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US Entity Classification Considerations for Non-US Investment Funds

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Introduction

The US federal income tax system has a unique entity classification regime that allows certain types of entities to choose their tax classification (i.e., opaque versus transparent). This choice is made by mailing to the US Internal Revenue Service a Form 8832 on which the entity literally checks a box corresponding to its desired tax classification, hence the phrase "check-the-box" election. This article provides an overview of the check-the-box rules and discusses some related considerations for non-US investment funds.

Overview of Check-the-Box Rules

Under US federal income tax law, an entity is classified as either a corporation (opaque), a partnership (transparent), a disregarded entity (transparent) or a trust. A non-US entity's default classification for US tax purposes will depend on whether the entity is a "per se" corporation versus an "eligible entity" and, in the case of an eligible entity, whether at least of the entity's owners has unlimited liability under local law.

Per Se Corporations

Certain types of non-US entities are identified in the US Treasury Regulations as being corporations that may not elect a different classification. These "per se" corporations include, for example, a Societe Anomyme (SA) in France or Luxembourg, an Aktiengesellschaft (AG) in Germany, and a Public Limited Company (PLC) in the United Kingdom or Ireland. The full list of per se corporations is available in US Treasury Regulations Section 301.7701-2(b)(8).

Eligible Entities

If a non-US entity is not a per se corporation, then it is considered an "eligible" entity and may elect a US tax classification that differs from its default classification. An eligible entity in which at least one owner has unlimited liability under local law (e.g., a general partner of a limited partnership) will, by default, be treated as a partnership for US tax purposes unless it affirmatively elects to be treated as a corporation. Such entities include, for example:

- Société de Libre Partenariat (SLP) in France;
- Simple Limited Partnership (Société en Commandite Simple, or SCS) in Luxembourg;
- Special Limited Partnership (Société en Commandite Spéciale, or SCSp) in Luxembourg;
- Corporate Partnership Limited by Shares (Société en Commandite par Actions, or SCA) in Luxembourg;
- Limited Partnership in England or Scotland;
- Limited Partnership (Kommanditgesellschaft, or KG) in Germany; and
- Limited Liability Company & Limited Partnership (Gesellschaft mit beschränkter Haftung & Compagnie Kommanditgesellschaft, or GmbH & Co. KG) in Germany

An eligible entity in which no owner has unlimited liability will, be default, be treated as a corporation for US tax purposes unless it makes an affirmative election to be treated as either a partnership (if it has two or more owners) or disregarded (if it has only one owner). Such entities include, for example:

- Société à Responsibilité Limitée (SARL) in France or Luxembourg;
- Societé par Actions Simplifieé (SAS) in France;
- Fonds Commun de Placement (FCP) in France or Luxembourg;
- Irish Collective Asset-management Vehicle (ICAV); and
- Special Purpose Vehicle (SPV) in Ireland organized as a Private Company Limited by Shares (LTD) or Designated Activity Company (DAC)

Regulatory Regimes

A non-US entity's designation under a regulatory regime – as opposed to an entity's legal form – has no bearing on its US tax classification. Such regulatory regimes include, for example:

- Reserved Alternative Investment Fund (RAIF) in Luxembourg;

- Specialised Investment Fund (SIF) in Luxembourg;
- Investment Company in Risk Capital (SICAR) in Luxembourg;
- Société d'investissement à Capital Variable (SICAV) in France or Luxembourg (and several other Western European countries);
- Société d'Investissement à Capital Fixe (SICAF) in France or Luxembourg;
- Société de Participations Financières (SOPARFI);
- Qualifying Investor Alternative Investment Fund (QIAIF) in Ireland; and
- Undertaking for Collective Investment in Transferable Securities (UCITS) in various EU countries

Umbrella Funds

Certain types of investment funds can be organized as a single legal entity with multiple sub-funds. Although there is limited authority on the subject, each sub-fund of an umbrella fund should have its own US tax classification. For example, if a Luxembourg SCS was formed as an umbrella fund with two sub-funds, then one sub-fund could retain its default US tax classification as a partnership, and the other sub-fund could affirmatively elect to be treated as a corporation for US federal income tax purposes.

Considerations for Non-US Investment Funds

Suppose an investment fund is organized as a Luxembourg special limited partnership (SCSp) and wants to admit both non-US and US investors. Suppose further that it is not practical to form any parallel funds or feeder funds to accommodate certain investors. In that case, should the fund retain its default US tax classification as a partnership, or should it elect to be classified as a corporation for US tax purposes? As discussed below, the right answer will depend on the tax profiles of the fund's investors and the nature of the fund's investments.

Non-US Investors

Non-US persons are subject to US federal income tax on their US-source income based on whether the income is categorized as capital gains, passive income (e.g., interest, dividends, royalties), or "ECI" (defined below).

Capital Gains – Non-US persons generally are not subject to US federal income tax on US-source capital gains attributable to the sale of investment securities, provided that the gains are not FIRPTA gains or otherwise considered ECI, as described below. The receipt by a non-US person of such US-source capital gains income does not trigger a US tax filing obligation.

Passive Income – Non-US persons generally are subject to a gross 30% withholding tax on US-source dividends, certain types of interest, and other "fixed or determinable, annual or periodical" (FDAP) income. This 30% withholding tax does not apply to "portfolio interest," which generally includes interest on debt instruments in registered form, provided that the non-US lender owns less than 10% of the US borrower. Income tax treaties frequently reduce the withholding rate on dividends to 15% (or less) and eliminate the withholding on non-portfolio interest. The receipt by a non-US person of US-source FDAP income does not trigger a US tax filing obligation, provided that the appropriate taxes are withheld.

ECI – A non-US person that is engaged (or is deemed to be engaged) in trade or business in the United States will be subject to US federal income tax on any income that is "effectively connected" with that trade or business, even if such income otherwise would not have been subject to US federal income tax or would have been considered FDAP income. Such taxable income commonly is referred to as "effectively connected income," or "ECI." The tax is levied on the net ECI at the same graduated rates that normally apply to US persons: up to 37% for individuals and 21% for corporations. While ECI generally is not subject to withholding, a US partnership that realizes ECI is required to withhold tax against any such ECI that is allocated to its non-US partners, even if not distributed. Importantly, a non-US person that realizes ECI will be required to file a US federal income tax return annually. For this reason, non-US investors generally want to avoid all ECI.

A non-US corporation that realizes ECI also will be subject to a 30% "branch profits" tax on it net after-tax ECI (unless such tax rate is reduced by a treaty), resulting in an effective tax rate of up to 47.5%. The purpose of the branch profits tax is to equalize the tax treatment between non-US corporations that conduct business in the United States through a US subsidiary corporation versus an unincorporated branch office. If a non-US corporation were to conduct business in the United States through a US subsidiary corporation, then there would be two levels of tax: first, the US subsidiary corporation would be subject to US federal income tax on all of its income, then then the non-US parent corporation would be subject to a 30% withholding tax on any dividends that it received from its subsidiary (unless such tax is reduced by a treaty). If a non-US corporation instead were to conduct business in the United States through an unincorporated branch, then, without a branch profits tax, the non-US corporation would be subject to only a single level of tax on the branch's income. Accordingly, to create a rough parity between these two arrangements, a non-US corporation with an unincorporated US branch would be subject to a 30% branch profits tax on the deemed remittance of profits from its US branch.

While non-US persons generally are not subject to US federal income tax on non-ECI capital gains, gain on the sale of a "United States real property interest," or "USRPI," is treated as ECI under rules added by legislation known as The Foreign Investment in Real Property Tax Act of 1980, or "FIRPTA." A USRPI is defined to include an interest in real property located in the United States, including certain leasehold interests, options to acquire real property, and "associated personal property," such as movable walls and furnishings. A USRPI does not include an interest solely as a creditor in real property. In some instances, the stock of a US corporation will be considered a USRPI if the corporation is deemed to be a "United States real property holding company" by holding 50% or more of specified assets in the form of US real property.

Under the ECI rules, a partner in a partnership is treated as directly realizing the partner's proportionate share of any ECI that is realized by the partnership. Accordingly, certain common activities of investment funds can result in ECI for their non-US investors:

1. Loan origination activities in the United States;

2. The receipt by the investment fund of certain types of fees from US sources (such as commitment fees, transaction fees, break-up fees or consulting fees);

3. Direct, indirect or derivative investments in US real estate, including an interest in a corporation that holds substantial US real estate; and

4. Investments in US portfolio companies that are structured as partnerships or limited liability companies that are taxed as partnerships.

What does this mean for our SCSp in the above example? That really depends on the nature of the fund's investments. As noted above, non-US investors generally want to avoid all ECI. Since an entity that is treated as a corporation for US tax purposes will "block" ECI, electing to treat the SCSp as a corporation for US tax purposes would ensure that ECI does not flow through to its non-US investors. And that may be the best strategy if the SCSp has little control over whether it will realize ECI, such as if the SCSp is a fund-of-funds targeting US-based VC funds. But electing corporate status may not be necessary if the SCSp does not expect to realize ECI or can structure its investments to avoid ECI.

US Taxable Investors

For several reasons, US taxable investors generally would want our SCSp to be treated as a partnership for US tax purposes. One reason is that, while US individuals are subject to US federal income tax at graduated rates up to 37% on "ordinary" income, they are eligible for a lower 21% rate on certain dividends and on "long-term capital gain" ("LTCG"), i.e., gain from the sale of a capital asset that is held for more than one year. Therefore, it is important that an investment fund is treated as a partnership for US tax purposes so that the character of the gain from the sale of portfolio companies as LTCG can flow through the fund to the investors. US corporations are not eligible for lower tax rates on LTCG.

A second reason why US taxable investors would want the SCSp to be treated as a partnership for US tax purposes is that US taxable investors want to avoid the SCSp being subject to an entity-level tax. Unlike corporations, partnerships generally are not subject to US federal income tax at the entity level. Instead, each partner is subject to tax on the partner's proportionate share of the partnership's income. Non-US corporations, on the other hand, are subject to US federal income tax on certain types of US-source income (as discussed above).

A third reason why US taxable investors would want the SCSp to be treated as a partnership for US tax purposes is that US taxable investors generally want to avoid investing in an entity that is classified as a "passive foreign investment company," or "PFIC," for US federal income tax purposes. Very generally, a non-US corporation will be classified as a PFIC if either (1) 75% or more of its gross income is "passive" income (i.e., interest, dividends, capital gain from the disposition of securities), or (2) 50% or more of its assets produce passive income. Based on these tests, a non-US investment fund that is classified as a corporation for US tax purposes likely would be a PFIC. The PFIC rules can result in additional reporting obligations and administrative burdens for both the PFIC and its US investors. In addition, the PFIC rules can result in penalty taxes and the conversion of capital gain into ordinary income for US taxable investors. US tax-exempt investors and non-US investors generally are not affected by the PFIC rules.

A US taxable investor generally can avoid penalty taxes and the conversion of capital gain to ordinary income by electing to treat the PFIC as a flow-through entity called a "qualified electing fund," or "QEF." (A separate "mark-to-market" election, not discussed here, is available if the PFIC's stock is marketable.) But while a QEF election would allow a US taxable investor to avoid penalty taxes and the conversion of capital gain to ordinary income, there still may be some negative tax consequences. For example, dividends passing through the PFIC would not be eligible for the lower 21% tax rate. And making a QEF election would not eliminate the administrative burden. For example, in order to make a QEF election, a US investor would need to receive from the PFIC an annual informational statement that allows the US investor to report their pro-rata share of the fund's ordinary earnings and net capital gains.

US Tax-Exempt Investors

US tax-exempt organizations, including universities, private foundations, charities and pension funds, generally are exempt from US federal income tax on their passive income, such as interest, dividends, royalties, loan commitment fees, and real property rents. However, an otherwise tax-exempt organization that regularly carries on a trade or business unrelated to its tax-exempt purpose will be subject to US federal income tax at corporate rates (or non-exempt trust rates, if the organization is a trust) on the net income generated by that unrelated trade or business. Such taxable income is called "unrelated business taxable income," or "UBTI."

Under the UBTI rules, a partner in a partnership is treated as directly realizing its proportionate share of any UBTI that is realized by the partnership. Accordingly, certain common activities of investment funds can result in UBTI for US tax-exempt investors, such as investments in portfolio companies that are structured as partnerships or limited liability companies that are taxed as partnerships, and the receipt by the investment fund of certain types of fees, such as director's fees, transaction fees, break-up fees or consulting fees. An entity that is treated as a corporation for US tax purposes would block such UBTI.

US tax-exempt organizations also are subject to US federal income tax on their "unrelated debt financed income," or "UDFI," which is treated as UBTI and subject to the same partnership attribution rule described above. UDFI includes income (including interest and dividends) from property with respect to which there was "acquisition indebtedness" at any time during the taxable year that such income was recognized, as well as gain from the disposition of property with respect to which there was acquisition indebtedness at any time during the 12 months preceding such disposition. Thus, for example, if an investment fund borrowed money to purchase portfolio company stock and then repaid that indebtedness during the same calendar year, any dividends earned with respect to that stock during the taxable year in which the stock was acquired would be treated as UDFI, and any gain from the sale of the stock within 12 months after the date the loan was repaid would be treated as UDFI.

What does this mean for our SCSp? Whether US tax-exempt investors would want the SCSp to elect to be classified as a corporation for US tax purposes would depend on the likelihood of UBTI and the nature of any such UBTI. For example, if the SCSp expected to use leverage as part of its investment strategy and thus generate a material amount of UDFI, then US tax-exempt investors likely would want the SCSp to elect to be classified as a corporation for US tax purposes. But if the SCSp did not expect to generate significant UDFI, then US tax-exempt investors may instead prefer the SCSp to be classified as a partnership for US tax purposes. In that case, US tax-exempt investors may request the SCSp to structure its investments in a manner to avoid UBTI, such as utilizing a "blocker corporation" if the SCSp planned to invest in a portfolio company that is structured as a partnership or a limited liability company that is taxed as a partnership.

Conclusion

The check-the-box rules can be a convenient tool for non-US investment funds. But determining the appropriate US tax classification may not be so simple. The right answer will depend on the tax profiles of the fund's investors and the nature of the fund's investments.

About Bird Tax Law

Chris has been practicing tax law for over 15 years, with much of that time at AM Law 100 firms. His practice encompasses investment funds, M&A and executive compensation. As part of his investment fund practice, Chris advises non-US fund sponsors and investors on the US tax aspects of fund formations and secondary transactions.