The No-Existence Theory and Pre-Immigration Check-the-Box Planning

by Seth J. Entin

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In this article, Entin examines the "no-existence" theory and considers whether an entity that is not "relevant" is deemed to exist, focusing on liquidation and basis step-up under sections 336 and 334.

The views expressed in this article are those of the author and do not necessarily represent the views of his firm or of its clients.

Significant U.S. federal income tax planning is often recommended for a nonresident alien individual who plans to become a U.S. citizen or resident for U.S. federal income tax purposes (referred to as a U.S. person). This article provides an overview of pre-immigration tax planning and analyzes a critical issue in this area that has received notable attention: whether an entity that is not "relevant" is deemed to exist.

I. Background

In many cases, a key component of an NRA's pre-immigration tax planning involves having "eligible entities" owned by the NRA that are classified under the applicable default rules as foreign corporations for U.S. federal tax purposes elect to be classified as partnerships or disregarded entities for U.S. federal tax purposes (a check-the-box election), effective no later than the day the individual becomes a U.S. person. The many benefits to this election include:

- having the entity classified as a partnership or disregarded entity allows the individual to avoid the controlled foreign corporation or passive foreign investment company regimes;
- having the entity classified as a partnership or disregarded entity allows the individual a foreign tax credit for the foreign income taxes incurred by the entity (subject to generally applicable limitations on the foreign tax credit); and
- converting the entity from a corporation to a partnership or disregarded entity causes a liquidation of the entity for U.S. federal income tax purposes. Under section 336, this liquidation causes the corporation to be deemed to sell its assets for fair market value, and under section 334(a) the tax basis of the assets owned by the corporation is increased to FMV (basis step-up).

This article focuses on the last benefit. Some practitioners have suggested that the basis step-up described above might only be achieved if the entity is "relevant" for U.S. federal tax or information reporting purposes immediately before the effective date of the check-the-box election. This position is based on interpreting a provision in the Treasury regulations governing entity classification (often referred to as the check-the-box regulations) to say that an entity does not exist unless it is relevant for U.S. federal tax purposes. If the entity does not exist, the argument goes, an election for the entity to be classified as a foreign partnership or disregarded entity cannot give rise to a liquidation of the entity, and hence

cannot result in a basis step-up. This article refers to this as the "no-existence" theory.[1]

With advance planning, some practitioners who are concerned about the no-existence theory will proactively arrange for the entity to become relevant before the effective date of the check-the-box election.[2] For example, some practitioners might arrange for the entity to acquire a non-de-minimis amount of U.S. treasuries or stock in a U.S. corporation and present a Form W-8BEN-E to the withholding agent before the effective date of the check-the-box election. However, even putting aside the questionable effect of this strategy,[3] many individuals are left in the lurch by the no-existence theory. For example, what if a practitioner is engaged by a client — now a U.S. person — whose entity made a check-the-box election years ago while the client was still an NRA, and the individual had not undertaken the formalism of making the entity relevant before the effective date of the election? Must the practitioner tell the client that he may not claim annual depreciation deductions or report gains using a stepped-up basis?[4]

Conversely, many taxpayers may benefit from the no-existence theory. For example (as discussed later in this article), say that a purchaser acquires the stock of a foreign entity that is classified under the applicable classification rules as a foreign corporation and that until now has not been relevant. Assume that the purchaser is not eligible to make a section 338(g) election because the transaction does not meet the criteria for a "qualified stock purchase" or it meets the criteria but the election is not made. Traditionally, one would have thought that the foreign target entity's basis in its assets and its earnings and profits would remain the same.

However, under the no-existence theory, the transaction would be treated as an asset purchase because the foreign target entity never existed. Hence, there would be an acquisition price basis in the assets and no historical E&P.[5] On the other hand, if for some reason the foreign target entity had a small U.S. bank account that made it relevant for U.S. federal tax purposes, the entire transaction would be treated as a stock purchase. That is because the foreign target entity existed as a foreign corporation before the acquisition, with the foreign target entity continuing to have a historical tax basis of its assets and historical E&P. This is truly a bizarre result.

This article demonstrates that the no-existence theory is misguided for several reasons, not the least of which are the relevant regulation's language and Treasury's own contemporaneous explanations of that regulation in its preambles.

This article first describes the regulation on which the no-existence theory relies, providing analysis and exposing problems. It then explains how Treasury's own contemporaneous description of the regulation explicitly contradicts what the proponents of the no-existence theory think it says. Next, this article shows that the proponents of the no-existence theory are attributing to the check-the-box regulations a radical departure from decades-old U.S. federal tax principles — something that Treasury never undertook to do and the courts would not permit it to do. Finally, it provides a sample of some consequences of the no-existence theory that one

[1] Under another theory, the classification that the entity elects would be treated as having been effective as of its formation. This theory is critiqued in David H. Schnabel, "Revisionist History: Retroactive Tax Planning," 60 *Tax Law.* 685, 718-722 (2007). This theory is not explicitly addressed in this article, but this article implicitly challenges many of its infirmities.

[2] As noted later in this article, the ability to manipulate the consequences based on a mere formality of acquiring some U.S. assets and presenting Form W-8BEN-E itself points to the infirmity of the no-existence theory.

[3] Arguably, the temporary existence of the entity as a corporation as a part of a plan to liquidate it may be ignored as transitory under step transaction principles, and hence a basis step-up may not be achieved.

[4] Similar problems would exist in other circumstances as well. For example, say that an NRA establishes a foreign trust for the benefit of his children, who are U.S. persons. The trust owns the stock of a foreign corporation that only owns "foreign situs assets." The trust is classified as a foreign grantor trust under section 672(f), but the trust (perhaps because of foreign law considerations) does not allow for a basis step-up on death under section 1014(b) (for example, distributions of income are at the sole discretion of the trustee, not "to or on the order or direction of" the decedent). Because there is no basis step-up available under section 1014(b), the U.S. heirs would want the foreign corporation to check-the-box effective no later than the date of death to obtain a basis step-up free of U.S. federal income tax. But what if the entity was not relevant? Will a basis step-up be denied?

[5] The check-the-box regulations provide that when a check-the-box election is made for a disregarded entity or partnership to be classified as a corporation, a deemed contribution of assets to the corporation occurs immediately before the effective date of the election. No such rule, however, is provided in the relevance provisions. Therefore, under the no-existence theory, the deemed contribution would have to occur on the acquisition date. (Further, even if, for the sake of argument, the deemed contribution were to occur before the date of the acquisition, it would likely not qualify for section 351 treatment because the shareholder does not have control immediately after the transaction, and hence the assets would have an FMV basis.)

can hardly believe that Treasury intended or would accept, or that even a proponent of the no-existence theory would subscribe to.

II. Analysis

A. The Regulation

The no-existence theory is based on the following language, which was added to the check-the-box regulations in 2003:

> Entities the classification of which has never been relevant. If the classification of a foreign eligible entity has never been relevant (as defined in paragraph (d)(1) of this section),[6] then the entity's classification will initially be determined pursuant to the provisions of paragraph (b)(2) of this section when the classification of the entity first becomes relevant (as defined in paragraph (d)(1)(i) of this section).[7]

The wording, if taken in isolation without further analysis, could lead one to conclude that if the classification of an entity has never been relevant, the entity will only be deemed to exist for U.S. federal tax purposes once it becomes relevant.

However, even if one were to read this regulation in isolation, without looking at Treasury's contemporaneous interpretations, a no-existence reading is questionable. The regulation provides that "if the classification of a foreign eligible entity has never been relevant . . . then the entity's classification will initially be determined pursuant to the provisions of paragraph (b)(2) of this section when the classification of the entity first becomes relevant." Note the reference to paragraph (b)(2) of the regulation. Paragraph (b)(2) refers to the default classification of a foreign entity that is not a "per se corporation" under reg. section 301.7701-2. It does not refer to the treatment of a per se corporation; in fact, the whole concept of relevance is not mentioned regarding per se corporations under reg. section 301.7701-2.

Under the no-existence reading of the regulation, what is the treatment of a foreign per se corporation that was never relevant? One would apparently have to conclude that such an entity is treated as existing for tax purposes, even though it is not relevant! For example, under the no-existence theory, a Mexican *Sociedad Responsabilidad Limitada* (not a per se corporation, but a corporation under the default rules of paragraph (b)(2)) that is not relevant does not exist for U.S. federal tax purposes. On the other hand, a Mexican *Sociedad Anonima* (a per se corporation that is not governed by the default rules of paragraph (b)(2)) that is not relevant exists for U.S. federal tax purposes. This is hardly a sensible result, as there is no principled reason why, under the no-existence theory, a per se corporation that is not relevant should have any more of an existence for U.S. federal tax purposes.

Further, it is interesting to note that the regulation never talks about whether the entity itself is relevant. Rather, it talks about whether the *classification* of the entity is relevant. As we will see below, Treasury (as it states in its preamble) deliberately referred to the *classification* of the entity being relevant, rather than to the *entity itself* being relevant, because it believes that an entity that is not relevant in fact exists for U.S. federal tax purposes.

This all points to a much narrower reading of the relevance regulation, which is described below. Not surprisingly, if one tracks the preambles to the various proposed and final regulations, this narrow reading of the regulation is precisely the reading intended and articulated by Treasury.

[6] This provision states:

> For purposes of this section, a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. For example, a foreign entity's classification would be relevant if U.S. income was paid to the entity and the determination by the withholding agent of the amount to be withheld under chapter 3 of the Internal Revenue Code (if any) would vary depending upon whether the entity is classified as a partnership or as an association. Thus, the classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared. The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined. Thus, the classification of a foreign entity is relevant, for example, on the date that an interest in the entity is acquired which will require a U.S. person to file an information return on Form 5471.

[7] Reg. section 301.7701-3(d)(2).

B. Preambles

The preambles to the check-the-box regulations, which are contemporaneous articulations of Treasury's intent, make it clear that the relevance provision was intended only for very limited procedural purposes, and this intent is reflected in the language of the regulation in question.[8] To fully appreciate the clarity of the guidance that the preamble provides, a tour down "memory lane" is necessary.

1. The initial regulations.

On December 18, 1996, Treasury published the check-the-box regulations as final regulations, without the relevance provision that is the subject of this article.[9]

2. October 28, 1997, proposed regulations.

On October 28, 1997, after the initial check-the-box regulations were promulgated, Treasury released a notice of proposed rulemaking (NPRM) containing proposed regulations.[10] This NPRM generally deals with the characterization of elective changes in an entity's classification.

The preamble to the proposed regulations states:

> Any eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification. The IRS and Treasury request comments on the appropriateness of allowing such a foreign eligible entity to make a classification election, and comments on what the federal tax consequences of such an election should be (e.g., with respect to the basis of property held by the entity).

This says a foreign entity that is not relevant already has a classification, but it may change that classification.[11] This means that the entity exists for U.S. federal tax purposes even though it is not relevant. Treasury also requested comments on the ramifications of a check-the-box election that is made by an entity that is not relevant.

As we will see throughout the rest of our survey of the evolution of the check-the-box regulations and the preambles, Treasury has never changed its view that a foreign entity that is not relevant nonetheless exists for U.S. federal tax purposes.

3. October 29, 1999, final regulations.

On October 29, 1999, Treasury promulgated final regulations adopting the October 28, 1997, proposed regulations.[12]

These final regulations do not make any changes regarding relevance. They do indicate, as before, that the IRS and Treasury are still studying "what, if any, consequences occur when a foreign eligible entity that is not relevant for federal tax purposes files an entity classification election" and that "IRS and Treasury continue to request comments on this topic."

4. November 29, 1999, proposed regulations.

On November 29, 1999, Treasury issued an NPRM setting forth proposed regulations.[13] The beginning of the preamble to these proposed regulations states again that the IRS and Treasury are continuing to consider the consequences of a check-the-box election made by a foreign eligible entity that is not relevant for U.S. federal tax purposes:

> In the preamble to the conversion regulations, however, the IRS and Treasury requested comments on the appropriate tax consequences of an entity classification election made by a foreign eligible entity that is not relevant for Federal tax purposes (e.g., with respect to the basis of property or earnings and profits of the entity). No comments have been received. The IRS and Treasury continue to study and solicit comments on this important issue and are considering whether, in certain circumstances, the election, combined with another event

[8] Even if, purely for the sake of argument, there were some ambiguity in the language of the regulation, Treasury's intent controls in resolving the ambiguity. *See, e.g.*, *Auer v. Robbins*, 519 U.S. 452 (1997); *Jewett v. Commissioner*, 455 U.S. 305 (1982); *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945); and *Focardi v. Commissioner*, T.C. Memo. 2006-56.

[9] T.D. 8697.

[10] 62(208) F.R. 55768 (Oct. 28, 1997).

[11] This observation is also made by John M. Peterson Jr. and Stewart R. Lipeles of Baker McKenzie in a letter to the IRS (the "Peterson and Lipeles letter" (Feb. 28, 2000)).

[12] T.D. 8844.

[13] 64(228) F.R. 66591 (Nov. 29, 1999).

whereby the entity becomes relevant, should be considered to be inappropriate and, therefore, invalid under these regulations.

Rather than stating that a check-the-box election made by a foreign entity that is not relevant has no effect because the entity never existed, Treasury said it is continuing to study and solicit comments on the consequences of such an election.

Then, the preamble to the proposed regulations introduces the new "relevance" provision that is the subject of this article. To be clear, the new relevance provision, described below, cannot be saying that a foreign entity that is not relevant for U.S. federal tax purposes does not exist, because the preamble just stated a few lines above that Treasury is continuing to study the effects of a check-the-box election by an entity that is not relevant. Rather, as is clear from the language of the preamble quoted below, the relevance provision is intended merely to deal with a procedural inequity that existed under the regulations at that time.

Under the regulations, "if the classification of a foreign eligible entity is not relevant . . . for sixty consecutive months, then the entity's classification will initially be determined when the classification of the foreign eligible entity becomes relevant."[14] Therefore, an entity that was relevant and ceased to be relevant for 60 months may obtain an "initial classification." This is beneficial because an entity that makes an initial classification election may change its initial classification within 60 months without IRS permission.[15] On the other hand, the regulations then in effect provided no such rule regarding a foreign eligible entity that was never relevant. In that case, an entity classification election by the entity would not have constituted an initial classification election, and the entity would have been precluded from making an entity classification for another 60 months.[16] The new relevance provision was intended to address this issue.

The preamble explains this provision as follows:

> Relevance
>
> The check-the-box regulations provide a special rule when the Federal tax classification of a foreign eligible entity is no longer relevant. The rule states that if the classification of a foreign eligible entity which was previously relevant for Federal tax purposes ceases to be relevant for sixty consecutive months, the entity's classification will initially be determined under the default classification when the classification of the foreign eligible entity again becomes relevant (hereinafter 60-month rule). Several practitioners have requested guidance on whether the act of filing an entity classification election (Form 8832, Entity Classification Election) causes an entity to be relevant for purposes of the 60-month rule. *Practitioners also have requested clarification regarding whether a newly formed foreign eligible entity, that has never been relevant, is subject to the 60-month rule.*
>
> These proposed regulations provide that if a foreign eligible entity files an entity classification election, it is considered relevant on the effective date of the election for purposes of the 60-month rule. However, if the foreign eligible entity is otherwise not relevant within the meaning of reg. section 301.7701-3(d)(1)(i), for purposes of applying the 60-month rule the entity will be considered to be not relevant on the day after the date the entity classification election was effective.
>
> *The preamble to the conversion regulations stated that a foreign eligible entity that is not relevant has a Federal tax classification. The proposed regulations clarify that such an entity is subject to the 60-month rule. However, the proposed regulations provide an exception for a foreign eligible entity that was never relevant (within the meaning of reg. section 301.7701-3(d)(1)) during its existence. Such entity's classification will initially be*

[14] Reg. section 301.7701(b)(2)(ii).

[15] Reg. section 301.7701(c)(1)(iv).

[16] *See* Peterson and Lipeles letter, *supra* note 11; letter from Philip D. Morrison of Deloitte & Touche LLP to the IRS (Feb. 28, 2000).

> *determined pursuant to the provisions of reg. section 301.7701-3(b)(2) when the entity first becomes relevant*.[17] [Emphasis added.]

In summary, the preamble to the new proposed relevance regulation says that a foreign eligible entity that has never been relevant exists as an entity for U.S. federal tax purposes, but that a special leniency is being provided. Under this special leniency, the entity's classification will be treated as initially determined when the entity first becomes relevant so that the entity may elect to change its classification within the following 60 months without being subject to the 60-month rule.

5. October 21, 2003, final regulations.

On October 21, 2003, Treasury issued final regulations.[18] The preamble to these final regulations has a section addressing "relevance of classification."

The language of the preamble to the final regulations is even clearer regarding the issue at hand. Moreover, as seen below, Treasury changed the language of the relevance provision from that of the proposed regulation to avoid any implications that a foreign entity that is not relevant does not exist for U.S. federal tax purposes:

> Relevance of Classification
>
> The check-the-box regulations provide that if the classification of a foreign eligible entity that was previously relevant for Federal tax purposes ceases to be relevant for 60 consecutive months and then subsequently becomes relevant again, the entity's classification at the start of the subsequent period of relevance will be determined under the default classification rules (60-month rule).
>
> *These final regulations adopt the two rules in the proposed regulations that relate to the application of the 60-month rule*. First, these final regulations adopt the rule providing that the classification of a foreign eligible entity that files an entity classification election is deemed to be relevant for Federal tax purposes on the effective date of the election for purposes of the 60-month rule. *Second, these final regulations adopt the rule providing that the classification of a foreign eligible entity whose classification has never been relevant for Federal tax purposes will initially be determined pursuant to the default classification provisions of reg. section 301.7701-3(b)(2) at the time the classification of the entity first becomes relevant*.[19] [Emphasis added.]

This makes it clear that the relevance language is intended only for the narrow purpose of the 60-month rule.

Last, but certainly not least, it is critical to examine a change that Treasury made to the relevance provision in the final regulations.

The relevance provision as it appears in the final regulations is as follows:

> Entities the classification of which has never been relevant. If the classification of a foreign eligible entity has never been relevant (as defined in paragraph (d)(1) of this section), then the entity's classification will initially be determined pursuant to the provisions of paragraph (b)(2) of this section when the classification of the entity first becomes relevant (as defined in paragraph (d)(1)(i) of this section).

Notice that the regulation refers throughout to the relevance of the classification of the entity. The proposed regulation, however, contained the phrase "when the entity first becomes relevant." At least one commentator brought to Treasury's attention that the language of the proposed regulation could lead one to the mistaken conclusion that a foreign entity that is not relevant does not exist for U.S. federal tax purposes.[20] Treasury took this seriously, and in the preamble to the final regulations stated:

> One commentator requested that the provisions be revised to clarify that it is the Federal tax classification of the foreign

[17] *Id*.

[18] T.D. 9093.

[19] T.D. 9093.

[20] *See* letter from the Association of the Bar of the City of New York Committee on Taxation of Business Entities to the IRS (Mar. 15, 2000).

> eligible entity, and not the entity itself, that is deemed to be relevant. Treasury and the IRS have adopted this clarifying change in these final regulations.

Therefore, Treasury made a specific change to the language of the final regulation to clarify that the relevance issue relates to the classification, rather than the existence of the entity.

C. Conflict With Well-Established Principles

As has been demonstrated above from the language of the regulations and the preambles, the relevance provision is not saying that a foreign eligible entity that is not relevant does not exist for U.S. federal tax purposes. Rather, it is saying that its classification will initially be determined when it becomes relevant for specific procedural purposes.

Having gone through the regulations and the preambles, it would be sufficient to stop here. However, for good measure, the following discussion demonstrates that the no-existence theory contradicts well-established U.S. federal tax principles, which is something that check-the-box regulations never attempted and are not authorized to do.

It is well established that even if the existence of an asset or transaction is not relevant for U.S. federal tax purposes, the asset or transaction is not treated as nonexistent. Instead, the U.S. tax law still tracks the tax attributes of the asset and consequences of the transaction even while it is not relevant. In 2006, several years after the relevance regulation was published in final form, Treasury stated that "under general principles of law, the Code applies to all transactions without regard to whether such application has any current U.S. tax consequences."[21]

As one example, if depreciable property is brought into U.S. tax jurisdiction (for example, its NRA owner becomes a U.S. person or starts to use the property in a trade or business in the United States), its tax basis must reflect depreciation for the period during which the existence of the asset was not relevant.[22] As stated by the Joint Committee on Taxation, "under current law, a taxpayer that becomes subject to U.S. taxation may take the position that it determines its beginning bases in its assets under U.S. tax principles as if the taxpayer had historically been subject to U.S. taxation."[23]

Moreover, the IRS Office of Chief Counsel, in a legal memorandum released several years after the relevance provision in the check-the-box regulations was promulgated,[24] made it clear that a section 338(g) election may be made regarding a foreign target corporation even if the foreign target corporation has no relevance for U.S. federal tax purposes. Under the no-existence theory, on the other hand, a section 338(g) election has no meaning, because the acquirer would be treated as directly acquiring assets given that the entity does not exist.

The IRS described this type of foreign target as follows:

> It has no previous connection to the U.S. tax system. That is, inter alia, it is not a CFC, is not a passive foreign investment company, is not engaged in a U.S. trade or business, does not hold any U.S. real property interests, and is not required to file a U.S. tax return. Its shareholders are also foreign persons similarly unconnected to the U.S. taxing jurisdiction.

[21] REG-110405-05.

[22] *See, e.g.*, *Gutwirth v. Commissioner*, 40 T.C. 666 (1963) (the amount of the adjusted basis of damaged property had to be decreased by allowable depreciation attributable to the period during which the taxpayer was a nonresident alien); *Abraham v. Commissioner*, 9 T.C. 222 (1947) (same); *Schnur v. Commissioner*, 10 T.C. 208 (1948) (same); GCM 39291 (Sept. 24, 1984) (in determining the amount of depreciation for two oil drilling rigs, the basis must be adjusted to properly reflect depreciation sustained while the rigs were not used in the United States and were not subject to U.S. federal income tax). *See also* LTR 8749008 (the adjusted basis of depreciable property placed in service in a foreign country and then used in the United States should be adjusted to reflect depreciation incurred while in foreign use); LTR 8728002 ("In order to determine the application of the installment method rules to the contract payments in 1983 and 1984, it must be determined what the United States tax treatment would have been in 1981 if taxpayer had been a resident at the time of the sale.").

[23] Treasury, "General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals," 205-207 (Feb. 2000). *See also* Rev. Rul. 64-158, 1964-1 C.B. 140 (Part 1) ("In determining the effects of a transaction for Federal income tax purposes, the Code governs, whether or not the parties to the transaction are United States taxpayers.").

[24] AM 2007-006.

The IRS concluded that "either a domestic or foreign purchasing corporation may make a section 338 election with respect to a foreign target that was previously unconnected with the U.S. taxing jurisdiction." It explained that:

> This result is not necessarily inappropriate because the appreciation in the Foreign Target's assets accrued while the Foreign Target was outside of the U.S. taxing jurisdiction. In general, our system permits, but does not oblige, the importation of gain into the U.S. taxing jurisdiction, with the consequences depending on how the taxpayers effectuate their transactions. In general, the U.S. tax results are not dependent on whether foreign tax is incurred. It happens to be the case that although many ways of obtaining a cost basis in assets for U.S. tax purposes also result in tax under many foreign tax systems, a section 338 election, because it is relatively unique to our system, typically does not.

Under the no-existence theory, the check-the-box regulations would be overturning this well-established law regarding the tax treatment of a foreign entity, which is well beyond the goals and authority of the check-the-box regulations. Before the check-the-box regulations, the *Kintner* regulations, promulgated decades earlier, based on *Morrissey*,[25] controlled the determination of an entity's classification. Under the *Kintner* regulations, a series of factors (continuity of life, centralized management, limited liability, and free transferability of interests) were used to distinguish whether an entity should be classified as an association taxable as a corporation or as a partnership. To be classified as an association, the entity had to possess more than two of those characteristics.[26]

The check-the-box regulations replaced the multifactor *Kintner* regime with an objective entity classification regime. The stated goals of replacing the *Kintner* regime with the check-the-box regime were simplicity (the reduction of the complexity involved in a highly factual determination), increased certainty, reduced compliance efforts and costs, and achieving a measure of fairness and neutrality between sophisticated and unsophisticated taxpayers.[27] None of this has anything to do with whether the existence of an entity that is not relevant is respected for U.S. federal tax purposes. The no-existence theory would have Treasury overriding long-standing judicial and administrative precedent in an area that has nothing to do with the reason for its promulgation of the regulations.

It also is interesting to note that the ability of clever taxpayers and their advisers to manipulate tax consequences through the easy and formalistic act of making a small investment in U.S. assets itself is contrary to the stated purposes of the check-the-box regulations. This form of manipulation is contrary to the goals of achieving predictability, fairness, and neutrality between sophisticated and unsophisticated taxpayers.

Moreover, it does not appear that Treasury even has the authority to implement the no-existence theory. Several courts have considered challenges by taxpayers to the validity of the check-the-box regulations on the basis that they conflict with the *Morrisey* line of cases. These courts have all concluded that the check-the-box regulations are a valid exercise of Treasury's regulatory authority.[28] The reasoning of these courts is generally that section 7701, the applicable definitional section, is ambiguous when applied to new forms of business entities that have different characteristics, and that it is reasonable for Treasury to enact regulations to fill in these gaps. While Treasury may have the authority to clarify an ambiguous definitional section, it does not appear that it has the authority to overturn well-established principles regarding the existence of an asset or entity that is not relevant for U.S. federal tax purposes.

[25] *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

[26] Former reg. section 301.7701-2. *See United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

[27] T.D. 8697; Notice 95-14, 1995-1 C.B. 297. *See also Dover v. Commissioner*, 122 T.C. 324 (2004), citing Notice 95-14; and JCT, "Review of Selected Entity Classification and Partnership Tax Issues," JCS-6-97 (Apr. 8, 1997).

[28] *See, e.g., Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007); *McNamee v. Department of the Treasury*, 488 F.3d 100 (2d Cir. 2007); and *Medical Practice Solutions LLC v. Commissioner*, 132 T.C. 125 (2009).

D. Unintended Consequences

For good measure, it is interesting to consider some of the bizarre consequences that result from this theory, both to taxpayers and to the government.

1. Unintended consequences to taxpayers.

The following is a sampling of some unintended and bizarre consequences that would result for taxpayers if the no-existence theory were correct:

- An NRA forms a foreign entity that is classified under the default rules as a corporation in 2020 to acquire raw U.S. real estate for $10 million. Initially, the entity has no U.S. bank account and has not otherwise established relevance under the check-the-box regulations. The foreign entity does nothing until 2023 other than holding annual meetings and maintaining other corporate formalities. In 2023 the foreign entity is ready to lease the property to a tenant and presents a Form W-8BEN-E or Form W-8ECI to the tenant and receives its first U.S.-source lease payment. At that time, the real estate is worth $25 million.

  Under the no-existence theory, the foreign corporation did not exist until 2023. Therefore, until 2023, the NRA was treated as owning the real estate directly. In 2023 the entity became relevant, and hence sprung into existence as a foreign corporation. Thus, the NRA was deemed to make a contribution of an appreciated "United States real property interest" to a foreign corporation in 2023. Under section 1445, the foreign corporation must remit to the IRS 15 percent of the $25 million realized on the contribution. Under sections 897 and 871, the NRA must obtain a U.S. taxpayer identification number and file a Form 1040NR to pay U.S. federal income tax on the $15 million of gain.

- Same facts as above, but the NRA dies before the entity becomes relevant. Under the no-existence theory, the NRA held a direct interest in a "United States situs asset" at the time of his death, and hence the NRA's estate would have to file a U.S. federal estate tax return and pay U.S. federal estate tax, at rates of up to 40 percent, on the FMV of the real estate.[29]

- An NRA owns an interest in a foreign entity that is classified under the default rules as a corporation and that is engaged in manufacturing outside of the United States. The foreign entity has a basis in its assets of $10 million; those assets are worth $100 million. The foreign corporation is not relevant under the check-the-box regulations, and the NRA, after consulting with his tax advisers, has decided not to check the box on the entity.[30] The NRA then becomes a U.S. person. Under the no-existence theory, as soon as the entity became relevant, the individual is deemed to make an outbound contribution to a foreign corporation and must report and pay tax on $90 million of gain under section 367(a).[31]

- Same facts as the prior example, except that the individual dies while he is still an NRA, and the stock of the foreign entity is inherited by his children, who are U.S. citizens. The U.S. citizen children will be deemed to make an outbound contribution to a foreign corporation. While in some cases it is possible that the children may not recognize gain on this outbound transfer

[29]The check-the-box regulations govern for all U.S. federal tax purposes, including for U.S. federal estate tax purposes. *See, e.g.*, reg. section 301.7701-1(a)(1); reg. section 301.7701-2(a), (b), (c); reg. section 301.7701-3(a). It has come to this author's attention that some practitioners have questioned this conclusion based on a Tax Court decision, *Pierre v. Commissioner*, T.C. Memo. 2010-106. However, *Pierre* has no bearing on this issue. *Pierre* deals with the valuation of an interest in a disregarded entity. *Pierre* holds — quite sensibly — that even though the entity does not exist for U.S. federal tax purposes, the nontax legal effects of the entity's state law existence have a bearing on the value of its assets. The author hopes to address this issue further in a future article.

[30]The analysis of whether a U.S. person's foreign entity should check-the-box to be classified as a disregarded entity or foreign partnership, or should instead be classified as a foreign corporation, is complex and involves several factors. A discussion of this issue is beyond the scope of this article. Suffice it to say, however, that in several different scenarios it may be beneficial for the entity to be classified as a foreign corporation rather than a disregarded entity or foreign partnership, especially if the foreign corporation is not a CFC.

[31]As noted above, the check-the-box regulations provide that when a check-the-box election is made for a disregarded entity or partnership to be classified as a corporation, a deemed contribution of assets to the corporation occurs immediately before the start of the effective date of the election. No such rule, however, is provided in the relevance provisions. Therefore, under the no-existence theory, the deemed contribution would have to occur after the NRA becomes a U.S. person.

because of the basis step-up provisions of section 1014,[32] they will be required to report the transfer on Form 926, and will be subject to significant penalties if they do not do so.

2. Unintended consequences to government.

The following is a sampling of some unintended and bizarre consequences that would result to the government if the no-existence theory is correct:

- On January 1, 2020, a U.S. company purchases for $100 million a foreign-owned foreign target entity that is classified under the default rules as a corporation and that has no relevance. The foreign target entity has a $20 million basis in its assets and accumulated E&P of $20 million. The acquirer is not eligible to make a section 338(g) election, or it is eligible to make the election but neglects to file Form 8023. Under the no-existence theory, the acquirer has nothing to worry about, because a section 338(g) election was unnecessary. The acquirer is deemed to purchase assets, and hence has an FMV basis in those assets.[33]
- Same as above, but further assume that at the end of the year of purchase, the foreign target entity has no current E&P but still has $20 million of accumulated E&P. At year's end, the foreign target entity makes a distribution to the U.S. acquirer of $20 million. Ordinarily, one would expect that this distribution would constitute a taxable dividend under section 301(c)(1). However, under the no-existence theory, the IRS would be surprised to learn that the $20 million distribution constitutes a nontaxable return of basis under section 301(c)(2) because the entity had no existence before January 1, 2020, and hence the newly formed foreign corporation had no E&P.

III. Conclusion

The no-existence theory has no support in the language and structure of the regulations and is contrary to Treasury's contemporaneous explanations in its preambles. Also, from a broader perspective, the check-the-box regulations were intended to provide simplicity and achieve fairness and horizontal equity in choice of entity. The regulations have not tampered (and are not even authorized to tamper) with these objectives and with the well-established principle that foreign entity exists even if it is not relevant, and they certainly do not allow serious tax consequences to hinge on whether a taxpayer has been clever enough to manipulate them one way or another based on mechanical formalities. ■

[32] But query whether the "super-royalty" provision of section 367(d) would require future income inclusions even if there was basis step-up at death.

[33] As above, it appears that the U.S. acquirer would have to file Form 926.