June 29, 2005

Hon. Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Multiple Charter Regulations Governing Multiple Chartered Entities under Section 7701

Dear Commissioner Everson:

Enclosed are comments on proposed and temporary regulations governing the definitions of a corporation and a domestic entity in circumstances where the business entity is considered to be created or organized in more than one jurisdiction under section 7701 of the Internal Revenue Code. These comments represent the views of those members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair

cc: Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury
Patricia A. Brown, Acting International Tax Counsel, Treasury
Donald L. Korb, Chief Counsel, IRS
Nicholas J. DeNovio, Deputy Chief Counsel – Technical, IRS
Hal Hicks, Associate Chief Counsel (International), IRS
David Sotos, Attorney-Advisor, Office of the International Tax Counsel, Treasury
Charles Besecky, Branch Chief, Branch 4, Office of the Chief Counsel (International), IRS
Thomas Beem, Senior Technical Reviewer, Branch 4, Office of the Chief Counsel, (International), IRS
Comments on Multiple Charter Regulations Governing Definitions of a Corporation and a Domestic Entity Where the Business Entity is Organized in More than One Jurisdiction

The following comments represent the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Foreign Activities of U.S. Taxpayers of the Section of Taxation. Principal responsibility was exercised by Mark D. Harris and Marissa Nguyen. Substantive contributions were made by Peter Blessing. The comments were reviewed by Jo-Renee Hunter of the Section of Taxation's Committee on Government Submissions Committee and by N. Susan Stone, Council Director to the Committee on Foreign Activities of U.S. Taxpayers.

Although the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by the comments, or have advised clients on the application of these principles, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

Contact person:

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Date: June 29, 2005
Executive Summary

These comments address the proposed and temporary regulations ("Multiple Charter Regulations") governing the definition of a corporation and of a domestic entity for U.S. federal tax purposes where the business entity is organized in more than one jurisdiction (a "multiple-chartered entity"). The comments are in response to the solicitation for comments in a notice of proposed rulemaking published August 12, 2004 in the Federal Register.

The Multiple Charter Regulations are currently effective as temporary regulations and would amend the existing entity classification regulations under section 7701 (the "Pre-Existing Regulations") by adding new Treas. Reg. § 301.7701-2T(b)(9). Under the regulations, if a multiple-chartered entity’s formation in any of the jurisdictions in which it is formed would cause it to be treated as a corporation under Treas. Reg. § 301.7701-2(b), the entity is treated as a corporation for U.S. federal tax purposes. The preamble to the Multiple Charter Regulations (the "Preamble") provides that the provision clarifies current law and does not alter the result under a proper application of the existing rules as applied to multiple-chartered entities.

Section I of the comments provides a brief history and summary of the existing rules. Section II of the comments suggests that, contrary to the statement in the Preamble, the Multiple Charter Regulations do not clarify existing law because a different conclusion may be reached under a reasonable interpretation of the Pre-Existing Regulations. Section III of the comments suggests that the Multiple Charter Regulations may be broader in application than intended by the Internal Revenue Service ("IRS") and Treasury Department. Specifically, the comments discuss the application of the Multiple Charter Regulations to non-per se entities. Section IV of the comments addresses the effective date of the Multiple Charter Regulations.

Comments on Multiple Charter Regulations

I. Background

A. Definition of “Domestic” and “Foreign”

Section 7701 of the Internal Revenue Code ("Code") provides definitions to determine the classification of a business entity and its status as a domestic or foreign entity. Section 7701(a)(4) states that a corporation or partnership is domestic if it is created or organized in the United States or under the laws of the United States or any State, unless in the case of a partnership, the regulations provide otherwise. Section 7701(a)(5) provides that a corporation or partnership is foreign if the entity is not domestic.

The definition of “foreign” was originally added to the Code as part of the Revenue Act of 1918.1 Under that definition, a corporation or partnership was foreign if it was

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1 Public Law No. 65-254 (40 Stat. 1057, Section 1).
“created or organized outside the United States.” Accordingly, an entity that was incorporated in the United States and in a foreign jurisdiction would have been considered both a domestic and foreign entity. As the result of this dual nationality, the definition of “foreign” was subsequently amended in the Revenue Act of 1924 to provide the definition that is the current version of section 7701(a)(5).\(^2\) This definition eliminates the potential for an entity to be considered domestic and foreign simultaneously. Accordingly, an entity that is incorporated in both the United States and a foreign jurisdiction is a domestic entity.

The regulations under section 7701 do not provide any additional guidance for interpreting the terms “domestic” and “foreign.” In fact, the regulations merely reiterate the definitions of “domestic” and “foreign” provided in the statute.

B. Classification of a Business Entity

Section 7701(a)(3) defines a corporation to include associations, joint-stock companies and insurance companies. Under section 7701(a)(2), a partnership is defined to include a syndicate, group, pool, joint venture, or other unincorporated organization by which any business, financial operation or venture is carried on and is not a trust, estate or corporation.

Regulations providing guidance for the determination of whether a business entity is a corporation or partnership were initially promulgated under section 7701 in 1960.\(^3\) Those regulations were largely based on the historical differences under local law between partnerships and corporations. After the regulations were promulgated, many states amended their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that traditionally have been associated with corporations. As a result, the distinction between a partnership and a corporation become increasingly distorted and, according to the IRS, the classification of a business entity became too formalistic. In 1996, the regulations under section 7701 were substantially modified to provide an entity classification system that is simpler and generally elective.\(^4\)

According to the preamble to the Pre-Existing Regulations, the first step in the classification process is to determine whether there is a separate entity for federal tax purposes.\(^5\) Treas. Reg. § 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for 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. Treas. Reg. § 301.7701-2(a) further provides that a business entity is any entity recognized for federal tax purposes that is not properly classified as a trust or otherwise subject to special treatment under the Code.

\(^3\) 25 F.R. 10928 (1960).
\(^4\) T.D. 8697 (December 18, 1996).
\(^5\) Preamble, T.D. 8697 (December 18, 1996).
Once the existence of a business entity is determined, the regulations provide that a business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded. If the business entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch or division of the owner.

Treas. Reg. § 301.7701-2(b) provides a list of entities that will always be treated as corporations ("per se corporations"). If an entity is not specifically treated as a corporation under that section, the entity is permitted to elect its classification for U.S. federal tax purposes. An eligible entity with at least two members can elect to be classified as either a corporation or a partnership. An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

If an entity does not affirmatively make an entity classification election, it will be classified under the default classification rules of Treas. Reg. § 301.7701-3(b)(1) and (2). Under those regulations, a domestic eligible entity is a partnership if it has two or more members or disregarded if it has a single owner. With respect to foreign eligible entities, the regulations provide that the entity is a partnership if it has two or more members and at least one member does not have limited liability, a corporation if all members have limited liability, or disregarded if it has a single owner that does not have limited liability. Accordingly, an entity classification election need be made only if the entity chooses to be classified initially as other than the default classification or when it desires to change its classification.

The Treasury and IRS issued the Multiple Charter Regulations on August 12, 2004, as proposed and temporary regulations. These regulations purport to clarify the definition of a corporation and of a domestic entity for U.S. federal tax purposes in cases when the business entity is considered created or organized in more than one jurisdiction. New section 301.7701-2T(b)(9) provides that a multiple-chartered entity is a per se corporation if the entity would be treated, under the rules of Treas. Reg. § 301.7701-2(b), “as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized.” The regulation also explicitly provides that the determination of the entity’s classification as a per se corporation is made independently of whether it is domestic or foreign. Application of this rule is illustrated in the following example, which is included in the regulations.

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6 Treas. Reg. § 301.7701-2(a).
7 Id.
8 Id.
9 Treas. Reg. § 301.7701-3(a).
10 Id.
11 Treas. Reg. § 301.7701-3(b)(1)(i) and (ii).
12 Treas. Reg. § 301.7701-3(b)(2)(i)(A), (B) and (C).
13 T.D. 9153 (August 12, 2004).
14 Treas. Reg. § 301.7701-2T(b)(9).
15 Id.
X is an entity with a single owner organized under the laws of Country A as an entity that is a *per se* corporation as defined in Treas. Reg. § 301.7701-2(b)(8)(i). Several years after its formation, X files a certificate of domestication in State B (a U.S. state) as a limited liability company (LLC) and does not terminate its charter in Country A. Under the laws of State B, X is considered to be created or organized in State B as an LLC upon the filing of the certificate of domestication and is therefore subject to the laws of State B. Because neither Country A nor State B requires X to terminate its charter in Country A as a result of the domestication, X is now a multiple-chartered entity. The example concludes that X is a corporation for U.S. federal tax purposes because, under Treas. Reg. § 301.7701-2(b)(8)(i), X is treated as a corporation because of its formation in Country A as a *per se* corporation.

II. The Multiple Charter Regulations Do Not Clarify Existing Law

As noted above, the Preamble states that the Multiple Charter Regulations are a clarification of current law rather than a change in position. The implied concern underlying the regulations is that Multiple Chartered Entities can be used to circumvent the *per se* corporation rules. The following example illustrates the issue:

A, a U.S. corporation, wants to form a business entity (“X”) in Japan. A would like for X to be a flowthrough entity for U.S. federal tax purposes. For business reasons, however, A is compelled to form the new entity (“X”) as a Kabushiki Kaisha (a “KK”), a Japanese entity that is a *per se* corporation under §301.7701-2(b)(8)(i). In an attempt to avoid per se corporate status for X, A causes X to file a certificate of domestication in Delaware as a limited liability company (“LLC”). Under the laws of Delaware, X is considered to be created or organized in Delaware as of the date of the filing.

Prior to the publication of the temporary regulations, some taxpayers took the position that, under these facts, X was properly classified as a domestic entity and therefore subject to the entity classification rules applicable to U.S. entities. As discussed above, under those rules, X would be disregarded as an entity separate from A for U.S. federal tax purposes.

We understand the IRS and Treasury are concerned that, as a policy matter, a foreign entity formed as a *per se* corporation should not be allowed to avoid corporate classification simply by domesticating itself as a U.S. LLC while retaining its foreign corporate charter. We do not agree, however, that it was clear that this treatment was not allowed under the Pre-Existing Regulations.

According to the Preamble, the determination of the U.S. federal tax classification of a business entity under the Pre-Existing Regulations was a two-step process. The first step was a determination of whether the entity was a corporation or a non-corporate entity; the second was a determination of the entity’s nationality.
Instead, we believe that a different and more reasonable interpretation of the Pre-Existing Regulations was that a taxpayer was required to determine its status as foreign or domestic prior to determining its classification as a corporate or non-corporate entity for U.S. federal tax purposes. In other words, we believe that a taxpayer could have reasonably interpreted the Pre-Existing Regulations as requiring an entity’s classification to be determined by first establishing the entity’s status as domestic or foreign, and then making a determination of the entity’s status as a corporation (either as a per se corporation, or a corporation under the elective rules), partnership or disregarded entity. Accordingly, we do not believe that the Multiple Charter Regulations merely reflect a clarification of existing law – a determination that necessarily indicates that the IRS and Treasury believe the position taken in the regulations will apply retroactively.

The position that a taxpayer should determine the entity’s nationality first, and then its classification as a corporation or non-corporate entity is supported by the Pre-Existing Regulations. In particular, the Pre-Existing Regulations are structured so that general principles, such as the definition of “domestic” and “foreign” are placed in the first section of the section 7701 regulations at Treas. Reg. § 301.7701-1. The regulations then define, in Treas. Reg. § 301.7701-2, the different types of business entities such as corporations and partnerships. Next in sequence is Treas. Reg. § 301.7701-3, which provides the rules for electing an entity’s classification. This structure and sequence of the regulations could reasonably be interpreted to mean that the process for determining an entity’s classification begins by first establishing an entity’s status as domestic or foreign, and then its classification as a corporation or a non-corporate entity.

Additional support for this approach is found under the default entity classification rules set forth in Treas. Reg. § 301.7701-3(b). This section provides a set of rules to determine the U.S. federal tax classification of an eligible business entity in the absence of an affirmative classification election. Under the default rules, a domestic entity will be treated as a partnership if it has two or more members. If a domestic entity has a single owner, it will be treated as a disregarded entity. With respect to foreign entities, the default rules provide that a foreign entity will be treated as a partnership if it has two or more members and at least one member lacks limited liability. If all members have limited liability, the foreign entity will be treated as a corporation. If the foreign entity has a single owner that does not have limited liability, it will be treated as a disregarded entity. Thus, the determination of a non-electing entity’s U.S. federal tax classification is dependent on first establishing the entity as either foreign or domestic. In fact, it is impossible to determine an entity’s default classification without first determining if it is domestic or foreign. Accordingly, it is reasonable to conclude that the default classification rules are only applicable after a determination has been made regarding whether the entity is domestic or foreign.

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16 Treas. Reg. § 301.7701-3(b)(1)(i).
17 Treas. Reg. § 301.7701-3(b)(1)(ii).
19 Treas. Reg. § 301.7701-3(b)(2)(i)(B).
20 Treas. Reg. § 301.7701-3(b)(2)(i)(C).
Further support for the conclusion that the Pre-Existing Regulations required the
determination of an entity’s nationality prior to the determination of its classification is
found in Treas. Reg. § 301.7701-2(b). That section provides a detailed list of certain
entities that are treated as per se corporations. Treas. Reg. § 301.7701-2(b)(8), which is
entitled “Certain foreign entities” provides a list of foreign entities that are per se
corporations for U.S. federal tax purposes. Treas. Reg. § 301.7701-2(b)(8) only applies
to foreign entities, as the title indicates. This section reasonably can be interpreted as
requiring the taxpayer to determine whether an entity is domestic or foreign before the
per se list would be relevant.21

Under this interpretation, assume that Foreign Corporation (“FC”) was formed in Year 1.
FC is a foreign entity specifically listed as a per se corporation under Treas. Reg. §
301.7701-2(b)8)(i). In Year 3, FC filed a certificate of domestication in Delaware as a
limited liability company. Under Delaware state law, FC is considered to be created or
organized in Delaware as a limited liability company and thus, would be subject to
Delaware law. Under the alternative interpretation of the Pre-Existing Regulations, in
Year 1, FC should be treated as a foreign corporation since FC is a foreign entity that is
identified as a per se corporation. After FC domesticates to become a Delaware LLC in
Year 3, however, FC should be treated as a domestic entity. Under the default entity
classification regulations, because FC should be treated as a domestic entity, the per se
list should not be relevant because, under U.S. tax rules, the entity is no longer
considered a foreign entity. Instead, to the extent FC has two owners, it should be treated
as a domestic partnership. If FC has only one owner, it should be treated as a domestic
disregarded entity. Under the Multiple Charter Regulations, however, because FC was
treated as a corporation under the laws of Country X, FC continues to be treated as a
corporation. Moreover, as the result of its domestication, FC is treated as a U.S.
corporation, which appears to directly contradict the title and purpose of Treas. Reg. §
301.7701-2(b)(8), the provision the regulation relies on to classify the entity as a
corporation.

As a result of the foregoing, we believe that the two-step approach adopted by the IRS
and the Treasury Department represents only one interpretation of the Pre-Existing
Regulations. For the reasons discussed above, we believe that it was reasonable for
taxpayers to assume that, under the Pre-Existing Regulations, an entity’s status as a
foreign or domestic entity had to be determined prior to determining that entity’s
classification as a particular type of business entity. Moreover, it was arguably more
reasonable for a taxpayer to adopt that approach given the structure and sequence of the
Pre-Existing Regulations, rather than the approach adopted by the IRS and Treasury in
the Multiple Charter Regulations. Accordingly, we do not believe that the Multiple
Charter Regulations are a clarification of existing rules, but instead represent the
establishment of new rules. As such, we do not believe it would be appropriate for the
IRS and Treasury to apply the position adopted in the regulations retroactively.

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21 The regulation actually goes one step further, requiring a determination of the specific foreign country’s
law under which the entity is formed.

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III. The Multiple Charter Regulations are Overbroad

The Multiple Charter Regulations, when read literally, affect more than multiple-chartered entities that are organized as foreign per se corporations in one of the jurisdictions listed in Treas. Reg. § 301.7701-2(b)(8). As drafted, the Multiple Charter Regulations apply to an entity that is classified as a corporation “as a result of its formation…” This language could be read as including eligible entities that default to corporate status. Treating an entity as a per se corporation if it is a corporation “as a result of its formation” implies that the ability to file an initial entity classification election is not taken into account in determining whether an entity is treated as a corporation as a result of its formation. As mentioned above, a foreign eligible entity is classified as a corporation as a result of its formation under the default rules if every owner has limited liability. While the owners of such an entity may choose to have the entity classified as a partnership or a disregarded entity if they file an initial entity classification election effective on the date of the entity’s formation, such a classification (as a result of an election) is not a result of the entity’s formation and will not affect the entity’s default classification as a result of its formation.

The breadth of the Multiple Charter Regulations may be illustrated by the following example. Assume a U.S. taxpayer formed a German GmbH (“GmbH”), an entity that is eligible to elect its U.S. tax classification, but whose default classification is as a corporation under Treas. Reg. § 301.7701-3(b)(2) (related to foreign eligible entities) because all members have limited liability. Assume further that GmbH does not file an entity classification election to be treated as a flow-through entity, but that simultaneously with the formation in Germany of GmbH, the U.S. taxpayer files a certificate of domestication in the State of Delaware to treat GmbH as a general partnership. Under the Multiple Charter Regulations, GmbH might be treated as a per se corporation for U.S. federal tax purposes because it is classified as an association as a result of its formation in Germany, due to the application of the default classification rules. Furthermore, even if GmbH had filed an initial entity classification election to be treated as a flow-through entity, such an election might be disregarded under the Multiple Charter Regulations and GmbH might be treated as a per se corporation. Such a result, however, would not seem justified and presumably is not intended. The Multiple Charter Regulations should be inapplicable in any case in which an entity classification election could have been filed to treat an entity as a flow-through entity as of its date of formation.

In addition, under the regulations, a per se corporation is not allowed to change its classification until it loses its status as a per se corporation. Based on the facts in the above example, and assuming GmbH could be treated as a per se corporation under the Multiple Charter Regulations, GmbH might not be allowed to elect to change its classification to a flow-through entity. This is so despite the fact that if GmbH were not a multiple chartered entity (i.e., formed solely in either Germany or the U.S., but not both) it would be permitted under the regulations to change its classification irrespective of its classification in either jurisdiction under whose laws it was formed. This result is not justified and presumably not intended. It would not be consistent with the regulatory
scheme to prevent GmbH from electing non-corporate status solely because it is formed as an eligible entity in two different jurisdictions.

IV. The IRS Should Reconsider the Effective Date of the Regulations

The definition of a per se corporation added by Treas. Reg. § 301.7701-2T(b)(9) applies to all business entities existing on or after the date the Multiple Charter Regulations are published in the Federal Register. That is, the regulations apply to any business entity in existence on or after August 12, 2004. The IRS and Treasury Department have stated that they adopted this special effective date based on the position that the Multiple Charter Regulations are a clarification of existing law. Thus, it would appear that the IRS and Treasury Department believe that such an entity is now and should always have been classified as a corporation for U.S. federal tax purposes. However, as discussed above, we believe that the Multiple Charter Regulations, and the interpretation set forth in the Preamble, represents one reasonable application of the Pre-Existing Regulations rather than the only reasonable interpretation of the rules prior to the issuance of the Multiple Charter Regulations. Further, the Multiple Charter Regulations potentially impact a broader range of entities than the Preamble suggests. Accordingly, we do not believe it is appropriate for the Multiple Charter Regulations to apply to entities in existence on the date such regulations were published in the Federal Register.

22 Although not discussed in these comments, the regulations literally seem to apply to entities described in Treas. Reg. § 301.7701-2(d), entities that have been specifically exempted from per se corporate treatment. In particular, Treas. Reg. § 301.7701-2(d)(1) provides an exception to Treas. Reg. § 301.7701-2(b)(8)(i) (the foreign per se list) for certain foreign entities in existence on May 8, 1996. It is clear that the IRS and Treasury intended to specifically except the entities described in Treas. Reg. § 301.7701-2(d) from per se corporate treatment. However, because they are drafted without an explicit exception, the Multiple Charter Regulations apparently would treat an entity described in Treas. Reg. § 301.7701-2(d) that is also a multiple chartered entity, as always having been a per se corporation. This result does not seem to be what was intended when Treas. Reg. § 301.7701-2(d) was initially promulgated.

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