

# A FOREIGN LAWYER'S GUIDE TO U.S. INTERNATIONAL TAX LAW

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## PART I: CORE CONCEPTS

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# Part I: Core Concepts

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1. Entity Classification Rules
2. Controlled Foreign Corporations
3. Passive Foreign Investment Companies
4. Distribution from U.S. Corporation to Shareholders

# I – U.S. ENTITY CLASSIFICATION RULES

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# U.S. Entity Classification Rules

## Four Classifications

- Trust
- Corporation
- Partnership
- Disregarded

## Seven Questions (U.S. Entities)

- Formed under state law in the U.S.?
- Date of formation?
- Trust or business entity?
- Is it a corporation?
- Does it have at least two members?
- Does it have only one member?
- Was an entity classification election made?

## Eight Questions (Non-U.S. Entities)

- Formed under the law of country other than U.S.?
- Date of formation?
- Trust or business entity?
- Is it a “per se” corporation?
- Liability of the member(s)?
- Does it have only one member?
- Does it have two or more members?
- Was an entity classification election made?

# U.S. Entity Classification Rules

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- Why is it important?
- Examples:
  - Who is the taxpayer? entity v. owner
  - Dividend v. flow-thru treatment
  - Does transaction result in a P&L entry (revenue) or a B/S entry (asset account)?
  - Is the income Subpart F income of Controlled Foreign Corporation?
  - Is an entity a Passive Foreign Investment Company?
  - Does the Global Intangible Low-Taxed Income regime apply?

# U.S. Entity Classification Rules

- Domestic and foreign classification rules are found in Treas. Reg. §§301.7701-1 to 301.7701-4.
- Generally applicable as of 1997.
- Regulations classify domestic and foreign entities for U.S. tax purposes and allow certain business entities (“Eligible Entities”) the flexibility to choose classification for Federal tax purposes.

# U.S. Entity Classification Rules

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- For both domestic and foreign entities: Is it a Trust?
  - A business entity is generally any entity recognized for Federal tax purposes that is not properly classified as a trust or otherwise subject to special treatment.
  - A trust is an arrangement created either by a will or by an *inter vivos* declaration whereby trustee takes title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

# U.S. Entity Classification Rules: Domestic Entities

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- For domestic entities: Is it a corporation for Federal tax purposes?
  - Generally, a corporation formed under Federal or State statute (look for the terms “inc.,” “incorporated,” “corporation”).
  - A business entity organized under a State statute that describes or refers to the entity as a joint-stock company or joint-stock association.
  - An insurance company.
  - A State-chartered business entity conducting banking activities.
  - Certain state or government-owned entities but not an incorporated village or municipality.
  - A business entity that is taxable as a corporation under a provision of the Code (other than Code §7701).

# U.S. Entity Classification Rules: Domestic Entities

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- A business entity that is not classified as a corporation under Treas. Reg. §301.7701-2(b) is an "eligible entity" and can elect its classification for Federal tax purposes under Treas. Reg. §301.7701-3.
- Two-step process: What is default treatment? Has it elected a different classification?
- Domestic eligible entities are classified under default rule as follows (in the absence of an election):
  - An eligible entity with 2+ members is classified as a partnership.
  - A single member entity is classified as a "disregarded entity" that is not separate from its owner.
  - Example: A U.S. L.L.C. with one member is a disregarded entity; A U.S. L.L.C. with at least 2 members is a partnership.

# U.S. Entity Classification Rules: Domestic Entities

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## Summary

Individual



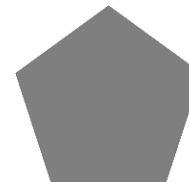
Partnership, L.L.C. or  
Disregarded



Corporation  
(U.S. “inc.” → *Always* a corporation)



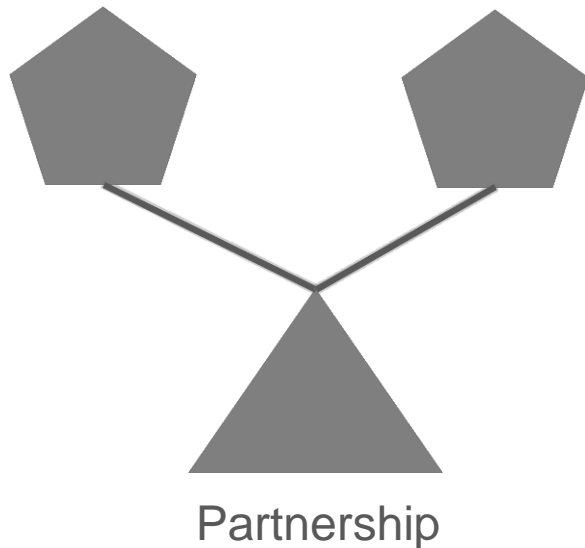
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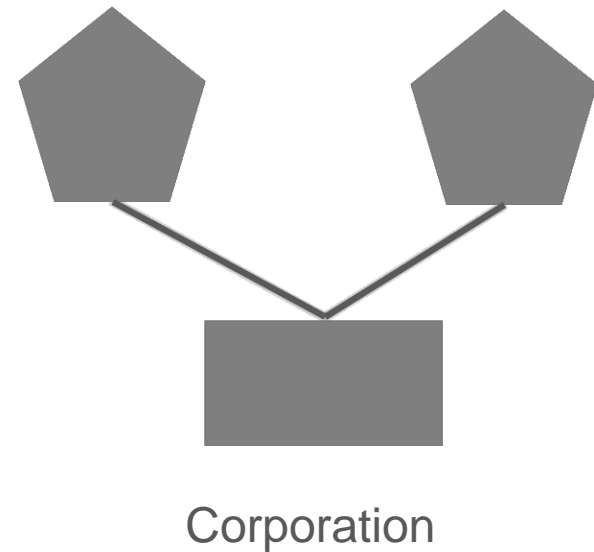
# U.S. Entity Classification Rules: Summary (Domestic Entities)

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## Default Rules for U.S. L.L.C.



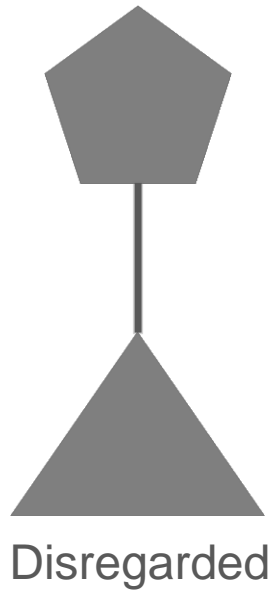
## After Check-the-Box Election



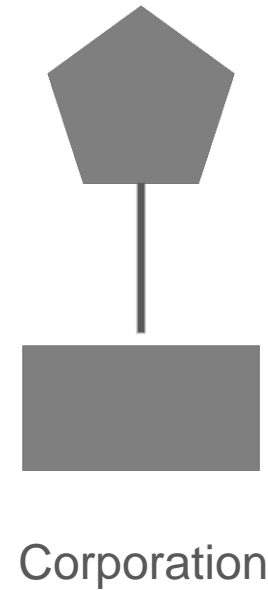
# U.S. Entity Classification Rules: Summary (Domestic Entities)

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## Default Rules for U.S. L.L.C.



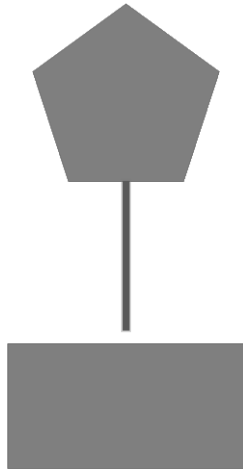
## After Check-the-Box Election



# U.S. Entity Classification Rules: Summary (Domestic Entities)

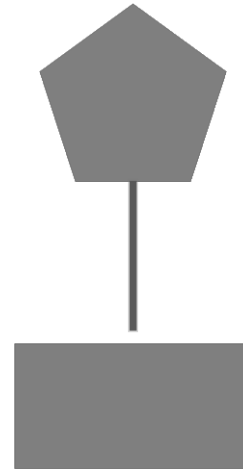
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## Default Rules for U.S. Corporation



Corporation

## No Check-the-Box Election Available



Corporation

# U.S. Entity Classification Rules: Foreign Entities

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- First question: Is it a *per se* corporations?
  - Different entity classification rules apply depending on the answer.
- Second question: If not, is it a business entity taxable as a corporation for Federal tax purposes?
- *Per Se* corporations:
  - Foreign entities that are specifically listed in Treas. Reg. §301.7701-2(b)(8).
  - Generally, these are entities that can be listed on a stock exchange for investment by the public.
  - These entities must be treated as corporations and cannot make an entity classification election.

# U.S. Entity Classification Rules: Foreign Entities

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- *Per Se Corporation Examples:*
  - An S.A. formed under Argentine, Brazilian, Chilean, Columbian, French, Luxembourg, Mexican, Panamanian, Polish, Portuguese, Spanish, Swiss, Uruguayan, Venezuelan law, etc.
  - An A.G. formed under German, Liechtenstein, Swiss law, etc.
  - An P.L.C. formed under Australian, Cypriot, Maltese, Singapore, South African, U.K. law, etc.
  - An O.A.O. formed under Russian law, an N.V. formed under Dutch law, and a G.Y.G. formed in under Chinese law
  - An *E.U. Societas Europaea*

# U.S. Entity Classification Rules: Foreign Entities

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- Unique Client Situations:
  - Countries with 2 or more languages
    - An A.G. = S.A.; a G.m.b.H = S.A.R.L.
  - Foundations
    - Is it formed for a business purpose such as a holding company for the founder?
    - Is it formed to marshal management of property for the benefit of the founder's heirs?
- Getting out of *per se* corporation status
  - Reorganize into an eligible entity
  - Typically tax free in country of formation of entity

# U.S. Entity Classification Rules: Foreign Entities

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- Eligible Entities:
  - All members have limited liability → default corporation.
    - An election is made only to obtain transparent tax treatment
    - Limited liability means that unlimited liability does not exist for any member
- Unlimited liability defined:
  - A member has liability for obligations of the entity simply because of status as member by reason of the memorandum of association or company law
  - Liability by reason of contract or guarantee is not taken into account.
  - Dummy corporation with no assets will qualify as having unlimited liability even if economically unable to pay creditors.

# U.S. Entity Classification Rules: Foreign Entities

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- Eligible Entities:
  - 2 members or more and at least one has unlimited liability → default partnership.
    - An election is made only to obtain U.S. tax character as a business entity taxable as an association.
  - 1 member with unlimited liability → default disregarded
    - An election is made only to obtain U.S. tax character as a business entity taxable as an association.
  - A foreign eligible entity may elect a different treatment on a timely filed Form 8832 (Entity Classification Election)

# U.S. Entity Classification Rules

- For treatment other as its default treatment, an election must be made by a domestic or foreign eligible entity by filing Form 8832 (“Entity Classification Election”) with the I.R.S.

<b>Form 8832</b> (Rev. December 2013) Department of the Treasury Internal Revenue Service	<b>Entity Classification Election</b>  ► Information about Form 8832 and its instructions is at <a href="http://www.irs.gov/form8832">www.irs.gov/form8832</a> .	OMB No. 1545-1516
----------------------------------------------------------------------------------------------------	------------------------------------------------------------------------------------------------------------------------------------------------------------------------	-------------------

<b>Type or Print</b>	Name of eligible entity making election	Employer identification number
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.	

► Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41  
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

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**Part I Election Information**

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**1 Type of election** (see instructions):

**a** ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.  
**b** ☐ Change in current classification. Go to line 2a.

**2a** Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☐ **Yes.** Go to line 2b.  
☐ **No.** Skip line 2b and go to line 3.

**2b** Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☐ **Yes.** Go to line 3.  
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

**3** Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.  
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

**4** If the eligible entity has only one owner, provide the following information:

**a** Name of owner ► \_\_\_\_\_  
**b** Identifying number of owner ► \_\_\_\_\_

**5** If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

**a** Name of parent corporation ► \_\_\_\_\_  
**b** Employer identification number ► \_\_\_\_\_

Page 2

6 Type of entity (see instructions):

- 7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ►

9 Name and title of contact person whom the IRS may call for more information

10 Contact person's telephone number

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

[illegible]

11 Provide the explanation as to why the entity classification election was not filed on time (see instructions).

[illegible]

# U.S. Entity Classification Rules: Summary (Foreign Entities)

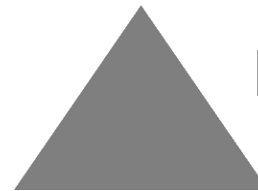
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## Summary – Foreign Entities

Individual –  
Unlimited Liability



Individual –  
Limited Liability



Partnership or  
Disregarded

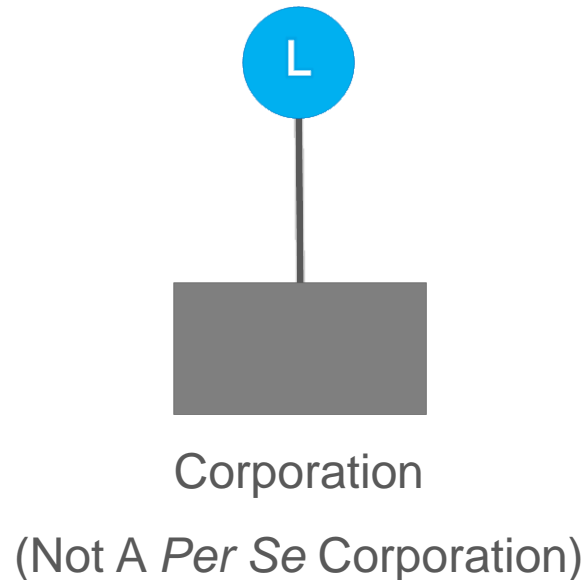


Corporation

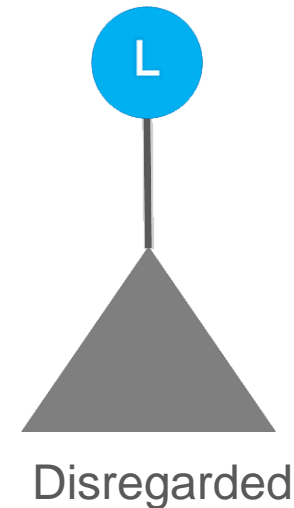
# U.S. Entity Classification Rules: Summary (Foreign Entities)

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## Default Rules



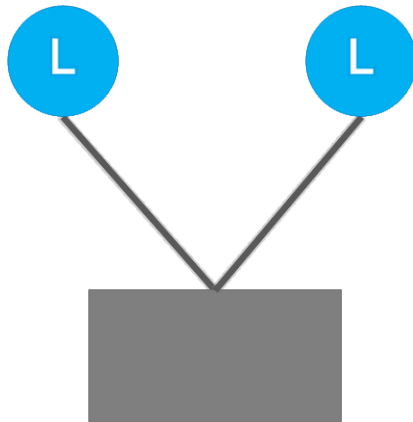
## After Check-the-Box



# U.S. Entity Classification Rules: Summary (Foreign Entities)

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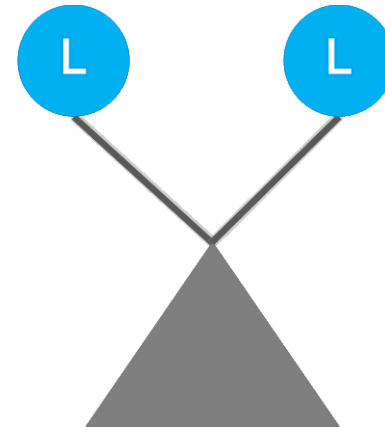
## Default Rules



Corporation

(Not A *Per Se* Corporation)

## After Check-the-Box

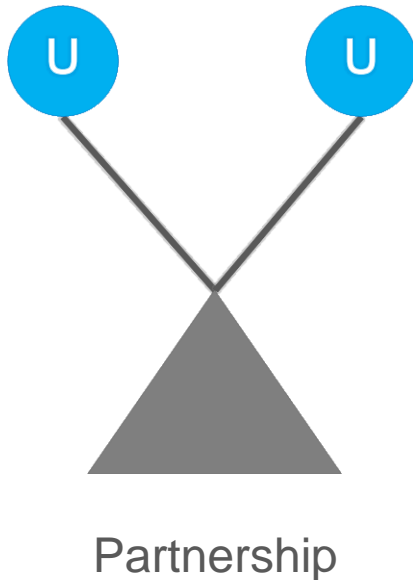


Partnership

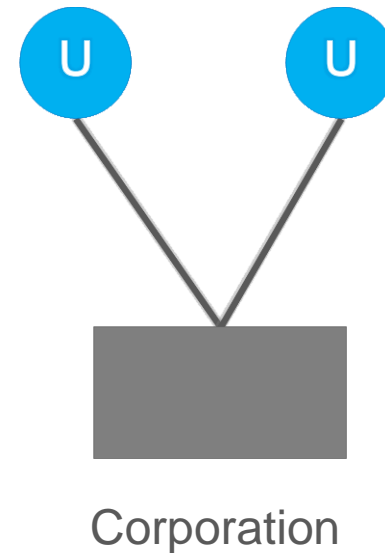
# U.S. Entity Classification Rules: Summary (Foreign Entities)

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## Default Rules



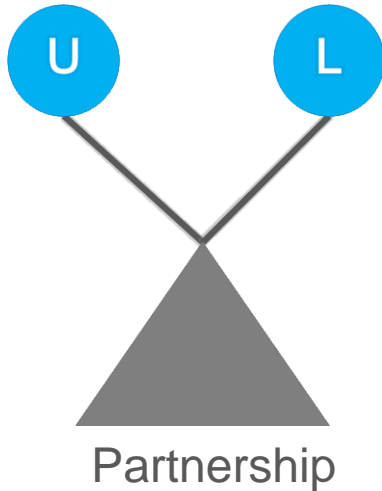
## After Check-the-Box



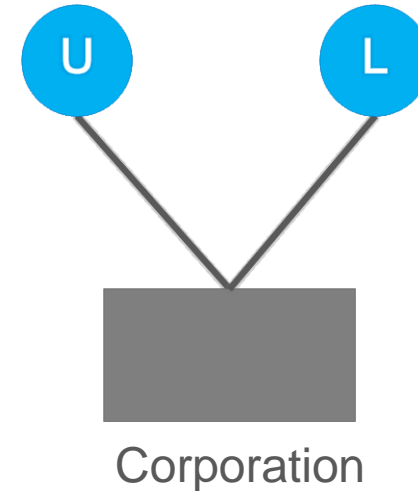
# U.S. Entity Classification Rules: Summary (Foreign Entities)

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## Default Rules



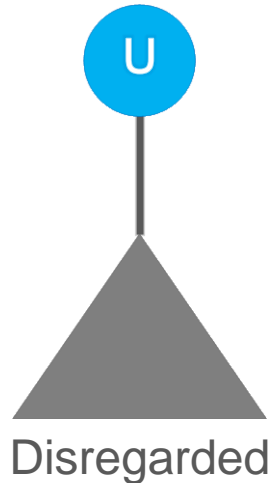
## After Check-the-Box



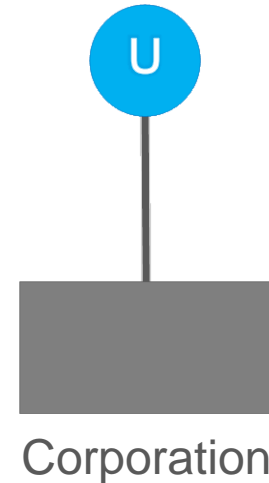
# U.S. Entity Classification Rules: Summary (Foreign Entities)

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## Default Rules

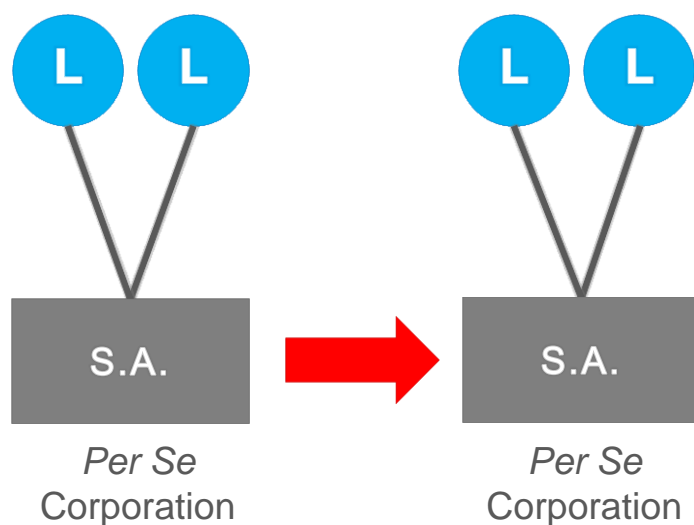


## After Check-the-Box

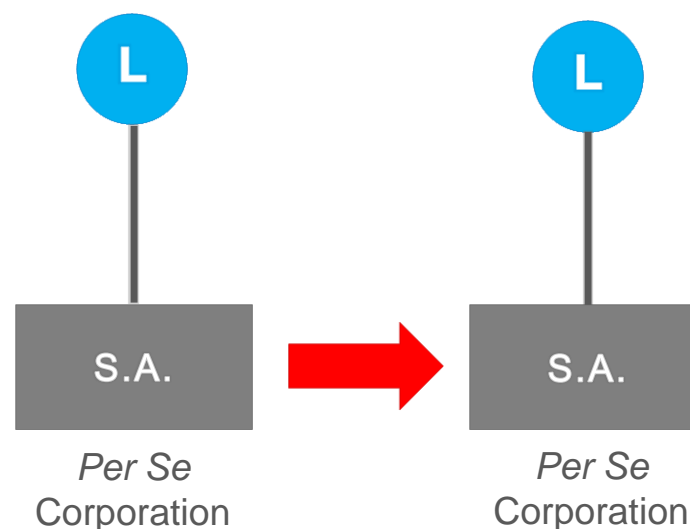


## Regularly Used Foreign Entities and their U.S. Classification: S.A., S.A.S., S.A.R.L., G.m.b.H., B.V., S.L.

### Two + Members

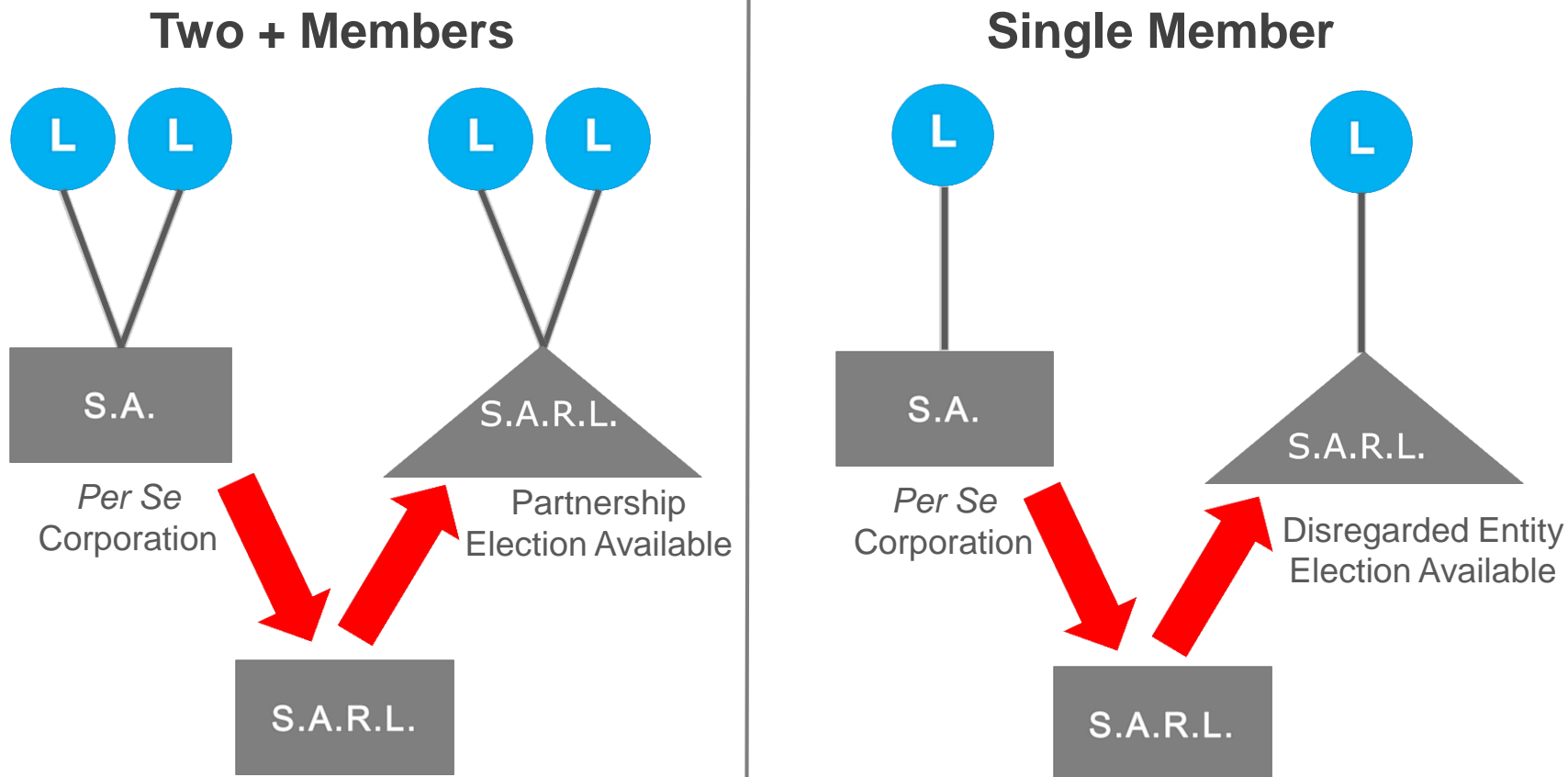


### Single Member



S.A.: *Per se* corporation → no election possible

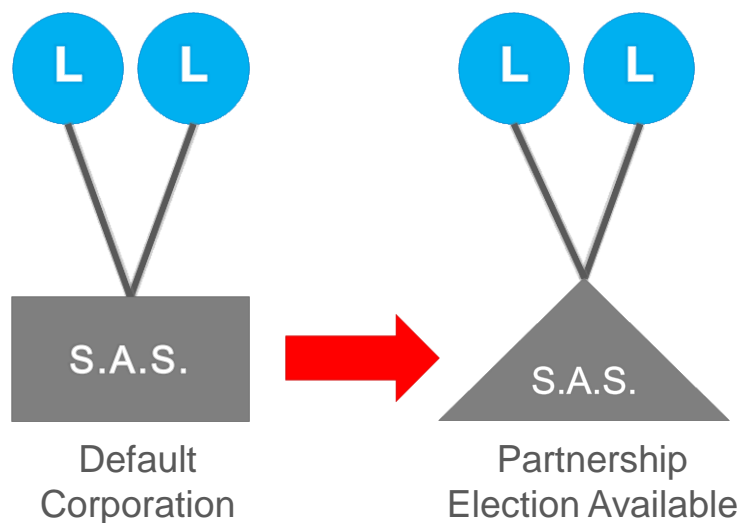
## Unique Situations for Foreign Entities and their U.S. Classification: S.A., S.A.S., S.A.R.L., G.m.b.H., B.V., S.L.



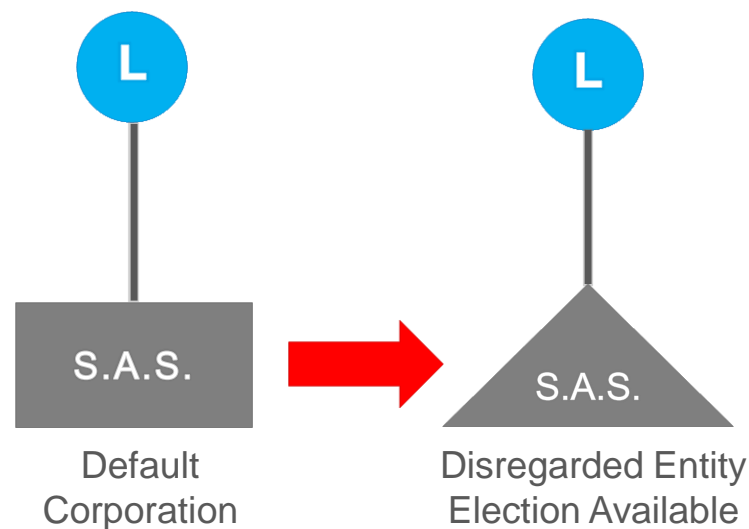
S.A.: *Per se* Corporation → no election possible  
 S.A.R.L.: Eligible Entity → election possible

## Regularly Used Foreign Entities and their U.S. Classification: S.A., S.A.S., S.A.R.L., G.m.b.H., B.V., S.L.

### Two + Members

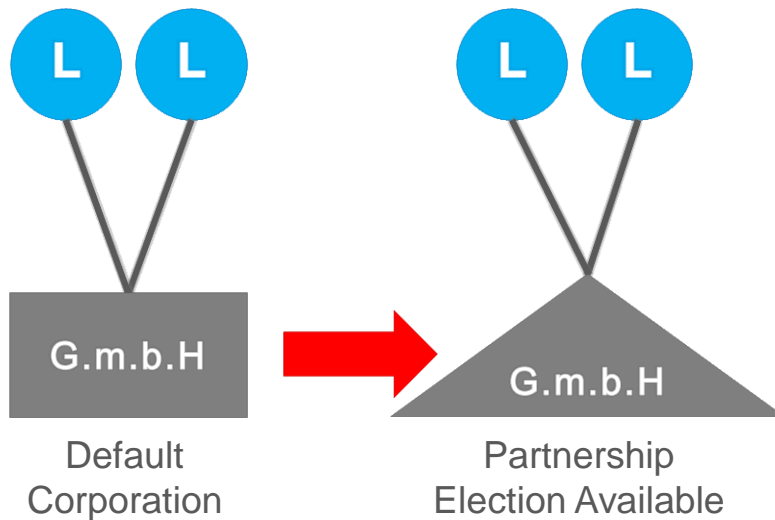


### Single Member

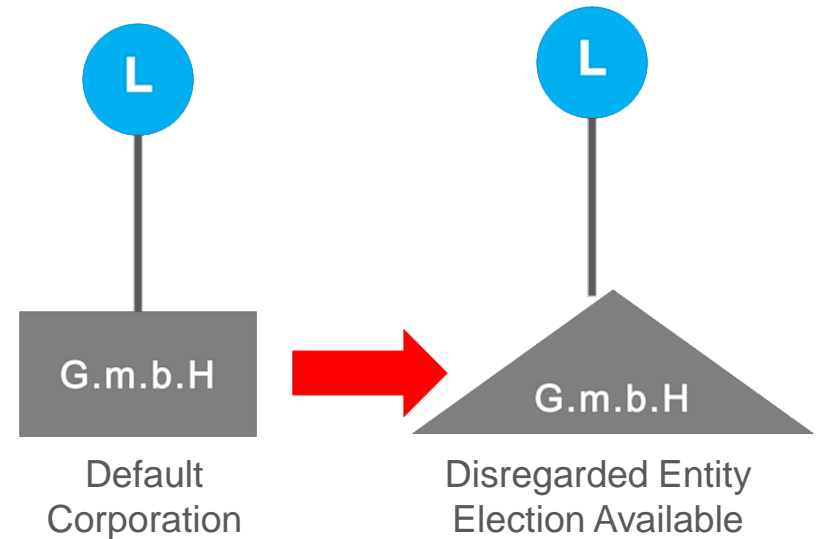


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### Two + Members

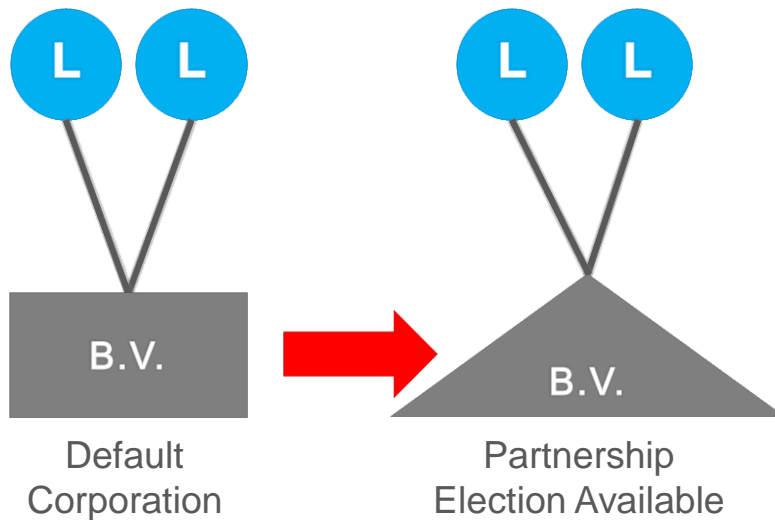


### Single Member

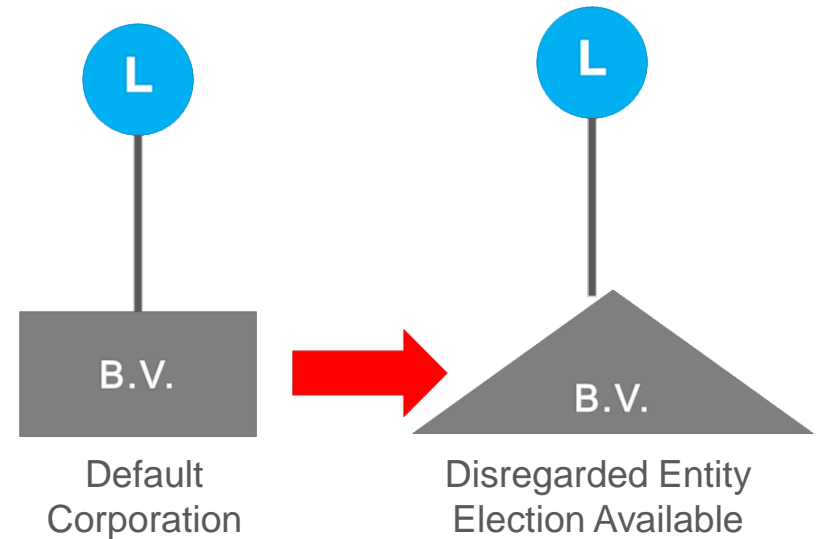


## Regularly Used Foreign Entities and their U.S. Classification: S.A., S.A.S., S.A.R.L., G.m.b.H., B.V., S.L.

### Two + Members

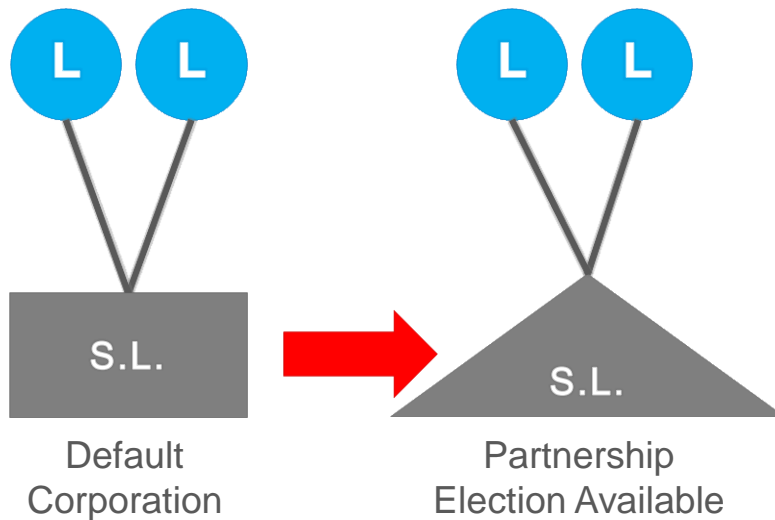


### Single Member

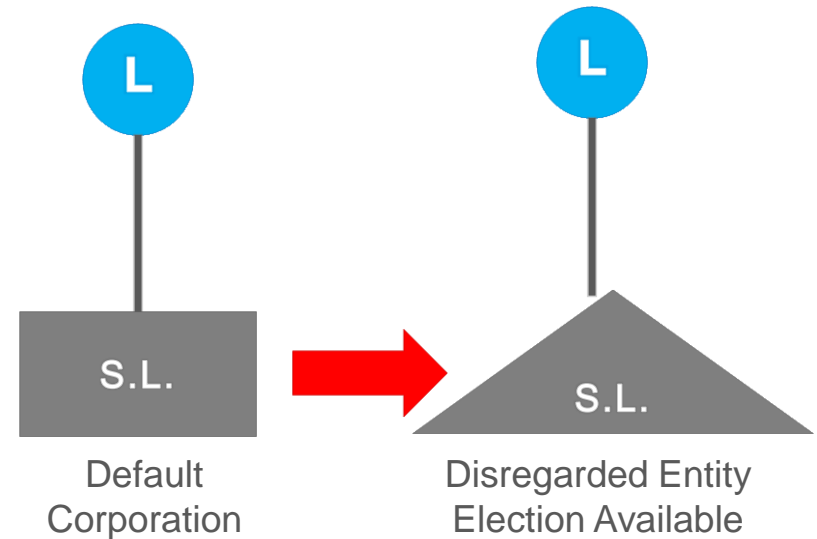


## Regularly Used Foreign Entities and their U.S. Classification: S.A., S.A.S., S.A.R.L., G.m.b.H., B.V., S.L.

### Two + Members



### Single Member



# Miscellaneous Considerations

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- In general, the election of status is first effective not more than 75 days prior to filing and not more than 12 months after filing.
- Relief for late entity classification election may be available.
  - Addresses failure to make an election that was authorized.
  - Reason for failure must be provided.
  - Contrary classification in an earlier return bars relief.
- Caution when making a non-retroactive entity classification election after the entity's formation.
  - Election cannot be undone for 60 months.
- Making an election when you are not a U.S. taxpayer and the asset is not a U.S. asset.
  - Can an election be made when there is no immediate effect for U.S. income tax purposes?

## **II – CONTROLLED FOREIGN CORPORATIONS**

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# C.F.C. Status

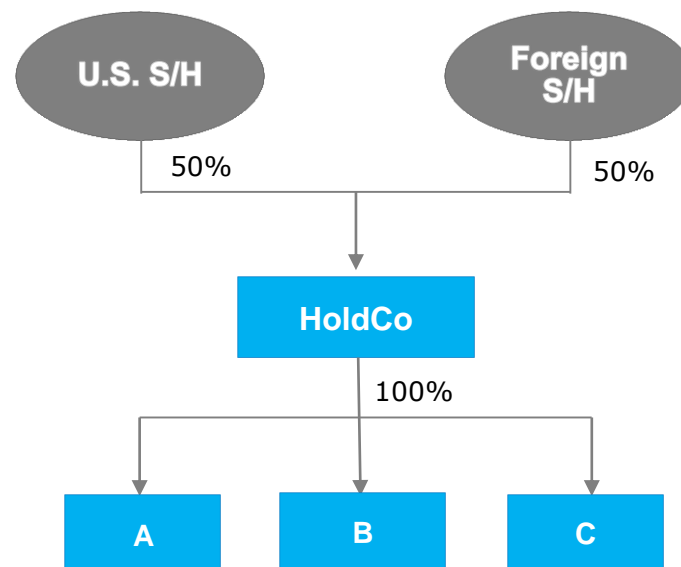
- C.F.C.

- Definition:

- Non-U.S. corporation, plus
    - U.S. shareholders, each owning  $\geq 10\%$  by vote/value (each a “U.S. Shareholder”), plus
    - $>50\%$  of vote/value owned by U.S. Shareholders

- Ownership means direct, indirect, and constructive ownership, but exception for attribution from non-U.S. individual.

- Indirect means look-thru the levels to determine deemed ownership in three Opcos based on ownership percentages in HoldCo x ownership percentage in each Opco.
    - Constructive takes into account shares attributed from others and expanded look-thru rule once control exists for HoldCo in Opcos.

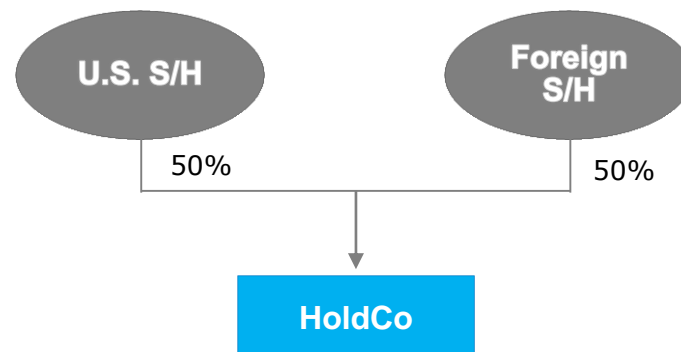


# C.F.C. Status

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- C.F.C. Status:

- Non-U.S. corporation
- U.S. shareholder(s)
- Attribution rules exist but exception for attribution from non-U.S. individuals
- $\geq 10\%$  by vote or value
- $> 50\%$  by vote or value

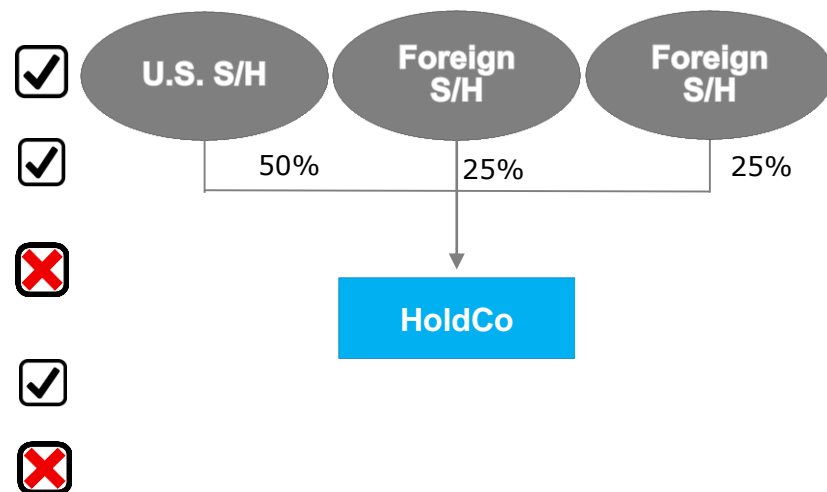


Conclusion: not a C.F.C.

# C.F.C. Status

- C.F.C. Status:

- Non-U.S. corporation
- U.S. shareholder(s)
- Attribution rules exist but exception for attribution from non-U.S. individuals
- $\geq 10\%$  by vote or value
- $> 50\%$  by vote or value

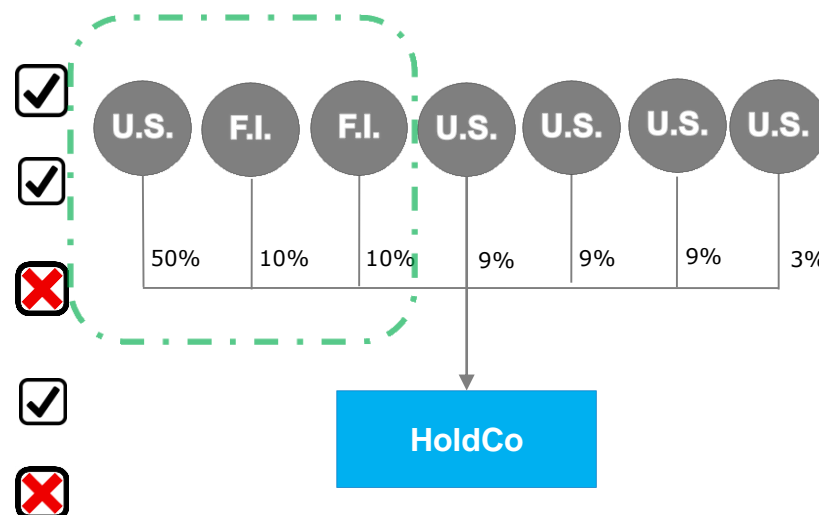


Conclusion: not a C.F.C.

Trap: If the 50% U.S. ownership gets a control premium  $\rightarrow$  holds  $> 50\%$  by vote  $\rightarrow$  C.F.C.

# C.F.C. Status

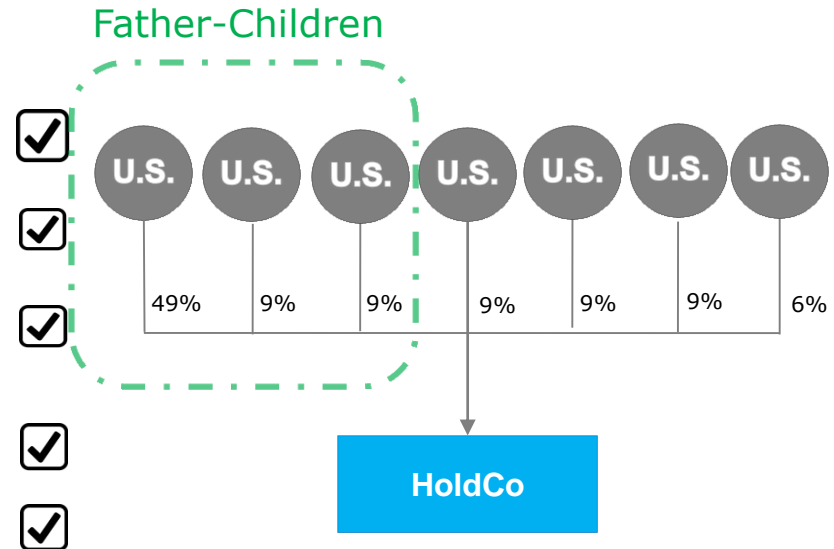
- C.F.C. Status:
  - Non-U.S. corporation
  - U.S. shareholder(s)
  - Attribution rules exist but exception for attribution from non-U.S. individuals
  - $\geq 10\%$  by vote or value
  - $> 50\%$  by vote or value



**Conclusion: Not a C.F.C. because there is only one U.S. Shareholder that owns 50% and no constructive ownership from foreign individuals together owning 20% of shares**

# C.F.C. Status

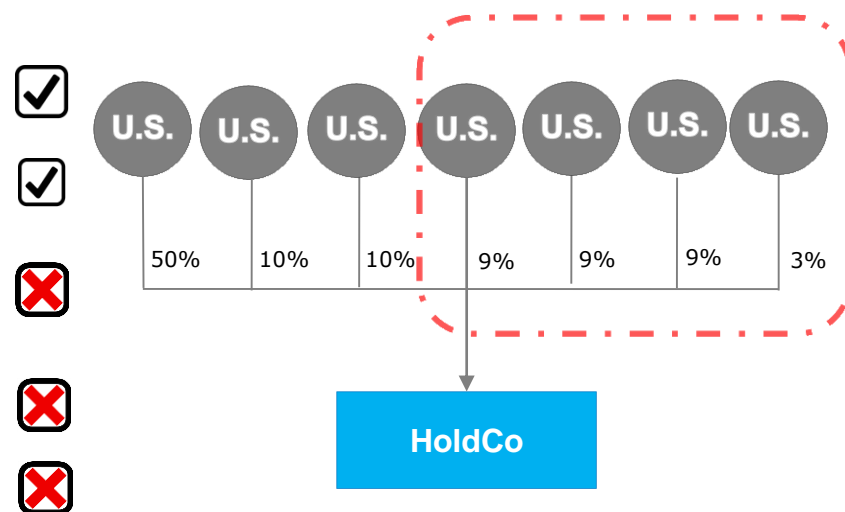
- C.F.C. Status:
  - Non-U.S. corporation
  - U.S. shareholder(s)
  - Attribution rules exist when attribution is from U.S. individuals
  - $\geq 10\%$  by vote or value
  - $> 50\%$  by vote or value



Conclusion: a C.F.C.

# C.F.C. Status

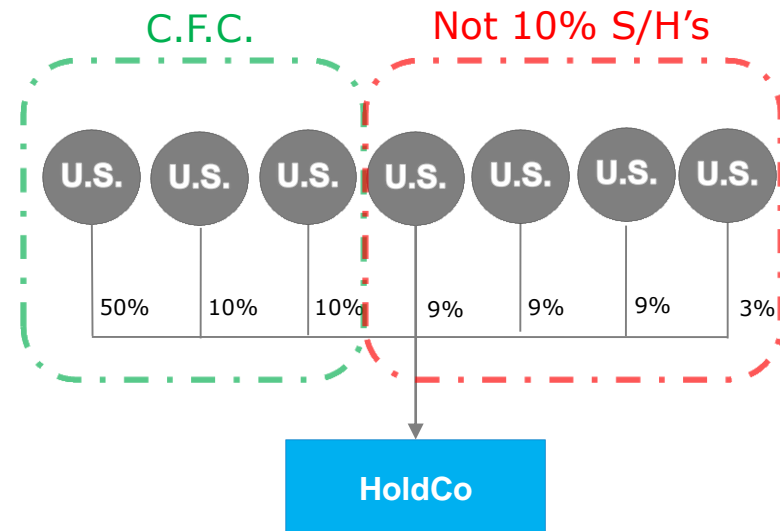
- C.F.C. Status:
  - Non-U.S. corporation
  - U.S. shareholder(s)
  - Attribution rules exist but exception for attribution from non-U.S. individuals
  - $\geq 10\%$  by vote or value
  - $> 50\%$  by vote or value



Conclusion: 9% and the 3% unrelated S/H's are not 10% S/H.'s in C.F.C.

# C.F.C. Status

- Consequences of C.F.C. Status:
  - Form 5471 filing for all entities by U.S. shareholders
  - Subpart F income inclusion to the extent of the C.F.C.'s E&P; subsequent dividend not taxed, except if it exceeds the pool of earnings from previously taxed income under Subpart F
  - G.I.L.T.I. rules apply
  - Transition tax may apply
  - If the C.F.C. is also a P.F.I.C., C.F.C. rules generally trump P.F.I.C. rules for a S/H that is a U.S. Shareholder



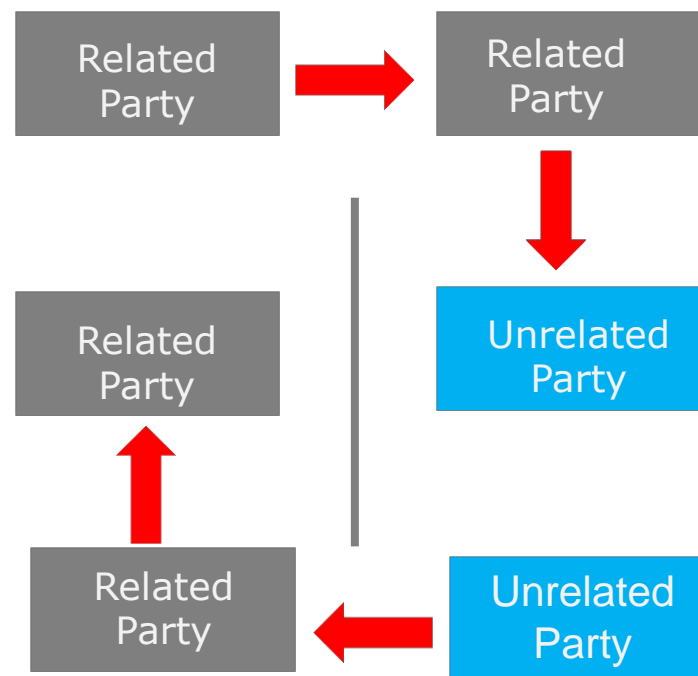
# C.F.C. Status

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- Subpart F Income:
  - Foreign Personal Holding Company Income:
    - Dividends, interest, royalties, rents, and annuities;
    - Income equivalent to interest;
    - Gains from certain property transactions when the property does not constitute inventory in the hands of the C.F.C. and (i) produces dividends, interest, rents, royalties or annuities, (ii) is an interest in a trust, a partnership or a R.E.M.I.C., or (iii) does not generate income, such as artwork;
    - Certain commodities gains;
    - Certain foreign currency gains;
    - Income from notional principal contracts such as currency or commodity swaps;
    - Payments in lieu of dividends derived from equity securities lending under Code §1058;
    - Income from personal service contracts where the services are performed by a controlling shareholder and either the contract requires the services to be performed by the shareholder, or the customer has the right to choose the employer service provider.

# C.F.C. Status

- Subpart F Income (Continued):
  - Foreign base company sales income means income (margins, commissions, fees, etc.) derived in connection with:
    - The purchase of personal property from a related person and its sale to any person (trading operation with a related party being the supplier),
    - The sale of personal property to any person on behalf of a related person (sales agent for a related party),
    - The purchase of personal property from any person and its sale to a related person, (trading operation with a related party being the customer), or
    - The purchase of personal property from any person on behalf of a related person



# C.F.C. Status

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- Subpart F Income (Continued):
  - Certain conditions must apply with regard to the inventory in order for Foreign Base Company Sales Income to exist:
    - The inventory is produced outside the country under the laws of which the controlled foreign corporation is created or organized, and
    - The property is sold for use, consumption, or disposition outside such foreign country
  - If a C.F.C. produces inventory in one jurisdiction and sells it through a permanent establishment in another jurisdiction and the arrangement reduces the overall tax by more than 5 percentage points and the tax rate is less than 90% of the amount that would be due if all operations were carried on in one jurisdiction.
  - A sale of inventory to a related party will not involve a purchase and sale of finished product if:
    - C.F.C. engages unrelated toll manufacturer in another jurisdiction
    - C.F.C. manages parts and supplies, logistics or performs another service that constitutes substantial assistance to the toll manufacturer;

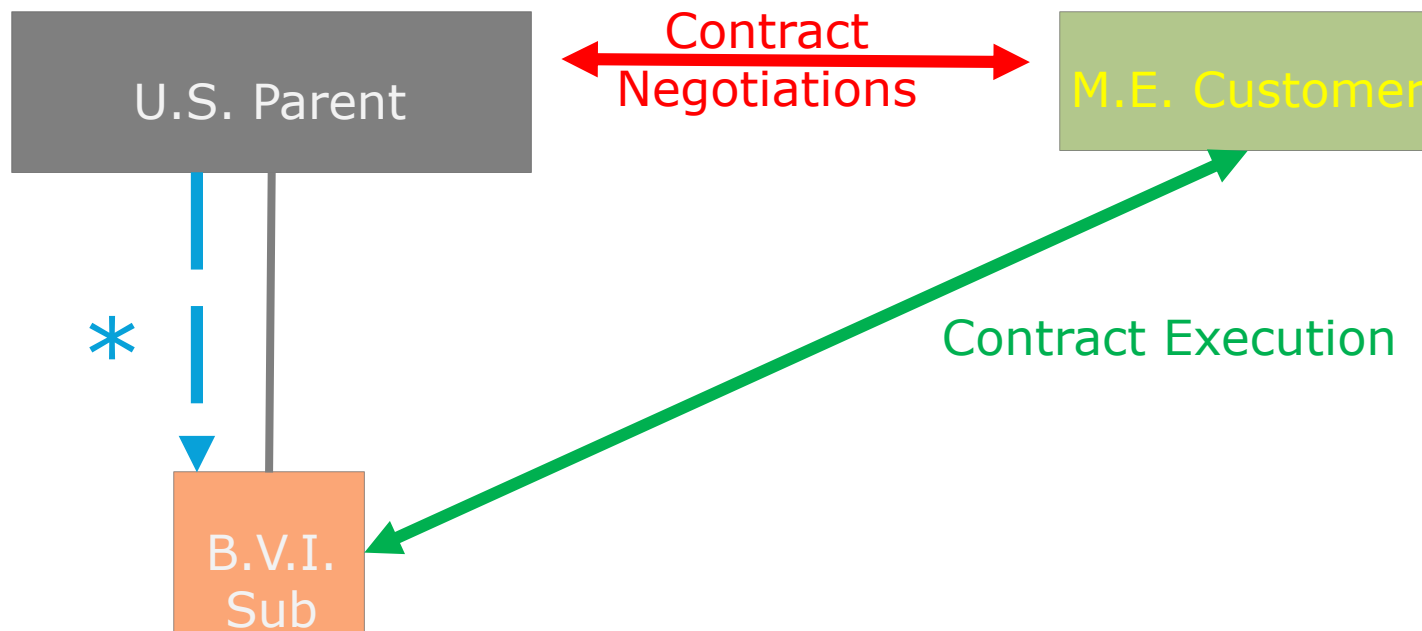
# C.F.C. Status

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- Subpart F Income (Continued):
  - Foreign Base Company Services Income arises when a C.F.C. performs technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services.
    - The services must be performed for or on behalf of any related person and
    - They are performed outside the country under the laws of which the C.F.C. is created or organized.
  - Examples include:
    - The related person pays the C.F.C. for the services.
    - The related person is or was obligated to perform the services before assigning the project to the C.F.C.
    - The services performed by the C.F.C. were a condition or material term of a sale of property by a related person.
    - The related person contributed “substantial assistance” to the C.F.C. in its performance of services.

# C.F.C. Status

- Subpart F Income (Continued):
  - Foreign Base Company Services Income fact pattern



\* U.S. Parent supplies personnel and knowhow to B.V.I. Sub for cost-plus fee

# C.F.C. Status

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- Subpart F Income (Continued):
  - In recognition of the global economy and the use of regional centers, the scope of Foreign Base Company Services Income was scaled back by the I.R.S. in 2007.
  - Literal application of the provision builds cost inefficiencies where duplication is required to avoid taxation.
    - As a result, a regional team can provide services to a client even if the services are performed in a third country
    - Nonetheless, if a related U.S. person provides assistance to a C.F.C. carrying out a project and the cost of those services amount to 80% or more of total costs, Foreign Base Company Sales Income will exist.

# C.F.C. Status

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- Subpart F Income (Continued):
  - Certain insurance income attributable to the issuing (or reinsuring) of an insurance or annuity contract
  - International boycott income
  - The sum of the amounts of any illegal bribes, kickbacks, or other payments on behalf of the C.F.C.
  - Income from countries the U.S. has no diplomatic relations with, or has severed its diplomatic relations with.

# **III – PASSIVE FOREIGN INVESTMENT COMPANIES**

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# P.F.I.C. Status

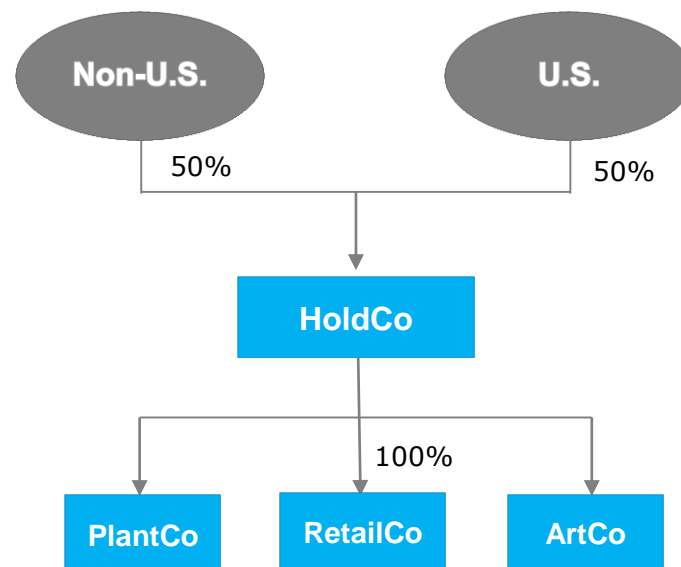
- Passive Foreign Investment Companies (“P.F.I.C.”):

- Definition:

- Non-U.S. corporation, plus
- Foreign Personal Holding Company Income items comprise 75% of gross income, or
- The average adjusted basis in assets that produce Foreign Personal Holding Company Income comprises 50% of the average adjusted basis in all assets.

- Note:

- Artwork and cash are considered assets producing Foreign Personal Holding Company Income
- If non-U.S. corporation is a C.F.C. and a P.F.I.C., C.F.C. status trumps for U.S. Shareholders during “qualified portion”
- If a non-U.S. corporation was ever a P.F.I.C. without being a C.F.C. as to U.S. Shareholder, it remains a P.F.I.C. when disposed even if C.F.C. rules trump income inclusion
- Benefit of purging election
- 25% ownership look-thru rule applies
- Average asset values are used for a foreign corporation that has publicly traded shares

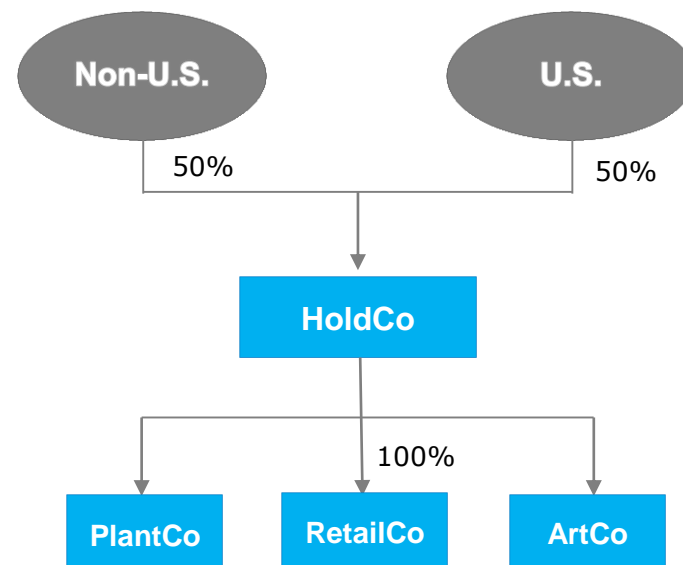


# P.F.I.C. Status

- P.F.I.C.:

- Consequences:

- Interest charge is imposed on tax arising from an excess distribution or direct or indirect disposition of shares of P.F.I.C.
      - The income inclusion is allocated to each day of the holding period and taxed at top marginal rates.
      - Interest is imposed on the deemed late payment of tax for those years.
      - The goal is to eliminate the benefit of deferral of tax but the Code definition of deferral is often a much greater period than actual deferral
      - Q.E.F. election is made to eliminate deferral, thereby making the P.F.I.C. tax transparent; the P.F.I.C. must agree to provide timely information to the U.S. investor.
    - An M.T.M. election is made for a publicly traded fund
    - Form 8621 filing requirement
    - If Q.E.F. is not pedigreed, a purging election must be made to avoid P.F.I.C. treatment on disposition
  - *De minimis* exception may apply if P.F.I.C. stock is worth not more than \$25,000 (\$50,000 if file jointly and both own stock)



# P.F.I.C. Status

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- P.F.I.C. status:
  - $\geq 25\%$  ownership – look-thru rule applies to the group of companies and all income and assets of group are aggregated at HoldCo's level to determine its P.F.I.C. status
  - HoldCo may be a P.F.I.C. in the U.S. shareholder's hands if the income or asset test is met
  - If so, the U.S. S/H must file Form 8621
- Special rule for U.S. Shareholders of a P.F.I.C.
  - U.S. Shareholders are removed from the scope of P.F.I.C. rules.
  - U.S. investors that are not U.S. Shareholders of the C.F.C. are subject only to the P.F.I.C. rules.

# IV – DISTRIBUTION FROM U.S. CORPORATION TO SHAREHOLDERS

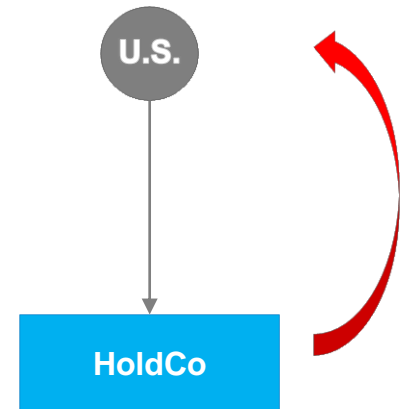
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# Distributions from Corporations

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- Taxation:

- Dividend up to the amount of E&P (up to 20%+3.8% N.I.I.T. + State and Local)
- Applied against basis if in excess of E&P (no taxation but increases future capital gain upon sale of stock)
- Capital gain if in excess of E&P and basis (up to 20%+3.8% N.I.I.T. + State and Local)



# Important Notice

This presentation is not intended to be legal advice. Reading these materials does not create an attorney-client relationship. The outcome of each case stands on its own merits.