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UK/US HYBRID ENTITIES

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The classification of a domestic or foreign entity as a corporation, or a partnership for US tax purposes will be determined generally by reference to the six basic characteristics of a corporation which are specified in US Treasury Regulations.[2] Two of these six characteristics, associates and an objective to carry on business and divide gains therefrom, are generally common to both corporations and partnerships. These features are not distinguishing characteristics and are, therefore, not considered further in this article.

The way in which the US classifies entities as corporations or partnerships is in contrast to the way in which a foreign entity is viewed as a company or a partnership for UK tax purposes. In the UK much greater emphasis is placed on the relevant statute under which the entity is formed/incorporated. This differing approach by the two tax jurisdictions can result in an entity being treated as a corporation/company in one jurisdiction but as a partnership in the other. Such "hybrid" entities can be put to particularly effective use in international structures involving the two countries. This article considers the US and UK tax laws in this area and the typical hybrid entities which may be used.

US classification of an entity

In determining whether a foreign entity is to be regarded as a corporation or a partnership for US tax purposes, the US Internal Revenue Service ("IRS") will take into account the presence or absence of each of the following corporate characteristics:

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2 Rev. Rul. 88-8, 1988-1, C.B. 403 holds that an entity organised under foreign law is classified for US federal income tax purposes on the basis of the characteristics set forth in Reg. Sec. 301.7701-2.

- Continuity of life;
- Centralisation of management;
- Limited liability; and
- Free transferability of interests.[3]

An entity will not be classified as a corporation unless it has more corporate characteristics than non-corporate characteristics. Equal weight must be given to each of these four corporate characteristics.[4] Therefore, if an entity possesses more than two of the above characteristics it will be a corporation. If it possesses two or fewer characteristics it will be a partnership.[5]

Continuity of life: An entity has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member/shareholder will not cause a dissolution of the entity.[6] For this purpose the dissolution of an entity means the alteration of the identity of the organisation by reason of a change in the relationship between its members as determined under local law. A dissolution of a partnership will, generally, occur on the death or withdrawal of a partner even where the partnership agreement provides that the business will be continued by the other partners in the event of the death or withdrawal of a partner. Consequently, a partnership will generally lack continuity of life. However, a corporation will have continuity of life because its identity is detached from the relationship between its shareholders.

An agreement establishing an entity might, for example, provides that it is to continue only for a stated period, or until the completion of a stated project/undertaking. However, such an entity will still not possess the characteristic of continuity of life if the effect of the agreement is that no member has the power to dissolve the entity in contravention of the agreement. For example, if the agreement expressly provides that the organisation can be terminated by the will of any member, it is clear that the organisation lacks continuity of life.

Whether the articles of association of a UK limited company can be drafted so that it lacks the corporate characteristics of continuity of life is presently unclear. In

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3 Reg. Sec. 301.7701-2(a).

4 This was concluded by the Tax Court, in *Larson v Commissioner,* 66 TC 159 (1976), *acq.*,1979-1 C.B. 1.

5 Reg. Sec. 301.7701-2(a)(3).

6 Reg. Sec. 301.7701-2(b).

PLR 9002056,[7] the IRS held that a UK limited company lacked continuity of life in circumstances where its articles of association provided that it would be wound up on

> "..... the dissolution, bankruptcy, or insolvency of a shareholder, or on assignment by a shareholder to or for the benefit of creditors."

The memorandum and articles of association included the provision that, on the occurrence of any such event, a shareholders' meeting would be held at which the shareholders were required (as provided by a provision in the memorandum and articles of association) to vote in favour of the resolution to wind up the company. However, the IRS subsequently issued PLR 9152009 where it held that a similar provision in the memorandum and articles of association of a Chinese limited liability company was insufficient for that company to lack continuity of life. The interpretation of this type of provision in an organisation's articles was partly clarified in Rev. Rul. 93-4[8] where, when considering the characteristics of a German GmbH, the IRS stated:

> "Because the memorandum of association of the GmbH requires dissolution upon the bankruptcy of either quotaholder, without further action, the GmbH lacks continuity of life."

It appears that the German statutes will permit such a self-executing provision in the memorandum of association of a GmbH to require its dissolution without further action of its members. However, is this in reality very much different to the situation in the UK limited company case described above where, although UK law requires the members to take further formal action to dissolve the UK company, they are bound by a legally enforceable agreement to complete the necessary formalities to dissolve the company? It may well be this somewhat curious distinction which the IRS regards as critical and which may cause the IRS to subsequently revoke PLR 9002056. A senior IRS official[9] has stated that the IRS is reconsidering the continuity of life issue for UK limited liability companies

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7 A private letter ruling ("PLR") is not binding on the IRS, other than in respect of the specific taxpayer who requested the ruling. However, it is useful as a guide to the position which is likely to be taken by the IRS in respect of a taxpayer with similar facts.

8 1993-3 I.R.B. 5.

9 The IRS official referred to is Neil Auerbach, branch chief, IRS Office of Associate Chief Counsel (International) who made such statements while speaking at a World Trade Institute seminar in Washington on 2nd August 1993 and again during The Tax Executive Institute's annual conference in Orlando, Florida on 26th October 1993.

and will be releasing a public ruling on the issue. Meanwhile the IRS is refraining from issuing further rulings until the public guidance is released.

Centralisation of management: An entity has centralisation of management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to conduct the business for which the entity was formed. Therefore, a company the management of which is exercised by the board of directors will have centralisation of management. This is because the concentration of management powers in the board of directors effectively prevents a shareholder from binding the company by his acts. However, in a general partnership, because the acts of any partner within the scope of the partnership business will usually bind all the partners, a general partnership is likely to lack centralisation of management.

Limited liability: An entity has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the entity. Therefore, a UK limited company will have the corporate characteristic of limited liability. However, the lack of this corporate characteristic together with the lack of free transferability of interests (discussed below) are the reasons why the IRS has determined a UK unlimited company should be treated as a partnership for US federal tax purposes.[10]

A limited partnership will generally lack limited liability. This is because its general partner has unlimited liability. However, it is interesting to note that the IRS will consider a limited partnership to have limited liability in circumstances where the general partner has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organisation and when he is merely a "dummy" acting as the agent of the limited partners.[11] Therefore, a UK limited partnership could have the corporate characteristic of limited liability if the general partner is a limited company with a nominal share capital and no assets other than its interest in the limited partnership.

Free transferability of interests: An entity has the corporate characteristic of free transferability of interests if each of its members, or those members owning substantially all[12] the interests in the entity, have the power, without consent of other members, to substitute for themselves in the same entity a person who is not a member. The substitute member must have all the attributes of a member in order for free transferability of interests to exist. Consequently, a member must

10 Rev. Rul. 88-8, 1988-1 C.B. 403.

11 Reg. Sec. 301.7701-2(d)(2).

12 The IRS in Rev. Proc. 92-33, 1992-1 C.B. 782, has interpreted "substantially all" to mean 80%.

be able to assign not only his right to share in profits but also his right to participate in the management of the entity.

If the articles of an entity include some form of pre-emption right, whereby a member can transfer his interest to a non-member only after having offered such interest to the other members at its fair market value, it will be recognised that a modified form of free transferability of interests exists. This modified corporate characteristic is accorded less significance than in an unmodified form and may be thought of as "half" a corporate characteristic.

In Rev. Rul. 88-8[13] the IRS held that a UK unlimited company lacked the corporate characteristic of free transferability of interests because its articles of association provided that a member may not substitute a person who is not a member, unless the member obtains the unanimous prior written consent of the other members. The lack of this corporate characteristic together with the lack of limited liability are the reasons why this UK unlimited company was held to be a partnership for US tax purposes.

In perhaps an uncharacteristic but helpful manner, the IRS made the following remark when considering whether a German GmbH lacked free transferability of interests:

> "If the memorandum of association of the GmbH in Rev. Rul. 77-214 had either prohibited the transfer of an interest or provided for the dissolution of the GmbH upon the transfer of an interest, the GmbH would have lacked free transferability of interests."[14]

Therefore, providing the articles of association of a UK or other foreign entity can be drafted to satisfy this condition, it should lack the corporate characteristic of free transferability of interests.

Application to UK companies/partnerships

UK Unlimited Company: It is reasonably well established that the articles of association of a UK unlimited company can be drafted so that, although it has the corporate characteristics of continuity of life and centralisation of management, it lacks limited liability and free transferability of interests. In such circumstances it will not have more corporate than non-corporate characteristics and may be classified as a partnership for US tax purposes.

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[13] See note 10, supra.

[14] Rev. Rul. 93-4, 1993-3 I.R.B. 5.

UK Limited Company: Similarly, a UK limited company should be able to adopt articles of association that prohibit the transfer of shares without the unanimous written consent of all the shareholders.[15] Therefore, it should be able to lack the characteristic of free transferability of interests. By its nature it will have both centralisation of management and limited liability. The issue for the avid tax planner is whether it can adopt articles so that it lacks the characteristic of continuity of life. Pending the release of a further public ruling on this point, there must be some doubt that this can be achieved.

There are a number of circumstances in which a UK company is permitted to commence a members' voluntary winding up. However, each circumstance requires the company's shareholders to take some specific action so that the company may resolve in general meeting, or by special resolution, or by extraordinary resolution, to wind up.[16] For the reasons discussed above this requirement that a provision in the articles cannot, without further shareholder action, dissolve the company on the event of, say, the bankruptcy or liquidation of a shareholder, could result in the IRS revoking PLR 9002056 and holding that a UK limited company does possess the characteristic of continuity of life.

In summary, it is clear that a UK limited company will, generally, be treated as a corporation for US tax purposes. It may also be possible for a UK limited company to adopt memorandum and articles of association which include provisions designed to ensure it will be treated as a partnership for US tax purposes. However, following comments from a senior IRS official towards the end of 1993, it now seems less likely that such articles will achieve the desired partnership status.

UK Limited Partnership: Applying the above guidelines it would seem that a UK limited partnership could be organised in such a way as to be treated as a corporation for US tax purposes.

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15 Such a provision was included in the memorandum and articles of association of the UK limited company under consideration in PLR 9002056.

16 Section 84 Insolvency Act 1986.

Centralisation of management may be present where 80% or more of the total partnership interest is held by limited partners. This is indirectly suggested by Rev. Proc. 89-12[17] which provides guidance on whether the IRS will accept a ruling request on whether an entity is a partnership for US tax purposes.[18]

Limited liability may be present if, as discussed above, the general partner maintains no substantial assets.[19]

The IRS will rule that a partnership lacks free transferability of interests:

> "..... if the partnership agreement expressly restricts ..... the transferability of partnership interests representing more than 20 percent of all interest in the partnership capital, income, gain, loss, deduction and credit."[20]

Conversely, an entity could potentially possess free transferability of interests where at least 80% of the partnership interests are freely transferable. Therefore, if the limited partners were permitted under the partnership agreement to assign their interests,[21] the limited partnership would possess free transferability of interests and could, potentially, be treated as a corporation for US tax purposes.

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17 1989-1 C.B. 798.

18 It states that limited partners' interests, excluding those held by general partners, may not exceed 80% of the total interest in the partnership. If this limit is exceeded the IRS will not rule that the partnership lacks centralisation of management.

19 The IRS has interpreted "substantial assets", for ruling purposes, to mean net worth equal to or greater than 10% of the total contributions to the limited partnership. Consequently, limited liability may be achieved if the corporate general partner maintains no assets aside from its partnership interest.

20 Rev. Proc. 92-33, 1992-1 C.B. 782.

21 Note that section 6(5)(b) Limited Partnerships Act 1907 provides that: "[s]ubject to any agreement expressed or implied between the partners ... [a] limited partner may, with the consent of the general partners, assign his share in the partnership, and upon such assignment the assignee shall become a limited partner with all rights of the assignor." The words "subject to any agreement" indicate that the partners could enter into an agreement which would not restrict transferability of the limited partners' interests.

UK classification of an entity

In contrast to US tax law, where there are detailed rules to determine whether an entity (foreign or domestic) is to be treated as a partnership or company, UK tax law provides very little guidance.

A "company" as defined for purposes of the Tax Acts means:

> "any body corporate or unincorporated association but does not include a partnership, a local authority or a local authority association."[22]

The terms "body corporate" and "unincorporated association" are not further defined in the Statute.

The UK Courts have considered the issue of whether a foreign entity is a partnership or a company on two occasions.

In *Dreyfus v IRC*[23] the Court of Appeal held that a French *société en nom collectif* ("SNC") was to be treated as a company for the purposes of determining whether super-tax should be levied on the partners/shareholders. The actual decision in this case is no longer particularly important because the Inland Revenue will, in practice, generally consider that an SNC should be regarded as a partnership for UK tax purposes. However, during his judgement Lord Hanworth MR said:[24]

> "We must respect the foreign entity established, because it is not a mere matter of the *lex fori*; it is a matter of the status which an entity brings over here with it."

This decision was, therefore, noteworthy because it established the principle that it is the foreign law under which the entity is established which should be considered to determine whether an entity should be viewed as a company/corporation for UK tax purposes.

The *Dreyfus* case was followed by *Ryall v The Du Bois Company, Ltd*[25]another Court of Appeal case, in which it was held that a German GmbH was to be treated

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22 Section 832(1) TA 1988. Note also that s832(2) details those sections of the Act for which this general definition does not apply.

23 (1929) 14 TC 560.

24 Ibid, at p577.

25 (1933) 18 TC 431.

as a company for UK tax purposes. In his judgment in the High Court (the decision of which was later affirmed by the Court of Appeal) Finlay J said:

> "The first thing to be noted, of course, is that this is a case relating to foreign income, and I do not think that it is useful to look at the precise technicalities of English law. There must, of course, be differences between English law and foreign law, and it is useless to attempt to restrict words in a case relating to foreign income to what would be considered income from shares if the company were an English company ... "

The principle established by *Dreyfus*, that it is the foreign law that should be considered to determine the status of a foreign entity, was clearly being followed. Finlay J went on to make further helpful comments by listing those features of the GmbH which he considered to contain the essential elements of a company:

> "[The GmbH] contains the essential elements of a company. You have the persons who have interests or shares in the company, and then you have, as a separate entity, the company itself, and the company, and not the shareholders, or interest holders, ... own the property. The assets are the property of the company, and what those who own those shares get is such dividend ... as a result of the trading as it is thought proper to divide."

In brief, therefore, the UK Courts have adopted the approach of looking at the local corporate law under which the entity is organised and its governing statutes and any other relevant facts, to determine whether the particular entity in question should be treated for the purposes of UK tax as having the essential characteristics of a corporation or a partnership. The manner in which the entity is taxed under the foreign tax law of the country in which it is resident will not determine its tax status in the UK.

Although the views of the Inland Revenue in this area are not published, it is understood that in practice they will follow the above principles. As is customary, the Inland Revenue are likely to determine the status of a foreign entity on a case by case basis by reference to all the relevant facts and local corporate law. If, therefore, the foreign corporate law holds the entity to be a company/corporation, it should not be treated as a partnership for UK tax purposes. If it is not a company/corporation under the foreign corporate law, it may then be necessary to apply principles of English law to determine whether the entity is a partnership.

Application to US corporations/partnerships

US "C" corporation: It is well established that a US "C" corporation, generally just referred to as a "US corporation", is treated as a company for UK tax purposes. A "C" corporation is a regular US corporation which is incorporated as a corporation under the law of a particular state of the United States or in the District of Columbia. Such a corporation is subject to US federal income tax as a corporation under subchapter C of the US Internal Revenue Code of 1986. Virtually all foreign (non-US) groups trading in the US through US subsidiaries will operate through "C" corporations.

US "S" corporation: A US "S" corporation is also a regular US corporation. It is incorporated as a corporation under the laws of a particular state of the United States or in the District of Columbia. From a corporate law perspective, there is no difference between a "C" corporation and an "S" corporation. However, for US federal income tax purposes certain corporations (broadly, US corporations that are owned by 35 or fewer US individual shareholders and that satisfy certain other conditions) can elect to be treated as "S" corporations.[26] The effect of the election is that, unlike "C" corporations, they are generally not treated as taxable entities for US federal income tax purposes. Instead, the income of the corporation passes through to the shareholders who pay tax on the corporation's income, irrespective of whether it is distributed. In this way an "S" corporation is treated, for US tax purposes, in a similar manner to a partnership. However, for UK tax purposes, as an "S" corporation is a corporation for corporate law purposes, it should be treated as a company for UK tax purposes - the classic UK/US hybrid entity.

US Limited Liability Company ("LLC"): An LLC is an entity created under the corporate law of a particular state of the United States or in the District of Columbia. Corporate law in the US varies from state to state. It is, therefore, necessary to have regard to the corporate law of the state under the laws of which the particular LLC is established in order to determine whether it will be treated as a corporation under local corporate law. However, typically, the relevant state law will provide that an LLC is a legal entity separate from its members and that it may own property in its own name. As its name suggests, its members will not be liable for any debts, obligations, or liabilities of the LLC. Therefore, an LLC will, typically, be a corporation for purposes of the corporate law of the state in which it is organised.

For US federal income tax purposes, however, the IRS has issued a number of rulings holding that LLCs are to be treated as partnerships for US federal income tax purposes. In Rev. Rul. 88-76[27] an LLC organised under the Wyoming Limited Liability Company Act was held to be a partnership for US federal tax purposes. Under the Act if a member ceases to be a member for any reason, the continuity of the LLC is not assured, because all remaining members must agree to continue the business. Consequently, the LLC lacked the corporate

[26] IRC section 1362(a).

[27] 1988-2 C.B. 360.

characteristics of continuity of life. Similarly, under the Act an assignee or transferee of a member's interests does not acquire all the attributes of the member's interest in the LLC unless all remaining members approve the assignment or transfer. Consequently, the LLC lacks the corporate characteristic of free transferability of interests. For the reasons explained earlier in this article, as the LLC did not have more corporate than non-corporate characteristics, it was held to be a partnership - another UK/US hybrid entity.

Practical uses of UK/US hybrid entities

The uses of hybrid entities are many and varied, limited only by the imagination of the tax planner. The following are a few examples of how such entities can be effectively incorporated into international group structures.

Reducing tiers of foreign corporations for US foreign tax credit purposes: A US parent corporation is entitled to an indirect foreign tax credit (for the underlying tax) as well as a direct foreign tax credit (for the withholding tax) when it receives a dividend from a foreign subsidiary in which it owns 10% or more of the voting shares in the foreign subsidiary. Similar rules apply if the foreign corporation owns at least 10% of a second tier foreign corporation, or if that corporation owns at least 10% of a third tier foreign corporation (provided there is a minimum 5% indirect ownership.) However, no foreign tax credit is available for dividends received from fourth tier or remoter foreign subsidiaries. The use of hybrid entities which are treated as partnerships for US tax purposes can reduce the number of tiers of foreign corporations, purely for US tax purposes, thereby enabling US groups to access foreign tax credits from lower tier foreign subsidiaries.

Converting indirect to direct tax credits: US individuals and partnerships trading in the UK through UK subsidiaries will receive dividends with a 15% tax credit under the UK/US tax treaty. They will, therefore, be subject to US tax at rates of up to 39.6% with a tax credit for only 15% If, however, they were to trade through an entity which was treated as a partnership for US tax purposes, they would be entitled to a tax credit for their pro rata share of the UK tax paid on the trading profits. The tax credit would, therefore, be approximately 33% if a non-UK resident company was used and approximately 29%[28] if a UK resident company was used.

Utilisation of losses: If a US group trades in the UK through a UK subsidiary which generates losses in the initial period of trading, the US group is unable to take an immediate tax benefit in the US for those losses. The use of an entity which is treated as a partnership for US tax purposes should, subject to certain

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28 Calculated after taking the tax credit refund under the UK/US tax treaty into consideration.

restrictions in the US dual consolidated loss rules,[29] enable benefit of the losses to be obtained by the US group.

Conclusion

I leave the many other and varied ways of using such hybrid entities in international tax planning to your imagination. For US tax purposes, the ability to "look through" one foreign entity to another can be put to particularly good use in the areas of US foreign tax credit planning and in minimising a group's exposure to US tax under the US controlled foreign corporation provisions. For UK tax purposes, the ability to remain a UK resident company, benefiting from the provisions of the UK/US tax treaty, while being treated as a partnership for US tax purposes, provides scope for some very interesting tax planning possibilities.

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29 IRC s1503(d)(3).