Cummins*, 66 TCM 1232 (1993).

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