

NEW REGULATIONS EXPLAIN CLASSIFICATION AND RESIDENCE OF ENTITIES ORGANIZED IN MULTIPLE JURISDICTIONS

ANDREW WALKER

THE NEW REGULATIONS FOR ENTITIES ORGANIZED IN MULTIPLE JURISDICTIONS HAVE RAISED SEVERAL ISSUES OF MAJOR CONCERN TO PRACTITIONERS.

On August 12, 2004, the IRS published temporary and proposed regulations clarifying the application of the check-the-box entity classification rules to business entities that could be viewed as organized concurrently under the laws of more than one jurisdiction ("multi-jurisdiction entities" or MJE). These regulations ("MJE Regulations") generally will be effective as of August 12, 2004.¹ The MJE Regulations purport to clarify existing law, and the Preamble states that they do not change the proper application of the existing rules to MJE.

Regulatory guidance was precipitated by the enactment of statutes in some jurisdictions (e.g., Delaware) that allow entities organized elsewhere to redomesticate (i.e., to be reclassified as an entity organized in that jurisdiction). If the original jurisdiction where the entity is organized requires the entity (or the entity elects) to surrender its original charter or certificate of organization, redomestication simply effects a change in the entity's jurisdiction. However, if the original certificate of organization or charter is not surrendered, the entity arguably thereafter is organized or created under the laws of two jurisdictions concurrently. Application of the existing check-the-box regulations ("CTB Regulations")² in this situation was not entirely clear.

OVERVIEW OF CTB REGULATIONS

The CTB Regulations generally provide that specified business entities must be treated as corporations ("per se corporations"). For domes-

tic entities, these include entities organized under federal or state statutes if the statute refers to the entity as incorporated, as a corporation, body corporate, body politic, joint stock company, or joint stock association.³ Also treated as per se corporations are specific organizational forms in particular foreign jurisdictions (e.g., U.K. public limited companies).⁴ Certain entities (such as insurance companies, certain banks, publicly traded partnerships, and taxable mortgage pools) are treated as per se corporations under generally applicable federal income tax principles regardless of organizational form.

Business entities that are not per se corporations ("eligible entities") may elect whether to be treated as associations (i.e., to be taxable as corporations) or pass-through entities.⁵ Absent an election, (1) a domestic eligible entity is treated as a pass-through, (2) a foreign eligible entity whose owner has no personal liability for the entity's debts is treated as an association taxable as a corporation, and (3) a foreign eligible entity any owner of which has personal liability for the entity's debts is treated as a pass-through.⁶ Pass-through entities are classified as partnerships if the entity has more than one owner or as disregarded entities if there is a single owner.

Before the MJE Regulations, application of the CTB Regulations to an entity organized in more than one jurisdiction was somewhat unclear. For example, a company is initially organized under the laws of Luxembourg as a *societe anonyme* (a form of Luxembourg entity listed as a per se corporation) and later converts to a Delaware LLC without surrendering its original charter.⁷ Is

the company a per se corporation based on its status under Luxembourg law or a pass-through entity, because it would not have been a per se corporation (indeed would have defaulted to pass-through treatment) had it been organized solely in Delaware? Should it be viewed as domestic or foreign? Which law is relevant in determining whether any person has personal liability for the entity's debts to establish its default classification?

OVERVIEW OF NEW REGULATIONS

The MJE Regulations clarify the application of the CTB Regulations in this situation. As a first step (before considering whether the entity is domestic or foreign), its status as a corporation or pass-through must be determined. Under the MJE Regulations, if the entity would be a corporation as a result of its organization under the laws of any of the jurisdictions where it is organized, it is a corporation.⁸ In the example above, the entity is organized under Luxembourg law in a form that would cause it to be a per se corporation had it been organized only in Luxembourg. It is also organized under Delaware law in a form that does not make it a per se corporation. However, because it would be a per se corporation based on its form of organization under

¹ TD 9153, 69 Fed. Reg. 49809 (August 12, 2004); Temp. Regs. 301.7701-1T, -2T, -5T.

² Regs. 301.7701-2, -3.

³ Reg. 301.7701-2(b)(1).

⁴ Reg. 301.7701-2(b)(8).

⁵ Reg. 301.7701-3(a).

⁶ Reg. 301.7701-3(b).

⁷ This and other examples provided below are intended merely to illustrate the principles of, and permutations under, the MJE Regulations. No inference is intended that the transactions described are possible or practicable under domestic or foreign law.

⁸ Temp. Reg. 301.7701-2T(b)(9).

EXHIBIT 1

Application of MJE Regulations

Jurisdiction and Status		Concurrent Jurisdiction			
		U.S. "Per Se" Corporation	U.S. Eligible Entity	Foreign "Per Se" Corporation	Foreign Eligible Entity
Original Jurisdiction	Foreign "Per Se" Corporation	Domestic Corporation	Domestic Corporation	Foreign Corporation	Foreign Corporation
	Foreign Eligible Entity	Domestic Corporation	Domestic Eligible Entity	Foreign Corporation	Foreign Eligible Entity
	U.S. "Per Se" Corporation	Domestic Corporation	Domestic Corporation	Domestic Corporation	Domestic Corporation
	U.S. Eligible Entity	Domestic Corporation	Domestic Eligible Entity	Domestic Corporation	Domestic Eligible Entity

Luxembourg law, it must be treated as a corporation.

As a second step, having determined whether the entity is a corporation or pass-through, its residence is determined. Under the MJE Regulations, if any jurisdiction where the entity is organized includes the U.S., the entity is treated as a domestic entity.⁹ Only if the U.S. is not among the jurisdictions where it is considered organized or created is the entity treated as foreign. Accordingly, in the example above, because one of the jurisdictions in which the entity is considered organized is Delaware, the entity is domestic and is therefore taxable as a domestic corporation.¹⁰

While this does not leap out from the text of the MJE Regulations, the effect of valid elections made for eligible entities is taken into account. For example, a company is initially organized under Cayman Islands law as an exempted limited company (a form that is not a per se corporation but defaults to corporate treatment because, under Cayman law, no owner has personal liability for the entity's debts). The company later converts to a Delaware LLC without surrendering its original charter. A Delaware LLC would default to pass-through status. Under the MJE Regulations, the

entity is a corporation if Reg. 301.7701-2(b) would treat it as a corporation "as a result of its formation in any one of the jurisdictions in which it is created or organized." Clearly, absent an election, its default status as a corporation based on its Cayman status prevails.

What if pass-through treatment is later elected by filing Form 8832 (Entity Classification Election)? One could worry (a little) that, because the company's formation as an entity of that type under Cayman law means that no owner has personal liability for the company's debts, it would be corporate "as a result of its formation." Nevertheless, because Reg. 301.7701-2(b)(2) cross-references the rules for eligible entities (Reg. 301.7701-3), the correct reading is that the election is effective. The outcome in various situations for MJEs under the MJE Regulations is shown in Exhibit 1.

The approach adopted by the MJE Regulations has the advantage of providing clear bright-line rules.¹¹ However, the MJE Regulations are biased towards concluding that an entity is corporate and domestic, as Exhibit 1 illustrates. Neither the MJE Regulations nor the Preamble articulate any rationale as to why the bias towards corporate treatment is appropriate. For example, why

could the rule not be that an entity is a pass-through if it is a pass-through in any jurisdiction of organization? Unfortunately, no principled reason for treating certain foreign entities as per se corporations has ever been articulated, making it difficult to assess which approach is more appropriate.

At the time the original check-the-box regulations were promulgated, commenters speculated that these per se entities were simply those that could not readily have avoided corporate treatment under the "four factor" test of prior law.¹² Why perpetuating that situation was a policy goal is not clear. But given that the CTB Regulations—for better or worse—extend the per se

⁹ Temp. Reg. 301.7701-5T(a).

¹⁰ See Temp. Reg. 301.7701-5T(b), Example 1.

¹¹ A more nuanced approach, for example, could have required an evaluation of which country would assert primary jurisdiction to determine the rights and entitlements of the shareholders as between different classes of shareholders and against the entity, and which law would have been applied under choice of law principles. But this type of approach is administratively complex and turns on jurisdictional and choice-of-law determinations outside the ken of most private or government tax lawyers, particularly where foreign law is at issue. One goal of the CTB Regulations in the international context was precisely to avoid such complex foreign law-based determinations. So it understandable that the government did not pursue such an approach.

¹² See former Reg. 301.7701-2(a)(2); Morrissey, 296 U.S. 344 (1935).

¹³ See Reg. 1.1441-1(b)(2)(iii).

corporation concept to foreign entities, presumably the government is uneasy about allowing taxpayers through self-help to side-step those rules. An approach contrary to that of the MJE Regulations would make it relatively easy to avoid per se corporation status as many per se entities would be able to adopt concurrent Delaware LLC status.

Similarly, it is unclear why the bias towards domestic treatment is appropriate as a policy matter. The rule will also lead to somewhat anomalous results. For example, a foreign partnership that forms a wholly owned Delaware LLC (treated as a disregarded entity) to hold portfolio investments in the U.S. remains foreign for purposes of the withholding regulations.¹³ If the same partnership instead obtains a Delaware LLC certificate and owns the investment directly, it will be domestic and may receive payments free of withholding tax (although the partnership itself must then apply withholding at the partnership level on amounts allocable to its foreign investors).¹⁴ In particular, if an entity's status as a matter of foreign corporate law is sufficiently substantive to justify corporate classification and trump its domestic classification, why should it not be treated as organized under foreign law?

The Preamble to the MJE Regulations suggests that domestic treat-

ment is required in this situation by the statutory provisions in Sections 7701(a)(4) and (5), which define "domestic" when applied to a corporation or partnership to mean created or organized under the law of a U.S. jurisdiction and define "foreign" as an entity that is not domestic. This explanation is not entirely compelling—it does not greatly strain the plain language of the statute to conclude that, to the extent that the entity is corporate solely because of its organizational form under foreign law, it is, insofar as it is corporate, organized as a corporation under foreign law and not U.S. law.

Taxpayers who have already formed foreign per se corporation MJE's based on interpretations of the current regulations should reasonably have understood that there was a meaningful risk that the entity would be determined to be corporate. It is far less clear that such taxpayers could reasonably have anticipated that the entity would be treated as a domestic corporation fully subject to U.S. net income tax. Some transitional relief in this situation seems warranted.

EFFECT OF CHANGE IN CLASSIFICATION

The Preamble makes clear that if, after applying the MJE Regulations, redomestication results in a change in classification or residence, the tax

effects of that change in classification or change in residence status are determined under regular tax principles.¹⁵ For example, under the current CTB Regulations, if a foreign entity treated as a partnership merges into another foreign entity treated as a corporation, the change in classification from a pass-through to a corporation is generally treated as a contribution by the partnership of the property to a new corporation followed by a liquidation of the partnership in which it distributes the corporation's shares. If a foreign partnership instead redomesticates to a jurisdiction and as a result must be treated as a corporation under the MJE Regulations, the consequences are the same.

One concern is that the MJE Regulations do not address when the concurrent organization in two jurisdictions is temporary. Assume that a foreign company that is a per se corporation redomesticates into a Delaware LLC. The entity intends to surrender its certificate of incorporation in the other jurisdiction. Not atypically, surrender will not become effective as a matter of the foreign jurisdiction's law until after a notice period and Secretary of State for the foreign jurisdiction has approved the certificate's surrender. This may take a few weeks. In the interim, it appears the entity arguably is a U.S. domestic corporation, but on the surrender becoming effective, it becomes by default a pass-through entity. This arguably constitutes a deemed liquidation of a domestic corporation rather than a foreign corporation, potentially triggering two levels of U.S. tax when a liquidation of the foreign company would at most result in only one level of U.S. tax.¹⁶

This is not merely a trap—it may not be practically possible to achieve legal effectiveness of both continuation and discontinuation

¹⁴ See Reg. 1.1441-5(b). In effect, the MJE Regulations appear to provide an alternative method for treatment as a withholding foreign partnership for purposes of Reg. 1.1441-5(c) without entering into a withholding foreign partnership agreement. See also Rev. Proc. 2003-64, 2003-32 IRB 306, as amended by Rev. Proc. 2004-21, 2004-14 IRB 702.

¹⁵ Several rules under the current CTB Regulations specify the tax effects of a change in classification. See, e.g., Reg. 301.7701-3(g)(1) and Rev. Rul. 2004-59, 2004-24 IRB 1050 (conversion of partnership to association treated as asset contribution to new corporation followed by partnership liquidation); Reg. 301.7701-3(g)(1)(iv) (conversion of disregarded entity to association treated as asset contribution to new corporation); Reg. 301.7701-

3(g)(1)(ii) (conversion of association to partnership or disregarded entity treated as liquidation of corporation, if partnership, followed by contribution to partnership); Rev. Rul. 99-5, 1999 C.B. 347 (conversion of disregarded entity to partnership treated as sale of assets to buyer followed by contribution by both parties to new partnership if purchase price received by seller, otherwise as contribution of property and cash to new partnership).

¹⁶ See Preamble to the MJE Regulations (TD 9153, *supra* note 1, at 49810) (stating that if an entity undertakes a transaction that on application of these rules changes its entity classification or residence status, the tax consequences are determined under regular tax principles)

on the same date. While one could certainly apply step transaction principles to argue against this result, the bright-line nature of the rules in the MJE Regulations may preclude complete confidence in the outcome. Presumably, the result is not intended, but clarification would be helpful. Final regulations could provide that, if the taxpayer has taken all steps reasonably within its control necessary to surrender its charter in the original jurisdiction, it will not be treated as organized in that jurisdiction merely because procedural requirements under foreign law delay the effective date of the surrender of its original charter or certificate of organization.

INTERACTION WITH TAX TREATIES

The Preamble states that the MJE Regulations “do not determine an entity’s place of residence for purposes of applying the provisions of a tax treaty.” It is commendable that the Regulations seek to avoid conflict with U.S. treaty obligations in the event of inconsistency. But the statement in the Preamble begs further clarification.

One could plausibly read this statement to mean that, in determining where an entity is resident for purposes of an income tax treaty, the determination should be made as if the MJE Regulations were not in effect—i.e., the Regulations are irrelevant in determining residence for treaty purposes. But it is very doubtful that this is the intended interpretation.

For example, Parent Company, organized in Country X, has a wholly owned U.S. subsidiary. Parent Company conducts no direct activity in the U.S.. Under the U.S.-Country X tax treaty, dividends from the U.S. subsidiary would be subject to withholding tax at a 10% rate. Accordingly, Parent Company redomesticates as a Delaware LLC but retains its orig-

inal charter. Since the MJE Regulations apply for all U.S. domestic law purposes, dividends from U.S. subsidiary are not subject to withholding because the recipient, Parent Company, is for U.S. domestic law tax purposes a U.S. corporation under these Regulations. Moreover, in this situation, the Parent Company generally would qualify for a 100% dividends-received deduction. This is a pyrrhic victory if the Parent Company is subject to concurrent full taxation as a U.S. corporation.

In this situation, however, the Parent Company may not be subject to tax if the Preamble is read literally. Under the treaty with Country X, the corporation clearly is a resident of Country X. Generally, under treaty residence articles, a resident is a person liable to tax because of domicile, residence, nationality, place of management, place of incorporation, or other similar criteria. Most treaties contain a “savings clause” under which the U.S. reserves the right to tax its residents as if the treaty were not in effect and “tie breaker” rules that establish a single residence country if a person is resident in both countries under their domestic laws. Absent the statement in the Preamble, it seems clear that Parent Company is also a U.S. resident (subject to any tie-breaker provision in the treaty).

But if the MJE Regulations “do not determine an entity’s place of residence for purposes of applying the provisions of a tax treaty,” one could argue that treatment as a U.S. resident entity resulting from application of the MJE Regulations should be ignored. Absent the MJE Regulations, a U.S. LLC with multiple owners not engaged in a U.S. trade or business would be a nonresident partnership. Parent Company arguably may therefore claim protection from U.S. corporate tax on business profits if it does not have a U.S. permanent

establishment. Nor do the regulations under Section 894 appear to alter the results above.¹⁷ The entity is not a hybrid considered from a purely domestic law perspective because it is a corporation for both U.S. and Country X purposes.

This cannot be what the Preamble intends. Presumably, what this statement means is not that the MJE Regulations are irrelevant but that they are inconclusive in determining an entity’s residence for purposes of income tax treaties. In other words, the MJE Regulations do not override any tie-breaker provisions in the applicable treaty. So interpreted, the tax effects that flow from the MJE Regulations (e.g., that the entity is generally subject to U.S. net income tax as a corporation and therefore presumptively a U.S. resident) should not be ignored in applying the treaty. Accordingly, Parent Company must then apply the treaty’s “savings clause” or “tie breaker” provisions to determine which benefits Parent Company may claim. Further clarification (preferably in regulations) of the interaction of the MJE Regulations, Section 894, and U.S. income tax treaties is needed.

MEANING OF ORGANIZED OR CREATED

A critical issue in applying the MJE Regulations—one that the MJE Regulations do not address—is when the invocation of a particular jurisdiction’s laws causes an entity to be treated as organized or created under a particular legal regime. The MJE Regulations and examples address only the obvious situation where an entity expressly and voluntarily subjects itself to the general jurisdiction

¹⁷Section 894 and the regulations thereunder discuss the tax treatment and the treaty eligibility of “hybrid entities,” which generally are foreign-owned pass-through entities treated as corporate for purposes of one country and pass-through for purposes of another.

and law of a particular jurisdiction through the formal procedure of adopting a charter and being recognized as an entity. But this will not always be so, particularly for pass-through entities.

Assume that a foreign entity organized in Country X (a low-tax jurisdiction) owns a portfolio of high-grade assets. To raise capital, it issues a relatively nominal amount of equity and several classes of debt under note purchase agreements or an indenture governed by New York law. Under general U.S. federal income tax principles, some of the more subordinated classes of debt are likely to be equity. Typically, the law of the jurisdiction of organization governs the rights and entitlements of an entity's owners (as between themselves and vis-à-vis the entity).

Surely, the fact that as a contractual matter the parties have elected to have certain debt classes governed by New York law does not mean that the entity is "organized"

in part under U.S. law as well as under foreign law merely because classes intended to be debt for non-tax purposes are treated as equity for federal income tax purposes. Corporate or company law imports a substantial body of statutory, and in some instances common law, governing relations between shareholders and with the corporate issuer. It would be anomalous to view contractual choice of law applicable only to certain portions of the capital structure as equivalent to being organized under the laws of more than one jurisdiction. But confirmation would be helpful.

A somewhat related problem may arise in a contractual joint venture. For U.S. tax purposes, assuming that the parties contract to pursue profit jointly and share associated expenses, this is an entity from a U.S. tax perspective and generally is a partnership. It seems highly unlikely that such a contractual arrangement would provide limited liability under

foreign law or otherwise constitute a per se corporation. However, the law under which the entity is "organized" may be unclear. If the parties elect New York law, but a foreign court would take jurisdiction, albeit applying New York law under choice-of-law principles, in which jurisdiction (or both) is the entity treated as organized?

Admittedly, this was an issue prior to the MJE Regulations but taxpayers could at least take some comfort if the legal relationships were predominantly governed by non-U.S. law. Under the MJE Regulations, arguably if any agreements pertinent to the joint venture arrangements between the owners are governed by U.S. law or perhaps even subject to the jurisdiction of a U.S. court, the entity may be domestic. The final MJE Regulations need to confront this lingering issue.

ANDREW WALKER is a Partner at Milbank, Tweed, Hadley & McCloy LLP in New York City.

CFTC FINAL RULES: MINIMUM FINANCIAL REQUIREMENTS, STRICTER REPORTING OBLIGATIONS FOR FCMs AND IBs; FOREIGN FUTURES AND OPTIONS TRANSACTIONS

JEFF BRYANT

THE COMMODITY FUTURES TRADING COMMISSION HAS FINE-TUNED ITS RULES FOR FUTURES COMMISSION MERCHANTS, INTRODUCING BROKERS, AND FOREIGN FUTURES AND OPTIONS BROKERS.

The Commodity Futures Trading Commission (Commission) has finalized the proposed rules amending the minimum financial requirements and related reporting obligations for futures commission merchants (FCMs) (introducing brokers (IBs) are also affected, but to a lesser extent).¹ These changes will significantly alter the adjusted net capital requirement of FCMs and reduce the time allowed for filing various reports.

The Commission has also finalized the proposed rules for foreign futures and foreign options transactions concerning when a foreign futures and options broker (FFOB) is exempt from registration as an FCM.² These two sets of rules are discussed below.

MINIMUM FINANCIAL AND RELATED REPORTING REQUIREMENTS FOR FCMs AND IBs

In July 2003, the Commission proposed amendments to its rules setting forth minimum financial requirements and related reporting obligations for futures commission merchants (FCMs) and introducing

brokers (IBs).³ After considering comments and reviewing data, the Commission has now issued amended final rules (Rules 1.10, 1.12, 1.16, 1.17, and 1.18). The final rules retain the key element of the proposed version that introduced a risk-based computation for deter-

¹ Proposed rules are in 68 Fed. Reg. 40835 (July 9, 2003), and final rules in 69 Fed. Reg. 49784 (August 12, 2004).

² Proposed rules in 64 Fed. Reg. 46613 (August 26, 1999) were republished in 69 Fed. Reg. 17998 (April 6, 2004); final rules are in 69 Fed. Reg. 49800 (August 12, 2004).

³ For a review of the proposed rules, see Bryant, "CFTC Proposes New Risk-Based Method for Determining Minimum Capital Requirements for FCMs, and Stricter Reporting Rules, Too," 5 Derivatives 11 (December 2003)