



An overview of various interesting complexities related to the use of trusts, foundations, “domestic” LLCs and similar entities in international tax and estate planning

*By Steven L. Cantor and Hal J. Webb*

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# Classification of Entities

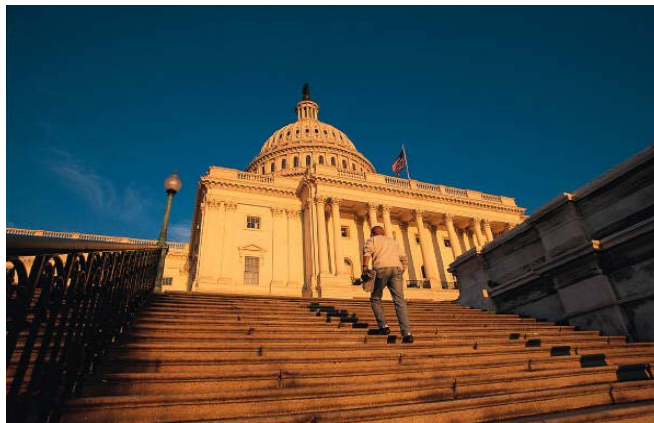
## Primary Types of Entities

**There are three primary types of tax paying entities:**

- **Corporations**
- **Partnerships**
- **Trusts**

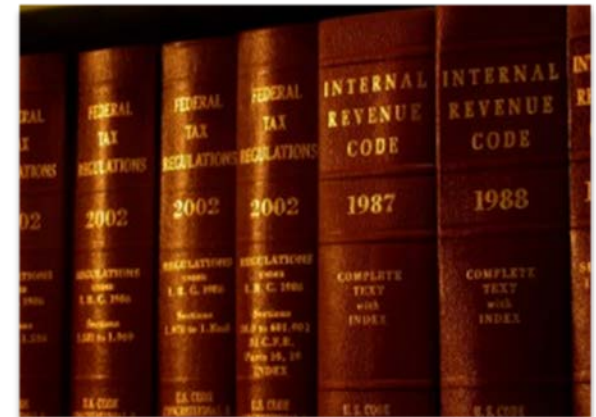
## Basic Rules for Classification

- Classification of separate entities is generally determined under Treasury Regulations Sections 1.301-7701-2 through -4
- Whether an entity is separate from its owners for US federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law



## Business Entities

For purposes of Treasury Regulations Sections 301.7701-2 and 301.7701-3, a “business entity” is any entity recognized for federal tax purposes that is not classified as a trust under Treasury Regulations Section 301.7701-4 or subject to special treatment under the Internal Revenue Code



## Foreign vs. Domestic Business Entity



- A business entity is domestic if it is created or organized as any type of entity in the US or under the laws of the US or of any State
- A business entity is foreign if it is not domestic

## Corporation Defined

A corporation is any entity that is described in Treasury Regulations Section 301.7701-2(b)

- Domestic Corporation
- Association (determined in 301.7701-3)
- Other special types of companies (bank, insurance company, business entity owned by a State, etc.)
- Certain Foreign Entities (per se corporations)

## Check-the-Box Election

- Election applies to an “eligible entity”
- An eligible entity is a business entity that is not classified as a corporation under Treasury Regulations Section 301.7701-2(b)(1) and (3)-(8)
- An eligible entity with at least two members can elect to be classified as either an association or a partnership
- An eligible entity with only one member can elect to be classified as an association or a disregarded entity





## Default Classification of Eligible Entities

- A domestic eligible entity is a partnership if it has two or more members or a disregarded entity if it has one member
- A foreign eligible entity is:
  - an association if all members have limited liability;
  - a partnership if it has two or more members and at least one member does not have limited liability; or
  - a disregarded entity if it has one member that does not have limited liability
- No automatic classification as a disregarded entity for a foreign company with one member who has limited liability
- Grandfather rule for eligible entities in existence before 1/1/97

## Entity Classification – Late Election Relief

- Rev. Proc. 2009-41 extends late entity classification relief to initial classification elections and change in classification elections, and it extends the time for filing late entity classification elections to within 3 years and 75 days of the requested effective date of the eligible entity's classification
- Need reasonable cause



## Relevancy Rules

- A foreign entity formed on or after October 22, 2003 is not classified for US purposes until it becomes relevant
- Foreign entities become relevant when their classification affects the liability or any person for federal tax or information purposes (such as reporting or a US person's ownership)
- Making a "check-the-box" election results in deemed relevance only on the effective date of the election
- A foreign entity that was once relevant but ceases to be relevant for 60 consecutive months loses its relevant status and gets reclassified when it becomes relevant again

# Classification of Trusts

## Trusts – Ordinary Trust

- Treasury Regulation Section 301.7701-4(a) defines the term “trust” as an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries



## Trusts – Ordinary Trust (Continued)

- **Regs. also state: “Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.”**

## Trusts – Business Trust

- **A business trust is:**
  - **An arrangement which is known as a trust because the legal title to property is conveyed to trustees for the benefit of beneficiaries**
  - **Contrary to an ordinary trust, a business trust is not classified as a trust for federal tax purposes because it is not an arrangement to protect or conserve the property for the beneficiaries**
  - **Typically created by the beneficiaries simply as a device to carry on a profit-making business which would normally be carried on through a business entity**
- **Substance over form**

## Trusts – Investment Trust

- An “investment trust” will be classified as a trust if there is a single class of ownership interests representing undivided beneficial interests in the assets of the trust, provided there is no power under the trust agreement to vary the investment of the certificate holders
- An “investment trust” will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders
- An “investment trust” having multiple classes of ownership interests will typically be classified as a business entity (some exceptions apply)



# Relevant IRS Rulings

## Private Letter Ruling 199911033

IRS ruled that a limited liability company owned by a grantor trust was disregarded as an entity separate from the trust because trust was sole member

- **Summary of facts:**
  - A is the grantor of Trust and treated as the owner of assets of Trust
  - Trust formed a limited liability company (“LLC”)
  - Operating agreement between trustees of the Trust and a corporation wholly owned by the Trust
  - All profits and cash flow allocated to Trust (none to corp.)
- Even though more than one member, substance over form
- Result should be the same even if not a grantor trust

## Private Letter Ruling 199939036

IRS ruled that a trust was a conduit and not classified as a trust for US federal tax purposes

### Summary of facts:

- Company A's parent corporation is Company B
- Company A maintained Plan X, a qualified profit-sharing plan
- Company B created Trust Z to acquire stock options from it, to execute those options at the direction of Company B, and then transfer the stock to Plan X to be credited to employees. It did this solely because it was prohibited from transferring the stock directly to the employees
- Important issue was that trustee could not exercise discretion or judgment concerning the shares

## Private Letter Ruling 104521-12

- The IRS ruled that a “fideicomiso” (Mexican Trust) is not a trust for federal tax purposes
- Summary of Facts:
  - A and B owned Company X, a US company.
  - Company X purchased a condo through a fideicomiso agreement with a bank as trustee because a non-Mexican person cannot own the condo directly
  - Bank only held legal title; A, B and X had all other benefits and rights

## Private Letter Ruling 104521-12 (Continued)

- IRS cited Rev. Rul. 92-105 regarding Illinois Land Trust, where grantor retained sole authority and responsibility for dealing with property for all purposes other than transfer of title
- See GCM 38700 (1981), where a fund that was created under Mexico trust law was treated as an ordinary trust because it did not have a business purpose.

## Private Letter Ruling 148068-06

- The IRS ruled that a fund was not a trust
- Summary of facts:
  - Unit trust
  - Trustee had broad power to vary investments based on market conditions to improve the investment for unit holders
- IRS concluded that the fund should not be an investment trust due to the trustee's power to vary the fund's investments
- IRS also concluded that the fund was a business entity created to carry on a profit-making business and was not a trust because it was not created to conserve and protect property for beneficiaries

# Revenue Ruling 75-258 and Private Letter Ruling 8852017

- The IRS ruled that trust was an association
- In each ruling, the trust instrument empowered trustee to engage in any lawful activity, including any business activities permitted by law
- Each case also involved trusts with certificate holders (transferable by beneficiaries or providing the trustee the power to issue additional certificates)

# Classification and Use of Foreign Private Foundations and Similar Entities



## Foreign Private Foundations

- A foundation is like a hybrid between a trust and a company
  - Formed under a local statute like a company, but does not have shareholders
  - Typically has Regulations or By-laws that contain dispositive provisions and other provisions like a trust



## Use of Foreign Private Foundations

- Utilized frequently in international estate planning
  - Retention of control by “founder” as the Board or Council (as opposed to giving up control to a trustee)
  - Comfort due to legal existence and familiarity of entity
- Trust or Corporation for US federal tax purposes?
  - Lack of authority or guidance
  - Risk that US federal tax consequences of treatment as a corporation could be significant
- Trusts often preferred when dealing with US beneficiaries because foundation does not have the same characteristics of any type of entity formed within the US and cannot be “domesticated”

## AM 2009-012

- **AM 2009-012 deals only with Liechtenstein Stiftungs (Foundations) and Liechtenstein Anstalts (Establishments)**
- **IRS position is that Liechtenstein Foundations are classified as ordinary trusts unless created primarily for commercial purposes**
- **IRS position is that Liechtenstein Establishments are classified as corporations unless it was created primarily to protect and conserve property for its beneficiaries**
- **The classification is determined by a facts and circumstances test based upon the nature of activities carried on by the entity and the primary purpose for which it was created**

# Use of Domestic LLCs in International Tax and Estate Planning

## Primary Benefits and Problems

- The primary benefit is that a domestic LLC is a disregarded entity for US federal tax purposes if it has only one member and there is no federal tax reporting required (other than FBAR)
- Another important benefit to foreign individuals and companies is that it is a US entity
- The primary problem is that a LLC has the characteristics of both a corporation and a partnership, and the laws of other countries typically cause a domestic LLC to be treated as a corporation for local tax purposes

## Canada

- **Partnerships are flow-through entities for Canadian tax purposes like they are for US federal tax purposes**
- **A Canadian resident corporation is taxed in Canada on its worldwide income whereas nonresident corporations are generally taxed in Canada on their Canadian source income**
- **A partnership or corporation is treated as a resident of Canada for Canadian tax purposes if it is formed or incorporated in Canada or if the company is managed and controlled in Canada**

## Canada

- **The Canadian Revenue Agency (“CRA”) has established a two-step approach to classify non-Canadian entities:**
  - **Determine the essential characteristics of the entity under the legislation governing that entity; and**
  - **Compare those characteristics with those of recognized categories of entities created under Canadian law so as to classify the non-Canadian entity under one of those categories**
- **While not formally settled, the CRA takes the position that a US LLC is treated as a corporation for Canadian tax purposes**

## Mexico

- For Mexican income tax purposes, a US LLC is treated as a separate taxable entity like a corporation.
- Even though a US LLC is treated like a separate taxable entity, the Mexican CFC rules could cause the income of the LLC to be taxed in Mexico when it is earned rather than only when it is distributed from the US LLC to its members.



## United Kingdom

- Non-UK entities are classified through case law and HMRC guidance as “opaque” or “transparent”
- Profits of an opaque entity are taxable to the members when distributed, like a corporation
- Profits of a transparent entity are taxable to the members when earned, like a partnership
- HMRC treats a US LLC as an opaque entity
- If the management and control of the LLC is handled from the UK, then the LLC would be treated as a resident of the UK for UK corporate tax purposes

## Germany

- **Non-German entities are treated as either a corporation or a partnership by comparison to the basic form of a general partnership or corporation under German law**
- **8 factors determine whether a US LLC is treated as a corporation or a partnership for German tax purposes:**
  - (1) **centralization of management,**
  - (2) **limited liability,**
  - (3) **free transferability of interests,**
  - (4) **discretion to access profits,**
  - (5) **equity contributions,**
  - (6) **continuity of life,**
  - (7) **profit allocation and**
  - (8) **formation requirements.**

# Examples Using Domestic LLCs

## Example 1

**Foreign  
Corporation**

**Domestic LLC**

**USRPI or  
US Business  
Interest**

**How  
should the  
LLC be  
classified?**



## Example 2



**How  
should the  
LLC be  
classified?**



## Example 3

**NRA or  
Foreign  
Corporation**



**LLC**



**Tangible  
Property**

**How  
should the  
LLC be  
classified?**



## Other Examples

- **LLC used as a partner of a foreign partnership**
- **LLC used as a shareholder of a foreign corporation**
- **LLC used as the settlor of a foreign trust**

## Contact Information

**Steven L. Cantor**

**Hal J. Webb**

**Cantor & Webb P.A.**

**1001 Brickell Bay Drive**

**Suite 3112**

**Miami, FL 33131**

**Tel: (305) 374-3886**

**Fax: (305) 371-4564**

**Email: [steve@cantorwebb.com](mailto:steve@cantorwebb.com); [hal@cantorwebb.com](mailto:hal@cantorwebb.com)**

**Website: [www.cantorwebb.com](http://www.cantorwebb.com)**