

## Qualification of Taxable Entities and Treaty Protection:

### United States of America

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#### Entity Qualification in Domestic Tax Laws

##### Domestic Entities

##### 1. Entities as taxpayers of income taxes

Whatever their form, business entities that are treated as corporations for U.S. federal tax purposes are separate taxpayers of the U.S. federal income tax.<sup>3</sup> Certain domestic entities that are treated as corporations are, however, eligible to elect to be treated as small business corporations for federal income tax purposes.<sup>4</sup> These small business (so-called S) corporations generally are not separate taxpayers of the federal income tax.<sup>5</sup>

##### 2. “Domestic” nature of an entity

Whether an entity is “domestic” for federal tax purposes is determined exclusively based on its place of creation or organization.<sup>6</sup> An entity that is created or organized “in the United States, or under the law of the United States or of any State” is a domestic entity.<sup>7</sup> For this purpose, an entity created or organized in the District of Columbia is a domestic entity,<sup>8</sup> as is an entity that is created or organized both within and without the United States.<sup>9</sup>

##### 3. Key factors for classifying an entity as a taxable one

The key factors for classifying an entity as taxable for federal tax purposes are (1) whether the entity is treated as a separate entity for federal tax purposes and (2) whether

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<sup>3</sup> I.R.C. s. 11.

<sup>4</sup> *Ibid.* s. 1361.

<sup>5</sup> *Ibid.* s. 1363(a).

<sup>6</sup> *Ibid.* s. 7701(a)(4)-(5); Treas. Reg. s. 301.7701-5.

<sup>7</sup> Treas. Reg. s. 301.7701-5(a).

<sup>8</sup> I.R.C. s. 7701(a)(9)-(10); Treas. Reg. s. 301.7701-1(e).

<sup>9</sup> Treas. Reg. s. 301.7701-5(a).

that separate entity meets the definition of a “corporation” under the so-called check-the-box regulations.

Regarding the first factor, whether an entity is treated as a separate entity is determined under the federal tax laws, rather than by reference to state law.<sup>10</sup> Thus, it is possible for persons who conduct business together in a joint venture to create a separate entity for federal tax purposes even though none is created under state law.<sup>11</sup> Conversely, it is possible for an entity to exist under state law but to be ignored for federal tax purposes (e.g., an organization that is wholly owned by a state government).<sup>12</sup> In addition, it is possible for what is nominally a trust arrangement to be characterized as a separate business entity that must be classified as a corporation or a partnership for federal tax purposes (rather than as a trust that is taxable under the special income tax regime applicable to trusts).<sup>13</sup>

The check-the-box regulations provide only limited guidance regarding whether an entity is treated as a separate entity for federal tax purposes. In the absence of firm guidance from the courts,<sup>14</sup> this limited regulatory guidance has given rise to differences of opinion regarding the continuing relevance of judicial decisions that pre-date the check-the-box regulations to determinations regarding separate entity status. Some commentators argue that the standard set forth in *Moline Properties, Inc. v. Commissioner* should now apply to all business entities.<sup>15</sup> In *Moline Properties*, the U.S. Supreme Court applied a very low threshold—requiring either a business purpose *or* business activity—for purposes of determining whether an entity formed as a corporation under state law will be treated as a separate entity for federal tax purposes.<sup>16</sup> The U.S. Tax Court has also applied this standard for purposes of determining whether a partnership has been created for federal tax purposes.<sup>17</sup> Other commentators argue for the continuing relevance of the predominant test historically applied by the courts to determine whether a partnership has been created for federal tax purposes.<sup>18</sup> The U.S. Supreme Court originally set forth this standard in *Commissioner v. Culbertson*. In *Culbertson*, the Court looked to the intent of the parties—specifically, whether “the parties in good faith and acting with a business

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<sup>10</sup> Treas. Reg. s. 301.7701-1(a)(1).

<sup>11</sup> *Ibid.* s. 301.7701-1(a)(2).

<sup>12</sup> *Ibid.* s. 301.7701-1(a)(3).

<sup>13</sup> *Ibid.* s. 301.7701-4(b).

<sup>14</sup> See *Superior Trading LLC v. Comm’r*, 103 T.C.M. (CCH) 1604 (2012) (acknowledging the issue raised by the taxpayer on a motion for reconsideration but failing to address it directly).

<sup>15</sup> William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 3.03[2] (2012); Ethan Yale, “Defining ‘Partnership’ for Federal Tax Purposes,” 131 *Tax Notes* 589 (2011).

<sup>16</sup> *Moline Properties, Inc. v. Comm’r*, 319 U.S. 436, 438-39 (1943).

<sup>17</sup> For example, *Bertoli v. Comm’r*, 103 T.C. 501, 511 (1994); see also *Superior Trading LLC v. Comm’r*, 103 T.C.M. (CCH) 1604 (2012).

<sup>18</sup> Arthur B. Willis et al., *Partnership Taxation*, para. 1.03 (2012); Karen C. Burke & Grayson M.P. McCouch, “Illusory Partnership Interests and the Anti-antiabuse Rule,” 132 *Tax Notes* 813 (2011).

purpose intended to join together in the present conduct of the enterprise”—to determine whether a partnership has been created for federal tax purposes.<sup>19</sup> In a step that has been criticized by some commentators, at least one federal court of appeals has taken the *Culbertson* test a step further in the context of tax shelter cases and has required more than a business purpose—namely, “a legitimate, non-tax business necessity”—in order for an entity formed as a partnership under state law to be treated as a separate entity for federal tax purposes.<sup>20</sup>

Regarding the second factor, the check-the-box regulations contain a definition of “corporation” that includes entities in a number of different categories. This multipart definition of “corporation” is explored in the next section of this report.

#### 4. Relevance of corporate law status

The corporate law status of a separate entity is not decisive when determining whether the entity is a taxable entity. Nevertheless, a separate entity’s corporate law status may be relevant to this determination. Thus, an entity that is organized under a statute that “describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic” or “as a joint-stock company or joint-stock association” is classified as a corporation for federal tax purposes and will, therefore, be a taxable entity.<sup>21</sup> In addition, insurance companies, state-chartered banks, and entities wholly owned by state or foreign governments are all classified as corporations for federal tax purposes and are also taxable entities.<sup>22</sup> Notwithstanding the corporate law status of the entity, any entity required by another provision of the federal tax laws to be treated as a corporation will be a taxable entity.<sup>23</sup> For example, certain publicly traded partnerships are treated as corporations for federal tax purposes.<sup>24</sup>

Domestic entities not otherwise required to be classified as corporations for federal tax purposes may elect to be treated as corporations, in which case they will become taxable entities.<sup>25</sup>

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<sup>19</sup> *Comm’r v. Culbertson*, 337 U.S. 733, 742 (1949).

<sup>20</sup> *Boca Investering Partnership v. United States*, 314 F.3d 625, 630 (D.C. Cir. 2003); see also *Southgate Master Fund, LLC v. United States*, 639 F.3d 466, 483-84 (5<sup>th</sup> Cir. 2011) (approvingly citing *Boca Investering Partnership*). For a critique of these decisions, see McKee et al., *supra* note 15, para. 3.03[2].

<sup>21</sup> Treas. Reg. s. 301.7701-2(b)(1), (3).

<sup>22</sup> *Ibid.* s. 301.7701-2(b)(4)-(6).

<sup>23</sup> *Ibid.* s. 301.7701-2(b)(7).

<sup>24</sup> I.R.C. s. 7704.

<sup>25</sup> Treas. Reg. s. 301.7701-3(a).

## 5. General reference to corporate law or list/catalogue approach

As described in the previous section, to the extent that corporate law status is relevant for entity classification purposes, there is a list of corporate law legal forms that are treated as taxable entities. This list is exhaustive in nature.<sup>26</sup> Thus, for example, limited liability companies are not included in this list, which renders them eligible to elect classification as either a corporation or a partnership for federal tax purposes.

## 6. Typical taxable entities

The typical taxable entities that are used in a business context in the United States are entities that are corporations both for tax and corporate law purposes. The typical vehicles used in the United States that are not taxable entities are limited liability companies and general or limited partnerships formed under state law.

## 7. Mandatory or optional classification

As described in section 4 above, classification as a taxable entity is mandatory for certain business entities.<sup>27</sup> Other entities (referred to as “eligible entities”) are permitted to elect their tax classification.

Eligible entities with more than one member can elect to be classified either as a corporation (i.e., taxable) or as a partnership (i.e., nontaxable) for federal tax purposes.<sup>28</sup> If no election is made, then the entity is treated as a partnership (i.e., nontaxable) for federal tax purposes.<sup>29</sup> An eligible entity with a single owner can elect to be classified as a corporation (i.e., taxable) or to be disregarded for federal tax purposes.<sup>30</sup> If no election is made, then the entity generally is disregarded for federal tax purposes.<sup>31</sup> Disregarded entities are treated as a sole proprietorship (if the owner is an individual) or as a branch or division of the owner (if the owner is an entity).<sup>32</sup>

Entity classification elections are made on Internal Revenue Service (IRS) Form 8832 (Entity Classification Election).<sup>33</sup> This form must be filed with the appropriate Internal Revenue Service Center and then attached to the entity’s federal tax or information return for the year of the election.<sup>34</sup> If no return is required to be filed, then the form must be

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<sup>26</sup> *Ibid.* s. 301.7701-2(b).

<sup>27</sup> *Ibid.* s. 301.7701-2(b)(9)(ii), ex. 2(i).

<sup>28</sup> *Ibid.* s. 301.7701-2(a).

<sup>29</sup> *Ibid.* s. 301.7701-3(b)(1)(i).

<sup>30</sup> *Ibid.* s. 301.7701-2(a).

<sup>31</sup> *Ibid.* s. 301.7701-3(b)(1)(ii).

<sup>32</sup> *Ibid.* s. 301.7701-2(a).

<sup>33</sup> *Ibid.* s. 301.7701-3(c)(1)(i).

<sup>34</sup> *Ibid.* s. 301.7701-3(c)(1)(ii).

attached to the return of all of the entity's direct (and, in some cases, indirect) owners.<sup>35</sup> The election is effective on the date filed unless the entity specifies a different effective date.<sup>36</sup> For this purpose, an election that is sent through the U.S. mail (or a private delivery service approved by the Department of Treasury, but not a foreign mail service) is treated as filed on the date on which it is postmarked.<sup>37</sup> The effective date may, in no event, be more than 75 days prior to the filing date or more than 12 months after the filing date.<sup>38</sup> The IRS may, however, grant relief for late elections (either with regard to the classification of newly formed entities or for changes in the classification of existing entities) filed within three years and 75 days of the proposed effective date of the election.<sup>39</sup>

An entity that files an election to change its existing classification is prohibited from again filing an election to change its tax classification for a period of sixty months following the effective date of that election.<sup>40</sup> The IRS may waive this limitation "if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election."<sup>41</sup> For this purpose, an election that is effective as of the date of an entity's formation is not an election to change and will not trigger the sixty-month limitation period.<sup>42</sup>

The current, largely elective entity classification system was adopted in the interests of simplification and fairness. Prior to the check-the-box regulations, tax classification depended upon whether an entity had at least three of four enumerated characteristics associated with corporations. By ensuring that an entity lacked at least two of these characteristics, well-advised taxpayers were able to essentially elect the classification of unincorporated entities even before the promulgation of the check-the box regulations. The check-the-box regulations converted this de facto elective system into a simpler, de jure elective system while ensuring that this electivity was available to all and not just the well advised.<sup>43</sup>

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<sup>35</sup> *Ibid.*

<sup>36</sup> *Ibid.* s. 301.7701-3(c)(1)(iii).

<sup>37</sup> I.R.C. s. 7502; Treas. Reg. s. 301.7502-1(a), (c)(1).

<sup>38</sup> Treas. Reg. s. 301.7701-3(c)(1)(iii).

<sup>39</sup> Rev. Proc. 2009-41, 2009-2 C.B. 439. This revenue procedure also holds open the possibility that taxpayers might request relief through a private letter ruling in situations not meeting all of the revenue procedure's requirements for affording relief.

<sup>40</sup> Treas. Reg. s. 301.7701-3(c)(1)(iv).

<sup>41</sup> *Ibid.*

<sup>42</sup> *Ibid.*

<sup>43</sup> See Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,989-90 (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301).

## 8. Varying tax status of an entity

The tax classification of all entities can vary depending on factors other than legal form. For instance, corporations that would normally be taxable entities can elect nontaxable status if they meet certain stock and ownership requirements and elect S corporation status.<sup>44</sup> Partnerships that would normally not be taxable entities will be classified as corporations and become taxable entities if interests in the partnership are traded on an established securities market or are readily tradable on a secondary market, unless the partnership is predominantly a vehicle for passive investments.<sup>45</sup> Trusts that would normally be subject to a hybrid taxable/nontaxable entity regime are treated as business entities subject to the check-the-box entity classification rules if they are formed to conduct business rather than merely to protect or conserve assets.<sup>46</sup>

## 9. Fictional taxable entities

Even absent the formation of an entity under local law, a joint undertaking or contractual arrangement will constitute “a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.”<sup>47</sup> For example, co-ownership of an apartment building will give rise to a separate entity for federal tax purposes if the co-owners provide services to the tenants (whether they provide the services themselves or through an agent).<sup>48</sup> Yet, mere co-ownership of property or sharing of expenses will not give rise to a separate entity for federal tax purposes.<sup>49</sup>

Proposed regulations would treat each series (i.e., a segregated pool of assets and liabilities) of a series organization (including a series limited liability company, series limited partnership, series trust, and a cell company) as a separate entity for federal tax purposes, even though most U.S. states that permit the creation of series organizations do not treat each series within the organization as a separate entity.<sup>50</sup> These proposed regulations are to be effective prospectively; that is, upon their publication as final regulations.<sup>51</sup> Currently, each separate fund of a regulated investment company is already treated as a separate corporation for federal income tax purposes.<sup>52</sup>

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<sup>44</sup> I.R.C. s. 1361.

<sup>45</sup> *Ibid.* s. 7704.

<sup>46</sup> *Ibid.* ss. 661-663; Treas. Reg. s. 301.7701-4(b).

<sup>47</sup> Treas. Reg. s. 301.7701-1(a)(2).

<sup>48</sup> *Ibid.*

<sup>49</sup> *Ibid.*

<sup>50</sup> Prop. Treas. Reg. s. 301.7701-1(a)(5), 75 Fed. Reg. 55,699 (Sept. 14, 2010).

<sup>51</sup> *Ibid.* s. 301-7701(f)(3).

<sup>52</sup> I.R.C. s. 851(g).

## 10. Registration with tax administration or other approvals

An entity wishing to be classified as a corporation (i.e., as a taxable entity) that would be treated by default as a partnership or disregarded entity (i.e., as a nontaxable entity) must file an election with the IRS and attach a copy of that election to its tax or information return for the year of the election (as described in section 7 above). The IRS has the discretion whether or not to accept such an election; however, the only ground specified for refusing to accept an election is failure to include all required information on Form 8832 (Entity Classification Election).<sup>53</sup> Failure to comply with the requirement to attach a copy of the election to the tax or information return for the year of the election may result in the imposition of penalties, but will not result in the invalidation of the election.<sup>54</sup>

## 11. Timing dimension

Normally, a corporation comes into existence for tax purposes upon its incorporation.<sup>55</sup> Nevertheless, there is precedent for treating a corporation as coming into existence prior to its formation under state law. For instance, in *Camp Wolters Land Co. v. Commissioner*, a corporation was subject to tax on income received (and was entitled to associated deductions for expenses incurred) prior to its incorporation because, in the months prior to incorporation, the corporation's incorporators held the entity out as a corporation, purchased land in the name of the corporation, entered into leases in the name of the corporation, made deposits in the name of the corporation, borrowed money in the name of the corporation, and issued checks in the name of the corporation.<sup>56</sup> Conversely, there is authority for ignoring the existence of a corporation that has been incorporated but that "has never perfected its organization and has transacted no business and has no income from any source."<sup>57</sup> Such a corporation may make application to the IRS for a waiver of the requirement to file a federal income tax return.<sup>58</sup>

The taxable status of a corporation ends upon its liquidation; however, formal liquidation under corporate law is not necessary for a corporation's existence to terminate for federal tax purposes. Indeed, a corporation that is administratively dissolved by the state (e.g., for failure to file annual reports) may continue to be classified as a corporation for federal tax purposes if it continues to be so treated under state law (e.g., under the de facto corporation doctrine).<sup>59</sup> The liquidation of the corporation is complete when it has ceased

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<sup>53</sup> Treas. Reg. s. 301.7701-3(c)(1)(i).

<sup>54</sup> *Ibid.* s. 301.7701-3(c)(1)(ii).

<sup>55</sup> I.R.S. Field Service Advisory, 1993 WL 1469552 (Feb. 12, 1993) (Westlaw); see also Treas. Reg. s. 1.443-1(a)(2) ("a corporation organized on August 1 and adopting the calendar year as its annual accounting period is required to file a return for the short period from August 1 to December 31").

<sup>56</sup> 160 F.2d 84, 88 (5<sup>th</sup> Cir. 1947).

<sup>57</sup> Treas. Reg. s. 1.6012-2(a)(2).

<sup>58</sup> *Ibid.*

<sup>59</sup> Priv. Ltr. Rul. 200315020 (Jan. 6, 2003); Priv. Ltr. Rul. 200114029 (Jan. 8, 2001). For a critique of these rulings, see John E. Bragonje, "The Rise and Fall of the Check-the-

doing business and has divested itself of all of its assets.<sup>60</sup> Nevertheless, it is possible for the corporation to retain a nominal amount of assets in order to preserve its charter and protect its name and to still be considered to have completely liquidated for federal tax purposes.<sup>61</sup>

## 12. All or nothing v. partial

Taxable entity status is granted under an “all or nothing” principle. For federal tax purposes, the entire entity is either a corporation, a partnership, or disregarded for federal tax purposes. This approach will change, however, if the series entity regulations (discussed above) are promulgated as final regulations.<sup>62</sup> In the nature of a “partial” taxable entity status, disregarded entities are treated as taxable entities for purposes of withholding income tax from wages, employment taxes, certain excise taxes, and certain antiabuse rules.<sup>63</sup>

## 13. Effect of tax exemptions

The fact that an entity is tax exempt does not affect its status as a corporation for federal tax purposes. The United States does not grant “holidays” from the federal income tax. Organizations that are exempt from taxation because of their charitable or other activities are deemed to have elected to be classified as corporations for federal tax purposes.<sup>64</sup>

## 14. Group taxation

If no election is (or can be) made to disregard a wholly owned entity under the check-the-box regulations, then the members of a group of affiliated corporations are each treated as separate entities for federal tax purposes. To prevent the abusive multiplication of tax benefits, however, a number of provisions require tax benefits to be shared among the members of the group rather than affording a separate allowance to each member of the group.<sup>65</sup> Alternatively, affiliated groups may elect to file a consolidated return reporting the income for the entire group.<sup>66</sup> Although “an increasingly dominant theme of the more recent regulations is the single-entity principle under which the group is treated

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Box Regime: A Solution to Recent Private Letter Rulings’ Troubling Use of the De Facto Corporation Doctrine,” 2005 TNT 87-45 (LexisNexis).

<sup>60</sup> Treas. Reg. ss. 1.332-2(c), 1.6012-2(a)(2).

<sup>61</sup> *Ibid.* s. 1.332-2(c); Rev. Rul. 84-2, 1984-1 C.B. 92; Rev. Rul. 61-191, 1961-2 C.B. 251.

<sup>62</sup> See *supra* note 50 and accompanying text.

<sup>63</sup> Treas. Reg. s. 301.7701-2(c)(iv)(B), (v); Temp. Treas. Reg. s. 301.7701-2T(c)(iv)(A), (C); Treas. Reg. s. 1.881-3(a)(2)(i)(C).

<sup>64</sup> Treas. Reg. s. 301.7701-3(c)(1)(v)(A).

<sup>65</sup> I.R.C. s. 1561; see also, for example, *ibid.* ss. 41(f)(1), 179(d)(6)-(7).

<sup>66</sup> *Ibid.* s. 1501.

(whenever possible) essentially the same as a single taxpayer,<sup>67</sup> the regulations do not completely disregard the existence of the separate entities comprising the group. For instance, in computing the consolidated taxable income of the affiliated group, the first step is to compute the separate taxable income of each member of the group and then to make appropriate adjustments.<sup>68</sup> In addition, notwithstanding the requirement that the group must employ a uniform taxable year, each member of the group is permitted to adopt its own accounting method.<sup>69</sup> Furthermore, the members of the group are sometimes treated as separate entities and at others as divisions of a single corporation for purposes of addressing the treatment of intercompany transactions.<sup>70</sup> As suggested above, a truer fiscal unity of the affiliated group could be achieved if the entities comprising the group are wholly owned eligible entities and an election is made under the check-the-box regulations to disregard their existence for federal tax purposes (see section 7 above).

## Foreign Entities

### 15. “Foreign” nature of an entity

Whether an entity is “foreign” for federal tax purposes is determined exclusively based on its place of creation or organization.<sup>71</sup> All entities *other than* those created in the United States or organized under U.S. federal or state laws or under the laws of the District of Columbia are foreign entities, including entities created or organized in U.S. territories or possessions.<sup>72</sup> Nevertheless, certain foreign entities may elect (or, in narrow circumstances, are required) to be treated as domestic entities for federal tax purposes.<sup>73</sup> As mentioned in section 2 above, entities organized both within and without the United States are classified as domestic entities.<sup>74</sup>

### 16. Key criteria for classifying foreign entities as taxable

As described in section 3 above, the key factors for classifying an entity as taxable for federal tax purposes are (1) whether the entity is treated as a separate entity for federal tax purposes and (2) whether that separate entity meets the definition of a “corporation” under the check-the-box regulations. The analysis described in section 3 above for

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<sup>67</sup> James S. Eustice & John P. Steines, Jr., *Federal Income Taxation of Corporations and Shareholders* para. 13.42 (2013).

<sup>68</sup> Treas. Reg. ss. 1.1502-11(a), -12.

<sup>69</sup> *Ibid.* ss. 1.1502-17(a), -76(a).

<sup>70</sup> *Ibid.* s. 1.1502-13(a)(2).

<sup>71</sup> I.R.C. s. 7701(a)(4)-(5); Treas. Reg. s. 301.7701-5.

<sup>72</sup> Treas. Reg. s. 301.7701-5(a); Huff v. Comm’r, 138 T.C. 258, 268 (2012).

<sup>73</sup> See, for example, I.R.C. ss. 269B(a)(1) (stapled entities), 897(i) (U.S. real property holding companies), 953(d) (insurance companies), 1504(d) (consolidated returns), 7874(b) (inverted corporations).

<sup>74</sup> Treas. Reg. s. 301.7701-5(a).

determining whether an entity is treated as a separate entity does not differ depending on the status of the entity as foreign or domestic.<sup>75</sup> Accordingly, please refer to section 3 for a summary of the relevant law in this area. As is the case with domestic entities, whether a foreign entity is classified as a corporation depends, in some cases, on its legal form and, in all others, on the election of the entity.

#### 17. List of foreign legal forms

In the definition of “corporation,” there is a list of foreign legal forms that are decisive in classifying those entities as taxable for U.S. federal tax purposes. The list is provided by country, with specific reference to the legal form(s) that is (are) classified as corporations for U.S. federal tax purposes.<sup>76</sup> The taxable classification of these entities is mandatory; however, the list itself provides exceptions in certain cases. For example, Canadian corporations and companies are classified as corporations (i.e., taxable entities) for U.S. federal tax purposes.<sup>77</sup> Nonetheless, Nova Scotia unlimited liability companies (or any other Canadian companies all of the owners of which have unlimited liability) are not subject to mandatory classification as corporations for U.S. federal tax purposes.<sup>78</sup>

If an entity is organized in more than one jurisdiction, then the entity will be classified as a corporation if it takes a legal form in any one of these jurisdictions (including the United States) that is included on the list of legal forms that are decisive in classifying the entity as taxable for U.S. federal tax purposes.<sup>79</sup> The check-the-box regulations provide several examples illustrating the operation of this rule. In one example, an entity is initially organized in a foreign jurisdiction in a legal form that is included on the list of foreign entities that must be classified as corporations for U.S. federal tax purposes. The entity later files a certificate of domestication in a U.S. state as a limited liability company but does not terminate its foreign charter, which causes it to be treated as organized in more than one jurisdiction. Under the rules applicable to entities organized in more than one jurisdiction, the entity must be classified as a corporation for federal tax purposes because its form in one of the two jurisdictions in which it is organized requires it to be classified as a corporation for U.S. federal tax purposes.<sup>80</sup>

#### 18. Comparability test

As with domestic entities, foreign entities that are not included on the list of entities that must be classified as corporations for U.S. federal tax purposes are “eligible entities” that

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<sup>75</sup> See Priv. Ltr. Rul. 201305006 (Oct. 15, 2012).

<sup>76</sup> Treas. Reg. s. 301.7701-2(b)(8).

<sup>77</sup> *Ibid.* s. 301.7701-2(b)(8)(i).

<sup>78</sup> *Ibid.* s. 301.7701-2(b)(8)(ii)(A)(1).

<sup>79</sup> *Ibid.* s. 301.7701-2(b)(9).

<sup>80</sup> *Ibid.* s. 301.7701-2(b)(9)(ii), ex. 1.

may elect their tax classification.<sup>81</sup> Thus, in keeping with the discussion in section 17 above, for entities organized in more than one jurisdiction, the ability to elect tax classification is available “only if [the entity] is created or organized in each jurisdiction in a manner that meets the definition of an eligible entity.”<sup>82</sup> The same elective choices are available to foreign entities as are available for domestic entities; however, the default classifications differ from those applicable to domestic entities.<sup>83</sup> Unlike the domestic entity default classifications, the default classifications for foreign entities generally turn on whether the members of the entity do (or do not) have limited liability.<sup>84</sup>

## 19. Relevance of foreign tax treatment

The foreign tax treatment of an entity is not relevant for purposes of determining the entity’s U.S. federal tax classification.

## 20. Optionality

As mentioned in section 18 above, foreign entities that are not required to be classified as corporations for federal tax purposes are eligible entities that may elect their federal tax classification. The available choices of entity and the procedures for electing an entity’s tax classification are generally the same for foreign and domestic entities (see section 7 above); however, as mentioned in section 18 above, the default classifications for foreign entities differ from those for domestic entities.<sup>85</sup>

Foreign eligible entities with more than one member can elect to be classified either as a corporation (i.e., taxable) or as a partnership (i.e., nontaxable) for federal tax purposes.<sup>86</sup> If no election is made, then the entity is classified as a corporation if all members have limited liability or as a partnership if at least one member does not have limited liability.<sup>87</sup> Foreign eligible entities with a single owner can elect to be classified as a corporation (i.e., taxable) or to be disregarded for federal tax purposes.<sup>88</sup> Disregarded entities are treated as a sole proprietorship (if the owner is an individual) or as a branch or division of the owner (if the owner is an entity).<sup>89</sup> If no election is made, then the entity is classified as a corporation if the single owner has limited liability or is disregarded for federal tax purposes if the single owner does not have limited liability.<sup>90</sup>

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<sup>81</sup> *Ibid.* s. 301.7701-3(a).

<sup>82</sup> *Ibid.* s. 301.7701-2(b)(9)(i).

<sup>83</sup> *Ibid.* s. 301.7701-3(b)(2).

<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.* s. 301.7701-3(a), (c).

<sup>86</sup> *Ibid.* s. 301.7701-2(a).

<sup>87</sup> *Ibid.* s. 301.7701-3(b)(2)(i)(A)-(B).

<sup>88</sup> *Ibid.* s. 301.7701-2(a).

<sup>89</sup> *Ibid.*

<sup>90</sup> *Ibid.* s. 301.7701-3(b)(1)(ii).

The default classification of foreign eligible entities thus turns on whether the members of the entity have limited liability. For this purpose, “a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member.”<sup>91</sup> This determination is normally made by reference to the law under which the entity is organized; however, if that law allows the entity to specify in its organizational documents whether members have limited liability, then the organizational documents “may also be relevant.”<sup>92</sup>

Foreign entities need only be concerned with their default status when their classification for U.S. federal tax purposes becomes “relevant.”<sup>93</sup> A foreign entity’s classification only becomes relevant when it “affects the liability of any person for federal tax or information purposes.”<sup>94</sup> For instance, the check-the-box regulations indicate that a foreign entity’s classification for U.S. federal tax purposes is relevant if it receives U.S. source income and the amount to be withheld from that income varies depending on whether the foreign entity is classified as a corporation or a partnership for U.S. federal tax purposes.<sup>95</sup> The date that an entity’s classification becomes relevant is “the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined.”<sup>96</sup> A foreign entity’s classification for U.S. federal tax purposes is initially determined when that classification first becomes “relevant.”<sup>97</sup> A foreign entity retains its default status even if there is a later change in the liability of the entity’s members.<sup>98</sup> If a foreign entity’s classification ceases to be relevant for sixty consecutive months, then its default classification is determined anew when it once again becomes relevant.<sup>99</sup> Of course, at any time that the entity’s default classification is being determined it may instead elect an alternative available classification and entities unsure about their default classification can file protective elections.<sup>100</sup>

The elective entity classification system was extended to foreign entities for the same reasons it was created for domestic entities—simplification and fairness.<sup>101</sup> In particular, the Department of Treasury and IRS cited the complexity and level of resources associated with applying the prior regime to foreign entities, which required both a review of the organizational documents and “a thorough understanding of the controlling

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<sup>91</sup> *Ibid.* s. 301.7701-3(b)(2)(ii).

<sup>92</sup> *Ibid.*

<sup>93</sup> *Ibid.* s. 301.7701-3(d)(2).

<sup>94</sup> *Ibid.* s. 301.7701-3(d)(1)(i).

<sup>95</sup> *Ibid.*

<sup>96</sup> *Ibid.*

<sup>97</sup> *Ibid.* s. 301.7701-3(d)(2).

<sup>98</sup> *Ibid.* s. 301.7701-3(a).

<sup>99</sup> *Ibid.* s. 301.7701-3(d)(3).

<sup>100</sup> T.D. 9093, 68 Fed. Reg. 60,296, 60,298 (Oct. 22, 2003); T.D. 8697, 61 Fed. Reg. 66,584, 66,587 (Dec. 18, 1996).

<sup>101</sup> Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989, 21,990 (proposed May 13, 1996) (to be codified at 26 C.F.R. pt. 301).

foreign law.”<sup>102</sup> They did note, however, the possibility of abuse of the partnership form under the elective regime and warned that they would “continue to monitor carefully the uses of partnerships in the international context.”<sup>103</sup>

## 21. Advance clarification

Where an issue regarding the classification of an entity is not free from doubt, it is possible to seek a private letter ruling from the IRS. The IRS has issued a number of rulings on questions relating to entity classification.<sup>104</sup>

### **Case Studies on Tax Treaty Entity Qualification Issues**

In all of the responses below, it is assumed that the Owners are not fiscally transparent entities; residents of a contracting state satisfy all requirements for treaty benefits, including statutory provisions, beneficial ownership requirements, and any limitation on benefits provisions;<sup>105</sup> income attributable to a U.S. permanent establishment is also effectively connected with the conduct of a U.S. trade or business; and entities are residents only of the jurisdiction in which they are established. For all questions related to whether a tax credit is available, it is assumed that the taxpayer has no income other than that described in the fact pattern. For the full set of facts of each scenario, please see the General Report.

#### 1. Treaty Entitlement

Except as otherwise provided, assume for the following case studies an entity established in State P (“Entity P”) receives interest and royalties from sources within State S and the owners of Entity P are residents of State R (the “Owners”).

- A. Assume States P and S treat Entity P as a taxable entity and State R treats Entity P as transparent.

If State S is the United States, both the treaty between States S and P and the treaty between States S and R will be available. Generally, the United States allows treaty benefits to entities that are not fiscally transparent under the laws of their jurisdictions.<sup>106</sup>

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<sup>102</sup> *Ibid.*

<sup>103</sup> *Ibid.*

<sup>104</sup> See, for example, *supra* note 75. But see Rev. Proc. 2013-3, s. 4.02(7), 2013-1 I.R.B. 113 (regarding limitations on the issuance of rulings to taxpayers organized in a jurisdiction where the IRS cannot effectively obtain relevant tax information itself); Rev. Proc. 2013-7, s. 4.02(4), 2013-1 I.R.B. 233 (same).

<sup>105</sup> See, for example, 2006 U.S. Model Income Tax Convention, art. 22.

<sup>106</sup> See Treas. Reg. s. 1.894-1(d)(1).

Treaty benefits may also be available at the interest holder level where the interest holder is not fiscally transparent but the interest holder's jurisdiction views the entity as fiscally transparent.<sup>107</sup> Here, the treaty between States S and P is available because Entity P is not fiscally transparent under the laws of State P. Additionally, the treaty between States S and R is also available because Entity P is fiscally transparent for State R purposes.<sup>108</sup>

If State R is the United States, the Owners will be entitled to a credit for any foreign withholding tax levied by State S. The United States generally provides a foreign tax credit for foreign taxes paid by U.S. taxpayers, including taxes imposed on an entity that the United States treats as a partnership but the foreign taxing jurisdiction treats as an entity.<sup>109</sup> This includes foreign withholding taxes paid in lieu of income taxes.<sup>110</sup>

B. Assume States R and S treat Entity P as a taxable entity while State P treats Entity P as transparent.

If State S is the United States, neither the treaty between States S and P nor the treaty between States S and R are available. The treaty between States S and P is not available because Entity P is fiscally transparent in its jurisdiction.<sup>111</sup> The treaty between States S and R is not available because Entity P is a taxable entity under the laws of State R.<sup>112</sup>

If State P is the United States, no income tax treaty is necessary to obtain a foreign tax credit. The United States generally allows a tax credit for foreign taxes imposed on income that is also subject to U.S. federal income tax because the income is effectively connected with a U.S. trade or business.<sup>113</sup> Generally, owners of a fiscally transparent entity are engaged in a U.S. trade or business if the entity is so engaged.<sup>114</sup> Therefore, the Owners will be subject to U.S. federal income tax on their share of any interest and royalties received from State S that are effectively connected with a U.S. trade or business and will be allowed a foreign tax credit against their U.S. federal income tax on that income.<sup>115</sup>

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<sup>107</sup> See *ibid.*

<sup>108</sup> See *ibid.* s. 1.894-1(d)(5), ex. 3.

<sup>109</sup> I.R.C. s. 901(a); see Treas. Reg. s. 1.901-2(f)(4)(i).

<sup>110</sup> I.R.C. s. 903; see also Treas. Reg. s. 1.903-1(b)(3), ex. 1.

<sup>111</sup> See Treas. Reg. s. 1.894-1(d)(1).

<sup>112</sup> *Ibid.*

<sup>113</sup> I.R.C. s. 906(a).

<sup>114</sup> *Ibid.* s. 875.

<sup>115</sup> See Treas. Reg. s. 1.901-2(f)(4)(i). There are limitations on the amount of the foreign tax credit that can be claimed. For example, the foreign tax credit generally is limited to the U.S. tax on the taxpayer's foreign source income. See I.R.C. s. 904. This and other foreign tax credit limitations are beyond the scope of this Report.

C. Assume State S treats Entity P as a taxable entity while States R and P treat Entity P as transparent.

If State S is the United States, the treaty between States S and R is available because the Owners are not fiscally transparent in their jurisdiction and Entity P is fiscally transparent under the laws of State R.<sup>116</sup> The treaty between States S and P is not available because Entity P is fiscally transparent under the laws of its jurisdiction.<sup>117</sup>

If State P is the United States and the interest and royalties are attributable to a U.S. permanent establishment, the United States will allow a credit to the Owners for taxes withheld by State S on the income of Entity P because the Owners are nonresidents engaged in a U.S. trade or business due to their ownership of Entity P.<sup>118</sup>

If State R is the United States, the Owners will be entitled to a U.S. foreign tax credit for any withholding taxes levied by State S on the income of Entity P because owners of fiscally transparent entities receive their allocable share of foreign tax credits.<sup>119</sup>

D. Assume States R and S treat Entity P as transparent and State P treats Entity P as a taxable entity.

If State S is the United States, both the treaty between States S and P and the treaty between States S and R are available. The treaty between States S and P is available because Entity P is not fiscally transparent in its jurisdiction.<sup>120</sup> Further, the treaty between States S and R is available because the Owners are not fiscally transparent in their jurisdiction and Entity P is fiscally transparent under the laws of State R.<sup>121</sup>

If State P is the United States, the United States will not allow a foreign tax credit to Entity P for the withholding taxes levied by State S on behalf of the Owners. The United States generally allows foreign tax credits to taxpayers legally liable for the related taxes.<sup>122</sup> This is true even if the tax is remitted by another person.<sup>123</sup> Here, the Owners are legally liable for the State S withholding taxes, not Entity P, and therefore the United States will not allow Entity P a credit for such taxes.

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<sup>116</sup> *Ibid.* s. 1.894-1(d)(1).

<sup>117</sup> *Ibid.*

<sup>118</sup> See *supra* notes 113-15 and accompanying text.

<sup>119</sup> Treas. Reg. s. 1.901-2(f)(4)(i); see *supra*, notes 113-15 and accompanying text.

<sup>120</sup> Treas. Reg. s. 1.894-1(d)(1).

<sup>121</sup> *Ibid.*

<sup>122</sup> *Ibid.* s. 1.901-2(f)(1).

<sup>123</sup> *Ibid.*

E. Assume State R treats Entity P as a taxable entity and States P and S treat Entity P as transparent.

If State S is the United States, the treaty between States S and P is not available because Entity P is fiscally transparent in State P.<sup>124</sup> The treaty between States S and R is not available because Entity P is not fiscally transparent under the laws of State R.<sup>125</sup>

If State R is the United States, the United States will view this situation as a foreign tax credit splitting event. The United States would normally view any potential credit as being available at the entity level because it sees Entity P as a taxable entity; however, State S views the Owners as having legal liability for the taxes withheld from Entity P.<sup>126</sup> Under recently enacted legislation, a foreign tax credit is not available to the Owners until they take into account the earnings and profits of Entity P that gave rise to the income upon which the foreign tax was imposed.<sup>127</sup>

F. Assume States R and P treat Entity P as a taxable entity and State S treats Entity P as transparent.

If State S is the United States, only the treaty between States S and P is available. The treaty between States S and P is available because Entity P is not fiscally transparent in its jurisdiction.<sup>128</sup> The treaty between States S and R is not available because Entity P is not fiscally transparent under the laws of State R.<sup>129</sup>

If State P is the United States, the United States will not allow a foreign tax credit to Entity P for the withholding taxes levied by State S because State S views the Owners as being legally liable for the withholding tax.<sup>130</sup>

G. Assume Entity P receives interest and royalties from sources within State P. Entity P is owned by the Owners, which are residents of State R. State P treats Entity P as a taxable entity and State R treats Entity P as transparent.

If State P is the United States, the treaty between States P and R will not be available. The United States treats an entity that is taxable as a corporation in the United States but fiscally transparent under the laws of the interest holder's jurisdiction as a domestic reverse hybrid entity.<sup>131</sup> A domestic reverse hybrid entity is not entitled to rate reductions

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<sup>124</sup> *Ibid.* s. 1.894-1(d)(1).

<sup>125</sup> *Ibid.*

<sup>126</sup> *Ibid.* s. 1.901-2(f)(1).

<sup>127</sup> I.R.C. s. 909; see Temp. Treas. Reg. ss. 1.909-1T to -6T.

<sup>128</sup> Treas. Reg. s. 1.894-1(d)(2)(i).

<sup>129</sup> *Ibid.*

<sup>130</sup> *Ibid.* s. 1.901-2(f)(1).

<sup>131</sup> *Ibid.* s. 1.894-1(d)(2)(i).

under any treaty provision on items of U.S. source income.<sup>132</sup> Further, owners of domestic reverse hybrid entities are not entitled to rate reductions on their recognition of such entity's U.S. source items of income.<sup>133</sup> Accordingly, neither Entity P nor the Owners will be entitled to the benefits of a treaty for the income received by Entity P.<sup>134</sup>

If State R is the United States, the United States will not respect State P's determination that State P is entitled to exclusive residence taxing jurisdiction over the income. The saving clause of most U.S. tax treaties preserves the right of the United States to tax its citizens and residents.<sup>135</sup> Accordingly, the Owners will be subject to tax on their share of the income earned by Entity P because the United States treats Entity P as a partnership for U.S. federal tax purposes. The Owners will, however, be entitled to a credit against their U.S. federal income taxes for their portion of the foreign taxes paid by Entity P.<sup>136</sup>

H. Assume Entity P is owned by the Owners, which are residents of State R and Entity P derives income from sources within State R. State P treats Entity P as a taxable entity and State R treats Entity P as transparent.

If State P is the United States, the income received from State R will be subject to tax in the United States in the hands of Entity P, because Entity P will be viewed as a domestic corporation for U.S. federal tax purposes. The allocation of the income to the Owners for State R purposes is not relevant to the determination of whether the income in Entity P is subject to U.S. federal income tax. However, the treaty between States R and P may be available to reduce the State R withholding tax because the United States will treat the income as being derived by a U.S. resident (i.e., Entity P).<sup>137</sup> The United States will not, however, allow a foreign tax credit for any State R withholding tax. Entity P will not be allowed a credit because the Owners, not Entity P, are legally liable for the State R withholding taxes.<sup>138</sup> Furthermore, the Owners will not be allowed a U.S. foreign tax credit because nonresident aliens are only allowed credits for foreign taxes paid with respect to income that is effectively connected with a U.S. trade or business.<sup>139</sup>

If State R is the United States, the United States will not respect State P's determination that State P is entitled to exclusive residence taxing jurisdiction over the income because the United States preserves the right to tax its citizens and residents.<sup>140</sup> Here, because the income earned by Entity P is U.S. source and Entity P is fiscally transparent for U.S. federal tax purposes, the Owners will not be entitled to a foreign tax credit because the

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<sup>132</sup> *Ibid.*

<sup>133</sup> *Ibid.*

<sup>134</sup> *Ibid.* s. 1.894-1(d)(2)(iii), ex. 1.

<sup>135</sup> 2006 U.S. Model Income Tax Convention, art. 1, para. 4.

<sup>136</sup> Treas. Reg. s. 1.901-2(f)(4)(i).

<sup>137</sup> 2006 U.S. Model Income Tax Convention, art. 1, para. 6; U.S. Treasury Department, Technical Explanation of the 2006 U.S. Model Income Tax Convention, at 6-7.

<sup>138</sup> Treas. Reg. s. 1.901-2(f)(1).

<sup>139</sup> I.R.C. s. 906(a); Treas. Reg. s. 1.901-1(a).

<sup>140</sup> See *supra* note 135.

United States does not impose withholding taxes on U.S. residents (i.e., the Owners).<sup>141</sup> If State P imposed tax on Entity P, the Owners will be entitled to a foreign tax credit for their allocable share of the foreign tax.<sup>142</sup> The credit could not, however, be utilized unless the Owners had other, foreign source income because the income giving rise to the foreign tax is U.S. source.<sup>143</sup>

## 2. Distributive Rules

### I. Dividends

For each of the following case studies, assume an entity established in State S (“Entity S”) distributes income to its owners (the “Owners”), which are residents of State R.

- A. Assume State R treats Entity S as transparent and State S treats Entity S as a taxable entity.

If State R is the United States, the United States will allow a foreign tax credit for each Owner’s allocable share of withholding taxes imposed on Entity S by State S.<sup>144</sup> The United States will not be prevented from taxing the Owners’ allocable share of income from Entity S because the United States reserves the right to tax its citizens and residents under the saving clause in its treaties.<sup>145</sup>

- B. Assume State R treats Entity S as a taxable entity and State S treats Entity S as transparent. Assume State S treats the Owners’ distributive share of Entity S’s income as income from immovable property.

If State R is the United States, the United States will treat the distribution by Entity S as a dividend. The character of the income will not flow through to the Owners because Entity S is treated as a corporation for U.S. federal tax purposes. Neither Article 6 nor Article 10 of the OECD Model Convention would be considered applicable in the United States because the United States reserves the right to tax its citizens and residents under the saving clause in its treaties. A U.S. foreign tax credit will be available for the Owners for

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<sup>141</sup> See Treas. Reg. s. 1.1441-5(c).

<sup>142</sup> Treas. Reg. s. 1.901-2(f)(4)(i).

<sup>143</sup> See I.R.C. s. 904.

<sup>144</sup> *Ibid.*

<sup>145</sup> 2006 U.S. Model Income Tax Convention, art. 1, para. 4.

the tax levied on the income from immovable property because State S views the Owners as having legal liability for such taxes.<sup>146</sup>

## II. Interest

For each of the following case studies, assume an entity established in State B (“Entity P”) is owned by residents of State A (the “Owners”) and pays interest to an unrelated entity established in State C (“Company X”).

### A. Assume State B treats Entity P as a taxable entity and States A and C treat Entity P as transparent.

The United States generally sources interest income according to the residence of the payor.<sup>147</sup> For this purpose, a payor includes both corporate and non-corporate entities (i.e., a partnership).<sup>148</sup> If State A is the United States, the United States will treat the interest as sourced in State B, provided that Entity P (which is treated by the United States as a foreign partnership) is not predominantly engaged in a trade or business within the United States, the interest is not paid by a U.S. trade or business of Entity P, and the interest is not allocable to income of Entity P that is effectively connected with a U.S. trade or business.<sup>149</sup> If the interest income is sourced in State B, it will not be subject to U.S. federal income tax because it will be considered foreign source.<sup>150</sup> Accordingly, Article 11 of the treaty between States B and C will not be relevant.

If State B is the United States, the United States will treat the interest as sourced in State B because the United States will view the interest as being paid by a domestic corporation.<sup>151</sup> Accordingly, the interest will be subject to U.S. federal income tax.<sup>152</sup> Article 11 of the treaty between States B and C may be available to reduce the U.S. federal income tax to the extent Company X is not fiscally transparent under the laws of State C.

If State C is the United States, and assuming that reduced withholding taxes were levied in both States A and B, the United States will allow a foreign tax credit for withholding taxes imposed by both State A and B on the interest received by Company X.<sup>153</sup> The United States allows a foreign tax credit to U.S. residents for all creditable foreign taxes

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<sup>146</sup> Treas. Reg. s. 1.901-2(f)(1). But see *supra*, note 127 and accompanying text, regarding the suspension of a foreign tax credit until the income to which the credit relates is recognized.

<sup>147</sup> I.R.C. ss. 861(a)(1), 862(a)(1).

<sup>148</sup> *Ibid.*

<sup>149</sup> I.R.C. s. 861(a)(1)(B).

<sup>150</sup> *Ibid.* ss. 881(a)(1), 1442(a).

<sup>151</sup> *Ibid.* ss. 861(a)(1), 862(a)(1).

<sup>152</sup> *Ibid.* ss. 881(a)(1), 1442(a).

<sup>153</sup> *Ibid.* s. 901.

paid, including withholding taxes.<sup>154</sup> This is true even where another person remits the tax, so long as the legal liability for the tax is imposed on a U.S. taxpayer.

B. Assume States B and C treat Entity P as a taxable entity and State A treats Entity P as transparent.

The results for the scenarios in which the United States is either State A or State B will be the same as in (A) above. The United States will treat the interest as sourced in State B in both situations, which will result in U.S. federal income tax (and application of a treaty) only if the United States is State B. Similar to (A) above, if State C is the United States, the United States will allow a foreign tax credit for withholding taxes imposed by both States A and B.

C. Assume State A treats Entity P as a taxable entity and States B and C treat Entity P as transparent.

If the United States is State A, the United States will treat the interest as sourced in State B because the United States will view the interest as being paid by a foreign corporation. Accordingly, the interest income will not be subject to U.S. federal income tax. Therefore, Article 11 of the treaty between States A and C is not relevant.

If the United States is State B, Entity P will be a domestic partnership. Interest paid to Company X will be considered U.S. source provided that Entity P is engaged in a U.S. trade or business at some time during the taxable year.<sup>155</sup> If the interest income is U.S. source, the treaty between States B and C may apply to reduce any U.S. income tax on the interest income.

Similar to (A) above, if State C is the United States, the United States will allow a foreign tax credit for withholding taxes imposed by both States A and B.

D. Assume States A and C treat Entity P as a taxable entity and State B treats Entity P as transparent.

The results for the scenarios in which the United States is either State A or State B will be the same as in (C) above. The United States will treat the interest as sourced in State B, which will result in U.S. federal income tax (and application of a treaty) only if the United States is State B (and Entity P is engaged in a U.S. trade or business). Similar to the above, if State C is the United States, the United States will allow a foreign tax credit for withholding taxes levied in States A and B.

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<sup>154</sup> Treas. Reg. ss. 1.901-2(a)(1)-(2), 1.903-1(b)(3), ex. 1.

<sup>155</sup> *Ibid.* s. 1.861-2(a)(2); see also I.R.C. s. 7701(a)(4).

- E. Assume Corporation X is established in State A rather than State C, the Owners are residents of State C rather than State A, State A treats Entity P as a taxable entity while States B and C treat Entity P as transparent, and State A treats the interest as State B source while State C treats the interest as State C source.

If State C is the United States and assuming the United States treats the interest as U.S. source income, the income will be subject to U.S. federal income tax.<sup>156</sup> Under U.S. law, the interest would only be deemed U.S. source if Entity P, a foreign partnership, were engaged in a trade or business in the United States and the interest were paid by the U.S. trade or business and were allocable to income effectively connected with that trade or business.<sup>157</sup> If Entity P's U.S. trade or business rises to the level of a permanent establishment, then the United States would be entitled to tax the interest income under article 11 of the OECD Model Convention.<sup>158</sup>

### III. Article 13(4) – Capital Gain

For each of the following case studies, assume an entity established in State P (“Entity P”), which derives more than fifty per cent of its value from ownership of immovable property located in State S, is owned by residents of State R (the “Owners”), including John, who sells his interest in Entity P to an unrelated resident of State R (the “Buyer”).

- A. Assume States P and S treat Entity P as a taxable entity and State R treats Entity P as transparent.

If State R is the United States, the United States will consider John's sale of his interest to be a sale of a partnership interest. Because the United States reserves the right to tax its citizens and residents under the saving clause of its treaties, the United States will not view article 13(4) of the OECD Model Convention as applicable.

If State S is the United States, the sale of John's interest will not be subject to U.S. federal income tax because the United States generally does not tax nonresidents' capital gains on the sale of shares in a foreign corporation that holds U.S. real property.<sup>159</sup> Here, because Entity P is not organized in the United States and is treated as a corporation for U.S. federal tax purposes, any gain derived by John will not be subject to U.S. federal income tax and article 13(4) of the OECD Model Convention will not be implicated.

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<sup>156</sup> I.R.C. ss. 1442(a).

<sup>157</sup> *Ibid.* s. 861(a)(1)(B).

<sup>158</sup> OECD Model Income Tax Convention, art. 11, para. 4; *ibid.* art. 7, para. 1.

<sup>159</sup> I.R.C. ss. 871(a)(1), 881(a), 897.

- B. Assume State S treats Entity P as a taxable entity and States R and P treat Entity P as transparent.

If State R is the United States, the United States will consider John's sale of his interest to be a sale of a partnership interest. Because the United States reserves the right to tax its citizens and residents under the saving clause of its treaties, article 13(4) of the OECD Model Convention will not be implicated.

If State S is the United States, the sale of John's interest will not be subject to U.S. federal income tax because the United States generally does not tax nonresidents' capital gains on the sale of shares in a foreign corporation that holds U.S. real property.<sup>160</sup> Here, because Entity P is not organized in the United States and it is treated as a corporation for U.S. federal tax purposes, any gain derived by John will not be subject to U.S. federal income tax and article 13(4) of the OECD Model Convention will not be implicated.

- C. Assume States R and P treat Entity P as a taxable entity and State S treats Entity P as transparent.

If State R is the United States, the United States will consider John's sale of his interest to be a sale of shares. Because the United States reserves the right to tax its citizens and residents under the saving clause of its treaties, article 13(4) of the OECD Model Convention will not be implicated.

If State S is the United States, John will be subject to U.S. federal income tax on gain recognized from the sale of his partnership interest to the extent attributable to a U.S. real property interest.<sup>161</sup> In addition to imposing an income tax on John, the United States will impose a withholding tax requirement on the Buyer.<sup>162</sup> Article 13(4) of the OECD Model Convention will not apply because the disposition of John's interest will not be considered an alienation of shares from the perspective of the United States, which is the contracting state whose tax laws are being applied. Under the U.S. Model Tax Convention, the United States will still be able to tax John because the United States reserves the right to tax U.S. real property interests (as defined for U.S. federal income tax purposes).<sup>163</sup>

- D. Assume State R treats Entity P as a taxable entity and States P and S treat Entity P as transparent.

Whether the United States is State R or State S, the answer will be the same as in (C) above.

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<sup>160</sup> I.R.C. ss. 871(a)(1), 881(a), 897.

<sup>161</sup> *Ibid.* s. 897(g).

<sup>162</sup> *Ibid.* s. 1445; Temp. Treas. Reg. s. 1.897-7T.

<sup>163</sup> 2006 U.S. Model Income Tax Convention, art. 13, para. 2(b).

#### IV. Employment Income

For each of the following case studies, assume an entity established in State P (“Entity P”) is owned by residents of State R (the “Owners”) and employs John, a resident of State P, who performs services partly in State P and partly in State R.

- A. Assume State R treats Entity P as a taxable entity and State P treats Entity P as transparent.

If State R is the United States, the United States will consider Entity P to be John’s employer. Applying U.S. tax law, Entity P will not be a resident of the United States because it is not organized in the United States and, therefore, is not subject to tax in the United States. Because the remuneration is paid by an employer who is not a resident of State R, article 15(2)(b) is likely to be satisfied.

If State P is the United States, article 15 will not be implicated because the United States reserves the right to tax its citizens and residents under the saving clause.

- B. Assume State P treats Entity P as a taxable entity and State R treats Entity P as transparent.

If State R is the United States, the result is uncertain. Commentaries to the OECD Model Convention indicate that employer status ought to be determined at the partner level.<sup>164</sup> If this approach is adopted here and the U.S. view of Entity P as a partnership is applied, then the United States will consider the Owners to be John’s employer. In that case, because the Owners are residents of State R, article 15(2)(b) is unlikely to be satisfied. If, however, U.S. law is used to define employer as dictated by article 3(2) of the OECD Model Convention, then Entity P will be considered John’s employer and, as in (A) above, article 15(2)(b) is likely to be satisfied.

If State P is the United States, article 15 will not be implicated because the United States reserves the right to tax its citizens and residents under the saving clause.

#### V. Directors’ Fees

For each of the following case studies, assume an entity established in State S (“Entity S”) is owned by residents of State R (the “Owners”) and compensates one of its directors, John, who is a resident of State R.

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<sup>164</sup> OECD Model Income Tax Convention commentary on art. 15, at para. 6.2.

A. Assume State S treats Entity S as a taxable entity and State R treats Entity S as transparent.

If State R is the United States, article 16 will not be implicated because the United States reserves the right to tax its citizens and residents under the saving clause in its treaties.

If State S is the United States, article 16 will apply because Entity S is a body corporate or is treated as a body corporate under the laws of the United States<sup>165</sup> and is thus a resident of the United States.<sup>166</sup> The United States has, however, entered a reservation with respect to article 16 and, under the U.S. Model Convention, will only permit State S to tax directors' fees for services rendered in State S.<sup>167</sup>

B. Assume instead State R treats Entity S as a taxable entity and State S treats Entity S as transparent.

If State R is the United States, article 16 will not be implicated because the United States reserves the right to tax its citizens and residents under the saving clause.

If State S is the United States, article 16 will likely be inapplicable. Entity S will not meet the definition of a company under the OECD Model Convention because it will neither be a body corporate nor treated as a body corporate for U.S. federal tax purposes.<sup>168</sup>

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<sup>165</sup> OECD Model Income Tax Convention, art. 3, para. 1(b); *ibid.* commentary on art. 3, at para. 3.

<sup>166</sup> *Ibid.* art. 4, para. 1.

<sup>167</sup> 2006 U.S. Model Income Tax Convention, art. 15; U.S. Treasury Department, Technical Explanation of 2006 U.S. Model Income Tax Convention, at 50.

<sup>168</sup> See *supra* note 165; see also Treas. Reg. s. 301.7701-2(b).