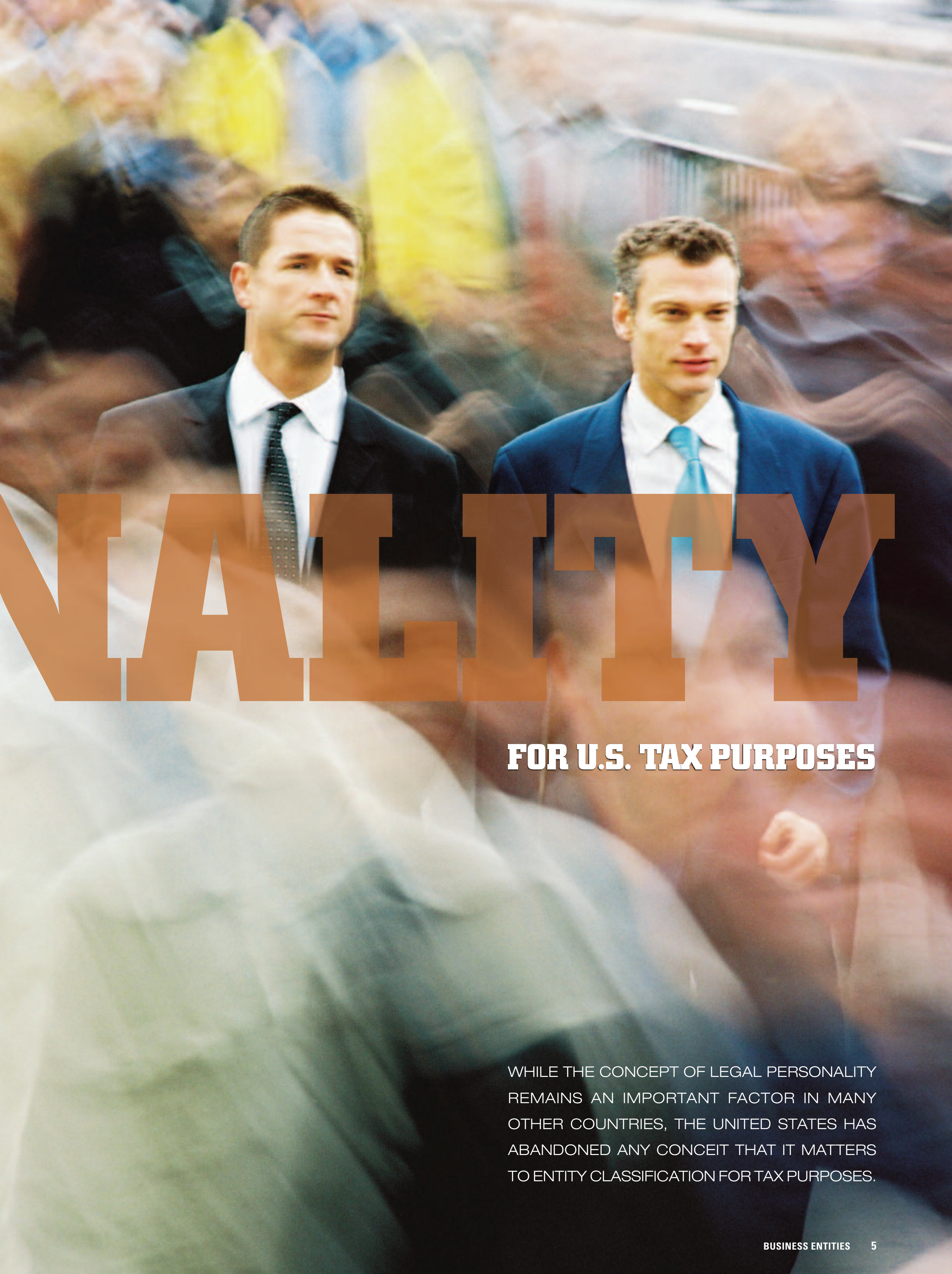
Kimberly Blanchard

THE SIGNIFICANCE OF LEGAL PERSON

Many countries employ the term "legal personality" to differentiate an entity treated as a separate corporate taxpayer from a tax-transparent partnership. In these countries it is sometimes said that a corporation has legal personality, whereas a partnership does not. The author first encountered the term legal personality in the course of advising foreign clients who were considering investments in U.S. partnerships. The concern raised by their non-U.S. tax advisors was that U.S. partnerships, whether general or limited partnerships, might be considered to possess the attribute of legal personality, and if so might be treated as corporations for tax purposes in the client's country of residence. This hybrid result can raise a variety of tax problems, including the loss of treaty benefits otherwise available,[1] the potential for timing and character mismatches, and the potential loss of credibility or exemption at home for U.S. taxes paid by the nonresident partner.



NALITY

FOR U.S. TAX PURPOSES

WHILE THE CONCEPT OF LEGAL PERSONALITY REMAINS AN IMPORTANT FACTOR IN MANY OTHER COUNTRIES, THE UNITED STATES HAS ABANDONED ANY CONCEIT THAT IT MATTERS TO ENTITY CLASSIFICATION FOR TAX PURPOSES.

Background

In researching the issue, it soon became clear that virtually every type of U.S. entity that exists today, including a simple general partnership, probably has what many other countries would view as legal personality. Not only is the construct of legal personality irrelevant to U.S. tax classification rules; the construct barely survives as a matter of U.S. commercial law. Already by the year 1928, papers presented at a legal symposium in Chicago on the subject of business entities illustrated that the concept was beginning to lose its meaning.[2] Over time, the conceit that in order to be a partnership for U.S. commercial law purposes, an entity must lack legal personality, was abandoned as a quaint artifact of an earlier age.

In one sense, U.S. tax law recognizes that corporations, but not partnerships, have something we might call "legal personality." A state law corporation will always be taxed as a corporation; it cannot elect to be treated as a partnership or other form of entity (putting aside special tax regimes such as RICs, REITs, and S corporations). *Moline Properties*[3] stands for the proposition that the mere act of incorporating a corporation creates a separate legal person that will generally be respected as separate from its owners for all tax purposes, absent sham or "piercing the corporate veil." A domestic corporation is a taxpayer and a resident of the United States for all tax and treaty purposes, whereas a partnership is neither.[4] But these are the legal results that follow from incorporating a corporation; they do not follow from any conceit that only a corporation possesses what one might call legal personality.

In a recent compendium on the subject of entity classification under treaties, published by the International Fiscal Association (IFA),[5] about half of the 40 responding countries mentioned legal personality as an important factor in classifying entities for tax purposes. The other half, including the United States, did not mention the term at all. The resulting tension between tax systems can give rise to hybrid entities, frustrating international efforts to eliminate hybridity in order to minimize classification conflicts and the resulting possibility of either double taxation or "homeless income."

BEPS Project. This is a timely topic–the OECD recently completed a monumental project, referred to as the Base Erosion and Profit Shifting (BEPS) project, to eliminate homeless income by tackling 15 areas where tax rules might be harmonized or changed.[6] One of these 15 projects involved hybrid entities, and others implicate the subject of hybridity. There is no question that one of the major drivers of the BEPS project was the perception among many countries that the U.S. "check-the-box" entity classification rules[7] constitute one of the principal evildoers in fomenting homeless income. But natural hybridity, which existed before and after the check-the-box regulations, is far more common than many countries acknowledge. It arises in part from the insistence by many countries that only their own entity tax classification criteria represent the "correct" approach.

The hybridity that results when one country classifies an entity as a corporation and another country classifies the same entity as a partnership would be rarely encountered if all countries adopted the approach set out in an earlier OECD report on treaties and partnerships.[8] That report recommended that the source country give effect to the taxation of the partners in their home country, ignoring the treatment of the entity in the source country and in the country where the entity is formed. Unfortunately, the 1999 OECD report was limited to treaty interpretation and therefore does not apply generally. Moreover, many countries have reserved on the report's recommendation and will not follow it.

This article is not about entity classification generally, but only about how the concept of legal personality is used

in legal classification. Legal personality, or something like it, is one criterion that many countries use to classify entities. Because U.S. tax rules do not give effect to the existence or non-existence of legal personality, this can result in hybridity without any taxpayer planning at all. The legal personality criterion is particularly pernicious in those countries that view it as a "superfactor" sufficient without more to require classification as an opaque corporation.

This article will undertake to describe the concept of legal personality and examine the possible reasons why it is often used as a tool for entity classification. It will also review some practical problems that arise when countries take different views on the significance of legal personality.

I. What is "Legal Personality"?

A. In General. A discussion of the topic of legal personality ought to begin by defining what that term means. Unfortunately, there appears to

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be no universal agreement on what it means. Apparently the difficulty of defining it has been with us a long time; in 1928 Smith wrote that philosophers "have sought for the 'internal nature' of legal personality, for an abstract essence of some sort which legal personality requires. . . . A more difficult task than to define the concept is to explain this persistent tendency to make it mysterious." [9]The author's understanding is that many countries that use the concept of legal personality do not generally bother to define it.

The most common formulation of legal personality is that an entity possessing it owns property in its own name and can sue or be sued in its own name. West's definition of legal personality is the capacity of an entity to have a name of its own, to sue and be sued, and to have the right to purchase, sell, lease, and mortgage its property in its own name. Property cannot be taken away from an entity having legal personality without due process of law.[10] Wikipedia cites to authoritative treatises[11] for the proposition that to have legal personality means "to be capable of having legal rights and duties within a certain legal system, such as to enter into contracts, sue, and be sued. Legal personality is a prerequisite to legal capacity, the ability of any legal person to amend (enter into, transfer, etc.) rights and obligations." Under the common law, legal personality consisted of five legal rights:

1. The right to own property (including money).
2. The right to make and sign contracts.
3. The right to sue and be sued (i.e., to enforce contracts).
4. The right to hire employees.
5. The right to make by-laws for self-governance.

One might distinguish between "legal personality" in the abstract and "separate legal personality" in the sense of an entity having a legal personality separate and distinct from that of its owners. That is, it seems possible that an entity such as a partnership could have legal personality and yet not possess a legal personality separate from its partners. However, most countries that give effect to legal personality do not adopt that view. In those countries, there is no meaningful distinction between an entity that has legal personality and one that has legal personality separate from its owners.

Individual human beings have legal personality in the sense that they can own property and be sued.[12] But it is the concept of legal personality as applied to entities–often called juridical personality–that allows one or more natural persons to come together in the form of a single entity for legal purposes. The English refer to this as a "body corporate," a term that is often confused with the term "corporation." Legal personality allows an entity to be considered under law separately from its individual members.

How did the concept of legal personality arise? The best explanation of the *need* for the concept of legal personality this author has found is set forth in a short book entitled *The Company: A Short History of a Revolutionary Idea.*[13] The argument goes essentially as follows. In ancient times, only a natural person could be sued. This made sense when most businesses were sole proprietorships or informal partnerships of a few persons known well to one another. In those cases, the individuals were liable for the debts of and claims against their business. For various reasons that won't be explored here, around the time of the Industrial Revolution people stated to form corporations that afforded limited liability for their owners. As long as only individuals could be sued, there was no legal remedy if the corporation broke the law or harmed another person.[14] The owners were protected and the corporation, not being human, couldn't be sued. In order to solve this problem, the concept of legal personality was extended to corporations.

B. The Significance of Limited Liability to Legal Personality. While this brief history illustrates the link between limited liability of an entity's owners and the development of legal personality, today many countries recognize that an entity that does not confer limited liability upon its owners, or at least not to all its owners, can have separate legal personality. For these countries, limited liability is not the equivalent of legal personality. Other countries appear to equate limited liability with legal personality.

It might be supposed that an entity that affords limited liability to all of its members would generally possess legal personality, and so it appears under the laws of most countries that employ the concept of legal personality. Most would agree that a U.S. limited liability company (an LLC), like a U.S. corporation, falls into this category, such that a country giving effect to legal personality would always classify an LLC as a corporation. And as we shall see, this has in fact largely been proven out.

However, U.S. limited partnerships, limited liability partnerships (LLPs), and limited liability limited partnerships (LLLPs) present more nuanced issues. A limited partnership provides limited liability for limited partners, reserving personal liability for the general partner. The early justification for limited partners' limited liability grew out of the division of managerial duties. Limited partners did not participate in management, and thus did

not bear personal liability for management's follies. This threshold test abides today in the Revised Uniform Limited Partnership Act (RULPA), which shields a limited partner from liability only to the extent such partner refrains from actively participating in management or holding herself out as a general partner.[15] The more modern Uniform Limited Partnership Act (ULPA), in contrast, extends limited liability to limited partners whether or not they participate in management.[16]

An LLP is a creature of general partnership law with LLP statutes having evolved over time. The LLP was originally conceived as a vehicle for professional firms to achieve some level of protection for innocent partners in the face of malpractice by other partners. Notably, New York and California still limit the availability of an LLP election to professional entities. These first generation LLPs dispensed only with vicarious liability for innocent partners from certain acts committed by their partners.[17] A number of states retain this "partial shield" for vicarious liability today.[18]

With the second generation statutes, set in motion by Minnesota in 1994, came "full-shield" limited liability protecting partners of an LLP not only from other partners' bad acts, but also from debts arising in the ordinary course of business.[19] There are statutory exceptions to the general provision of limited liability for limited partnerships and general partnerships, i.e. for purporting to operate as a partner post-dissolution, but the official comments to ULPA make clear that it is intended to buttress the limited liability accorded to partners, stating "Both general and limited partners benefit from a full, status-based liability shield that is equivalent to the shield enjoyed by corporate shareholders, LLC members, and partners in an LLP."[20]

Similarly, an LLLP, which is to a limited partnership what an LLP is to a general partnership, provides limited liability for general partners and limited partners alike, not only for one another's wrong doings but also for debts arising in the ordinary course of the business.[21] The LLP and the LLLP represent the logical extension of the ULPA's extension of limited liability to partners who participate in management.

A non-U.S. observer focusing on limited liability as a factor in entity classification might well ask why this proliferation of entities was needed. What do owners achieve by using a Delaware LLP rather than an LLC? The answer may be as simple as the fact that some states have laws more suited to a particular purpose than others, and have taken the lead in adopting new statutes, only to find that other states eventually catch up. U.S. tax law, having seen the writing on the wall, has abandoned any conceit that limited liability matters to entity classification for tax purposes, given the reality that almost any type of U.S. entity can today afford almost complete protection from liability.

C. How Can We Tell Whether Legal Personality Exists? Whether an entity can own property in its own name, or can be party to a lawsuit, should in theory be ascertainable by reference to local law. An interpretive bulletin issued by the Canada Revenue Agency states that an entity possesses legal personality or personhood when it has an "existence separate and distinct from the personality and existence of the person who created it and that possesses its own capacity to acquire rights and to assume liabilities."[22] If this definition is not merely tautological, it must mean that the capacity to acquire rights and to assume liabilities must be accorded by a positive provision of law. However, it appears that no Canadian statute contains such positive provisions. Rather, it is simply understood to be the case that a partnership formed under Canadian commercial law lacks legal personality—in fact that it is not an "entity" at all.[23] Various provisions of Canadian law distinguish between entities possessing legal personality or "personhood," and those that do not.[24]

1 See Reg. 1.894-1(d)(1). Under this regulation, if a nonresident person is a partner of a partnership that earns an item of U.S. source income such as a dividend, and his home country treats the partnership as non-fiscally transparent (e.g. because it considers the partnership to have legal personality), the U.S. will not grant treaty benefits to the nonresident partner. The theory of the rule is that the nonresident partner is not paying tax at home on the income as it arises, and therefore that no double taxation exists.

2 Smith, "Legal Personality," 37 Yale L.J. 283 (1928) (hereafter, Smith). This was one of several papers submitted to the symposium, and refers to the others.

3 319 US 436, 30 AFTR 1291 (1943). In Saba Partnership, TCM 2003-31, the Tax Court went so far as to state that a partnership must be regarded as a separate entity in the same way that the *Moline Properties* case treated a state law corporation as a separate entity.

4 In Smith's paper on the subject of legal personality, he mentions a fascinating English case, Continental Tyre & Rubber v. Daimler, [1915] 1 K.B. 893, [1916] 2 A.C. 307, tried during the First World War. The plaintiff was an English corporation conducting business solely in England, but all of its directors and shareholders were residents of Germany. The question was whether the corporation was English or German within the meaning of the Enemy Trading Act. Although the lower court stuck with the fiction of legal personality and held the corporation to be English, on appeal it was held to be subject to the Act, because it could not appoint an agent without the act of Germans, and thus could not sue anyone as a practical matter. In this case we can see a premonition of what would later become U.S. tax treaty policy in the form of its limitation on benefits article–one can agree that a corporation is separate from its owners, subject to tax at the corporate level and resident wherever it is resident, but that does not require us to grant benefits to it if doing so would offend some policy relevant to its ultimate ownership.

In the same way, Dutch statutes do not refer to the facts of legal personality, but merely state which entities have legal personality and which do not.[25] And under English law, it is unclear whether limited liability follows from having legal personality or whether the presence of limited liability dictates that one is in the presence of an entity possessing legal personality. A recent article discussing English entity classification states that an English law LLP, which confers limited liability on all its members, "is not a partnership at all, but a body corporate . . . "[26] and that "it is clear from the [enabling legislation] that an LLP is a body corporate."[27] So, notwithstanding the fact that the word "partnership" appears in the name of the entity, it is not a partnership "at all," apparently because the legislature decided that this was so.

In these and other countries, therefore, it appears that the definition of legal personality is, in fact, tautological. The statement that an entity has legal personality is a conclusion based not on its intrinsic characteristics, but based on what the legislator deems desirable as a matter of policy. As aptly stated by Smith in his 1928 article:

> Whenever society, in the administration of justice, sees fit to disregard the individual members of an organization for a particular purpose, and for that purpose to look upon the organization as a unit, the organization to that extent or for that purpose becomes a legal person. This is true even where the group is organized as a partnership or other unincorporated association.[28]

The preceding observation explains why many countries that purport to give legal effect to legal personality do not have statutes that make clear whether a particular form of entity can or cannot own property in its own name. And in fact, many countries insist that certain types of entities, such as partnerships, lack legal personality *even though these entities can in fact own* property *in their own name and otherwise possess all of the powers normally associated with separate legal personality.* Thus, statements made about legal personality seem based more on tradition that on law.

The next section of this article reviews some basic precepts of U.S. tax entity classification rules relevant to the application of legal personality principles in the United States.

II. Legal Personality and U.S. Tax Classification

A. The Three-Step Approach. Both before and after the promulgation of the check-the-box regulations,[29] U.S. tax law entity classification rules have been unique both in ignoring commercial law[30] and in applying to domestic and not just foreign entities. The U.S. tax rules employ a three-step process to classify arrangements for tax purposes. First, it must be determined whether or not the arrangement rises to the level of an entity, or is merely a contract or co-ownership arrangement. If it is an entity, it must next be determined whether it is a "business entity" or a trust. Finally, if the entity is a business entity, it will be characterized as an opaque corporation or as a tax-transparent entity (a partnership or, under the current scheme, a disregarded entity) under the regulations.

The former entity classification regulations replaced by the check-the-box regime in 1997 had their genesis in case law. In *Hecht v. Malley*,[31] decided in 1924, the Supreme Court determined that a business trust was subject to an excise tax because it engaged in carrying on a business enterprise, an activity that was fundamental to the concept of an association. The *Hecht* case laid the foundation for treating all business entities as corporations or as partnerships. Eleven years later, in *Morrissey*,[32] the Supreme Court delineated the traits of a corporate entity for federal tax purposes in considering whether a state

5 IFA Cahiers 2014 - Volume 99B: Qualification of taxable entities and treaty protection.

6 OECD, Action Plan on Base Erosion and Profit Shifting (2013), available at http://www.oecd-ilibrary.org/docserver/download/2313331e.pdf?expires=1445371581&id=id&accname=guest&checksum=C84F838E300C58C9FB619F39E3909D53.

7 Reg. 301.7701.

8 Organization for Economic Cooperation and Development, The Application of the OECD Model Tax Convention to Partnerships: Issues in International Taxation 6 (1999).

9 Smith, note 2, *supra*, at p. 284.

10 *West's Encyclopedia of American Law, 2d ed.* (Thomson Gale, 2008). The definition is of "corporate" personality.

11 E.g., Smith, note 2, *supra*; Dewey, "The Historic Background of Corporate Legal Personality," 35 Yale Law Journal 655 (1926); Machen, "Corporate Personality," 24 Harvard Law Review 253 (1910).

12 Individuals can in fact have multiple "legal personalities." A person acting as trustee has a different legal personality than when she contracts on behalf of herself. The longstanding refusal of the IRS to acknowledge that an individual can be both a partner of a partnership and an employee of the same partnership is an anachronism traceable to ancient common law, before the concept of dual personality became accepted. See Smith, note 2, *supra*, at pp. 289-291 (Smith also points out some anachronisms prevailing in 1928, such as the fact that a partnership could not sue another partnership if they had a common member – derived from the view that a partner could not sue a partnership in which he is a partner.)

13 Micklethwait and Wooldridge, (Modern Library Chronicles 2005).

14 In Salomon v A Salomon & Co Ltd [1897] AC 22, a unanimous ruling upheld the doctrine of corporate personality, as set out in the English Companies Act 1862, such that creditors of an insolvent company could not sue the company's shareholders to collect the company's debts.

law trust created to develop a for-profit golf course was an association taxable as a corporation. In holding that the trust should be classified as a corporation under the federal tax law, the *Morrissey* court pointed to five traits that it associated with corporateness: (1) the ability of the organization to hold title to property; (2) the continuation of the organization regardless of the death of an owner; (3) "centralized management"; (4) free transferability of ownership interests in the organization; and (5) limitation of personal liability of the organization's members.

In applying *Morrissey*'s multi-factor test, it was clear that an entity did not have to display all the corporate characteristics to be classified as a corporation. In *Kintner*,[33] the IRS ran into some difficulty with the multi-factor test. *Kintner* turned on whether an association of doctors organized as a partnership for state law purposes should be treated as a corporation for federal tax purposes. The doctors had specifically structured the entity in order to use certain pension benefits that were available only to organizations classified as corporations for federal tax purposes. Citing the multi-factor test used in *Morrissey*, the court held that the entity at issue should be classified for tax purposes as a corporation because it possessed three of the five corporate traits:

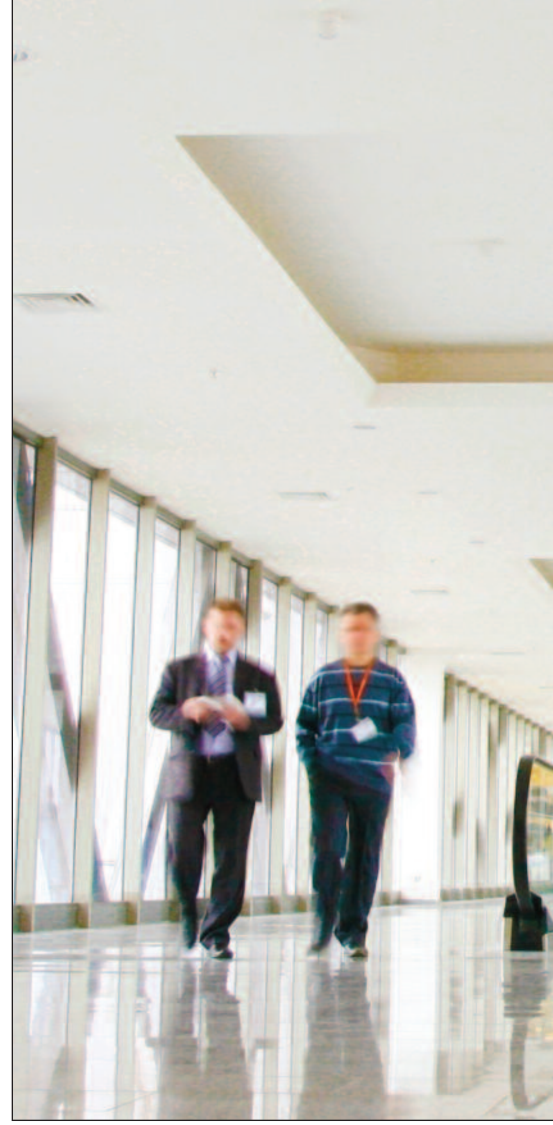
1. The organization held title to property.
2. The organization continued regardless of the death of an owner.
3. The organization provided for centralized management.

Further, the court specifically rejected any reference to state entity classification, reasoning that such a reference "would introduce an anarchic element in federal taxation if we determined the nature of associations by State criteria rather than by special criteria sanctioned by the tax law, the regulations and the courts."[34]

Unhappy with the result in *Kintner*, the IRS initially responded by issuing Revenue Ruling 56-23,[35] which rejected any precedential effect emanating from the decision. The Revenue Ruling was rescinded the following year and replaced by new entity classification regulations issued in 1960. Referred to as the "*Kintner* regulations," the newly-minted entity classification regulations listed six characteristics of an entity taxable as a corporation for federal income tax purposes: "(i) associates, (ii) an objective to carry on a business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests."

In applying the six factors, the regulations first sought to determine whether the organization being tested was a business entity or a trust. The absence of either of the first two factors would generally cause the organization at issue to be classified as a trust rather than as an association or business entity.[36] If an entity was a business entity, the regulations proceeded to determine if the entity was a partnership or a corporation. Characteristics common to all business entities were disregarded. Thus, in determining whether an entity should be classified as a partnership or as a corporation, the first two factors—presence of associates and a business objective—were ignored. An entity that had at least three of the remaining four corporate characteristics was classified as a corporation.

Many of the *Kintner* factors derive from common law understandings of what is entailed by "legal personality."



The first corporations had to raise capital from numerous investors, not all of whom could be managers of the business; hence centralized management. Investors deprived of management rights would naturally desire protection from personality liability beyond their investment; hence limited liability. It would be very inconvenient if the corporation were to dissolve simply because one of the investors were to fall off a ladder and die; hence continuity of life. And to raise capital in large amounts, it would have been

[15] RULPA § 303(a).

[16] ULPA (2001) § 303.

[17] See e.g., Naylor, "Is the Limited Liability Partnership Now the Entity of Choice for Delaware Law Firms?," 24 Del. J. Corp. L. 145, 156 (1999).

[18] See Donn, "Is the Liability of Limited Liability Entities Really Limited?," Limited Liability Entities (ALI-ABA, 2013), page 501.

[19] Delaware is a full-shield state, protecting partners from "any debt, obligation or other liability of or chargeable to the partnership . . . whether arising in contract, tort or otherwise" other than any liability arising from a partner's own negligence. Sometimes this bifurcation is explained in terms of liability protection from voluntary creditors vs. liability protection from involuntary/tort creditors. See Naylor, note 17, *supra*, at 162.

[20] ULPA (2001), ix.

[21] The LLLP form is prohibited in New York and California, although California allows a foreign LLLP to register and do business in state.

[22] Interpretive Bulletin IT-343R (Sept. 26, 1977).

[23] See Johnson & Lille, "The Taxation of Partnerships in Canada," Bull. for Int'l Taxation (Aug./Sept. 2009), CTF, pp. 381-394 (hereafter, Johnson & Lille).

[24] See e.g. R.S.C., 1985, c. 1 (5th Supp.), s. 95 (defining the term "specified person or partnership" by distinguishing the concept of personhood from an organization treated as a partnership); Uniform Law Conference of Canada, Uniform Income Trust Act (2008) ("Except to the extent otherwise provided in any other enactment, a trust or a mutual fund is not a body corporate or other legal person.") s. 4. See also Fredette v. R, 3 C.T.C. 2468 (Tax Court of Canada 2001) ("It must be borne in mind that a partnership is not considered as having separate legal personality either in common law or in civil law.").

[25] For a paper by a Dutch tax lawyer complementary to this article, see Molenaars, "The Tax Significance of Legal Personality: A Dutch

necessary to allow investors to transfer their shares to others; hence free transferability.

However, it will be noted that one of the *Morrissey* factors did not make the cut of the regulations: the ability of the entity to hold property. *Morrissey* was decided in 1935, when U.S. law still was wrestling with what effect, if any, to accord traditional legal personality concepts. In the end, the courts and the IRS appear to have recognized that since any type of entity, including a partnership, could own property in its own name, this factor was no longer determinative.

The four factors distinguishing a partnership from a corporation are, as this discussion will show, quite similar if not identical to the factors that other countries use to classify foreign entities. Limited liability is nearly universally taken as an indication of corporate status. In looking for the presence of limited liability, the regulations adopted an all or nothing approach pursuant to which limited liability is present only if "under local law there is no member who is personally liable for the debts or claims against the organization." By 1980, the rise of the limited liability company prompted the IRS to propose amending the regulations so as to make limited liability a sufficient condition or "superfactor" for classifying an association as a corporation. The proposed regulations were withdrawn two years later in the face of widespread criticism.

Free transferability of interests in the entity is another factor very commonly seen in many countries. It is related to the existence of fungibility of interests. The *Kintner* regulations found free transferability to exist only when an owner could transfer all legal rights as an owner, not just economic rights, to a third party. Thus, for example, an interest in a partnership would not be considered to be freely transferable if the assignor could not cause the partnership to admit the assignee as a partner.

Almost all countries that employ the fiction of legal personality take seriously the notion that the death or retirement of a partner results in an automatic dissolution of a partnership. The *Kintner* regulations' continuity of life factor is thus highly correlated with a finding of legal personality. However, continuity of life had long since been reduced to a formalism, as most state laws allow the remaining partners to reconstitute the partnership and continue its existence as though nothing had happened. No U.S. law firm, even before LLP statutes were introduced, took seriously the notion that the death or retirement of a partner had any effect on its existence.[37]

The last *Kintner* factor, centralization of management, does not seem as closely linked to legal personality, although as already noted, it is usually assumed that an entity possessing separate legal personality would be centrally managed. This factor was fairly easy to manipulate. To this day, tax advisors intent on drafting a partnership or LLC agreement in a fashion to convince a non-U.S. person that it is "corporate like" will engraft upon the agreement a board, even if they otherwise would not bother.

It will be noted that only one of the four *Kintner* factors, limited liability, can be derived from any positive rule of non-tax commercial law. Free transferability, continuity of life and centralization of management were each contractual provisions and thus susceptible to drafting. This was one reason that the *Kintner* regulations were replaced by the check-the-box regulations. Although many observers, within and outside the United States, mistakenly view the check-the-box regulations as unprecedented, apart from their recognition of disregarded entities, they were not. They represented merely the extension of the long-settled principle that U.S. entity classification for tax purposes is unrelated to commercial law labels.

B. Deemed Partnerships. Recall that the first step in U.S. entity classification analysis is to determine whether an entity exists or not. Under U.S. tax rules, it is relatively common to find an entity for tax purposes where none exists as a matter of non-tax law. If a given country believes that a partnership lacks legal personality, one might suppose that that country would have a robust concept of deemed partnerships. That is, if to be a partnership it is necessary to lack legal personality, then any arrangement clearly lacking legal personality, such as co-ownership of property, might seem to be a candidate for a partnership. Yet few countries outside the U.S. employ the

View," Tax Review No. 316 (12/15/2014) (unpublished).

26 14 IFA Cahiers 2014 - Volume 99B: Qualification of taxable entities and treaty protection: United Kingdom reporters Baldwin and Kiranoglu, at 836.

27 *Id.* at 839.

28 Smith, note 2, *supra*, at page 289.

29 Reg. 301.7701.

30 Reg. 301.7701-1(a)(1). In one very important respect, U.S. commercial law reigns supreme: an entity formed as a state law corporation will be classified as a corporation. The following discussion deals only with entities not taking the form of a state law corporation.

31 265 U.S. 144, 4 AFTR 3976 (1924).

32 296 U.S. 344, 16 AFTR 1274 (1935).

33 216 F2d 418, 46 AFTR 995 (CA-9, 1954).

34 *Id.* at 1001. This is an important observation. Because the income tax is a creature of federal law, it was early recognized that giving effect to the labels adopted by the 50 states whose laws governed entity formation would be impracticable.

35 1956-1 CB 598.

36 For some helpful background on the trust classification issue, see Gross, "Is It a Partnership or a Trust? Are We Done With This Issue?," Tax Forum Paper No. 660 (12/1/2014) (unpublished).

concept of a deemed partnership.[38] This would seem to be a conundrum.

U.S. tax jurisprudence distinguishing deemed partnerships from mere contractual arrangements or co-ownership arrangements illustrates the presumption in favor of finding an entity. It is very difficult for two or more co-owners of property to argue that their relationship doe not rise to the level of a partnership. In 2002, the IRS published Rev. Proc. 2002-22,[39] announcing that it had lifted its no-rule policy on the question whether an undivided fractional interest in real property (and only real property) is an "interest in a separate tax entity" for purposes of the like-kind exchange rules. The ruling set out in some detail the conditions under which the IRS would consider such a ruling, it being understood that most taxpayers requesting such a ruling would desire a ruling that there is in fact no separate tax entity. Even where the conditions are met, there is no safe harbor; the IRS will merely consider the question.

In order to avoid deemed partnership status, it must be shown that the co-owners of property do not engage in a business, even through an agent.[40] Even joint decision making—what one might call "corporate governance"—is sufficient to find that a co-ownership arrangement is a partnership for tax purposes.[41] As the Revenue Procedure stated, "where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes."[42]

U.S. tax law employs the concept of a deemed partnership to accord substance to certain types of contractual relationships that incorporate sharing of risk of loss and possibility of upside. The need to invent entities out of whole cloth may arise from assignment of income principles, another concept that most countries lack. U.S. law does not recognize attempts to separate income from the person who economically earns the income. Certain entities classified as partnerships may elect out of Subchapter K pursuant to Section 761. In general, the election out is limited to arrangements that do not rise to the level of an active trade or business. The key is that the owners are able to demonstrate that their income from the venture can be calculated without resort to the operating rules of Subchapter K, the most important of which is Section 704, which generally prevents the artificial shifting of income among partners. Section 761 thus further illustrates the strong presumption in favor of separate legal personality—although that term is never used—in the application of the federal income tax to joint undertakings.

Few other countries deem entities to exist solely for tax purposes. Thus, they have no need to perform the first step of U.S. entity classification, which is to determine whether an entity exists. Not only do other countries not "invent" entities, they often treat arrangements formed in fact as entities as non-entities. At least in part, this seems to be explained by a finding that these entities lack legal personality. However, it remains mysterious why a partnership is respected as an entity lacking legal personality, whereas some other arrangement, such as an investment fund, is not respected as an entity.

The mystery may be explainable by reference to whether a particular arrangement is used to conduct a business. As noted earlier, U.S. entity classification rules consider whether an entity is carrying on a trade or business to be relevant to whether the entity should be classified as a trust or a business entity; the conduct of a trade or business is inconsistent with trust classification. However, outside the United States, many countries seem to distinguish between a mere co-ownership agreement, not amounting to an entity, and a partnership based on whether the arrangement conducts a business. Moreover, many countries treat investing as not a business for this purpose.

The Netherlands and England view a passive investment vehicle such as a mutual fund as not a legal person;[43] the same is true in the case of a French fonds commun de placement and an Irish common contractual fund. England and Canada generally distinguish a partnership from an unincorporated association based on the notion that the latter is not formed to conduct a business.

A recent release from the United Kingdom sets out in detail the tax treatment of "authorized contractual schemes," what we might call investment funds.[44] The release is very interesting because it shows that, in England, an entity that clearly possesses every facet of what one would define as legal personality is nevertheless treated as lacking legal personality due solely to the labels placed on it. Moreover, the release states that these arrangements do not rise even to the level of a partnership—they are merely co-investment arrangements, and thus not entities at all.

There are two types of authorized investment schemes: a "co-ownership fund" and a "limited partnership." The release starts out with a statement that an authorized contractual scheme of either type is a tenancy in common that "has no legal personality." It then proceeds to contradict that claim on nearly every page.

First, an authorized contractual scheme has "units," a construct that seems inconsistent with what we might regard as a tenancy in common. Second, in the case of a coownership fund (but not a limited partnership), a sale

[37] The U.S. tax rules pertinent to continuity of life are schizophrenic. On the one hand, Reg. 1.736-1(a)(1)(ii) provides that after the death or retirement of a partner, the retired partner or his successor in interest is treated as a partner until his interest is completely paid out, a rule totally at odds with lacking continuity of interest, and incidentally of no local relevance to the non-U.S. partners of a global partnership. On the other hand, Section 708(b)(1)(B) deems a partnership to be terminated for tax purposes if more than 50% of the partnership interests are sold or exchanged over any 12-month period, a vestige of continuity principles often criticized as being antiquated.

[38] A contractual joint venture may be treated as a partnership in Canada, generally where it is not limited to the accomplishment of a specific purpose within a specific timeframe. Johnson & Lille, note 23, *supra*, at ¶ 2.3.

[39] 2002-1 CB 733.

[40] See, e.g., Rev. Rul. 75-374, 1975-2 CB 261.

[41] See, e.g., Bergford, 12 F. 3d 166, 73 AFTR2d 94-498 (CA-9, 1993).

[42] Rev. Proc. 2002-22 at § 2.

[43] IFA Cahiers 2014 - Volume 99B: Qualification of taxable entities and treaty protection: The Netherlands reporters de Graaf and Gooijer, at 560. The Dutch form of mutual fund, fonds voor gemene rekening or FGR, is a creature of the tax law rather than corporate law, much like U.S. RICs and REITs.

[44] http://www.hmrc.gov.uk/drafts/acs-manual.pdf.

[45] Canada also recognizes that a partner has a separate tax basis in her partnership interest, even though Canada insists that a partnership is not an entity but only a "relationship" between its partners. Johnson & Lille, note 23, *supra*, at ¶ ¶ 3.4, 3.5.

[46] Inoue & Katahira, Foreign Entity Classification in Japan, Tax Notes Int'l 335 (10/26/2015).

U.S. or the other country) and that they agree to split the income from the rental activity such that A is entitled to receive 100% of the cash flow until A has earned a certain threshold amount, whereupon B will become entitled to receive 100% of the cash flow until B has caught up with A, following which A and B will split cash equally. U.S. tax rules would certainly treat this arrangement as a partnership. But the other country might not deem this to be a partnership, perhaps because the arrangement is not organized under any law or because that country does not regard the mere ownership of a rental building to rise to the level of a business justifying a finding of an entity. Thus, instead of a partnership-corporation hybridity, we have a partnership-nonentity hybridity.

The next section of this discussion will examine how countries classify entities and the degree to which they apply the concept of legal personality in doing so.

of an asset by the fund does not result in the realization of any gain to the owner; the owner is taxed on her gain only when she sells "units."[45] This is inconsistent with any claim that the assets of the fund are owned by its beneficial owners rather than the fund itself, which one would think is fundamental to the lack of legal personality. Third, a co-ownership fund can be a party to a merger. It is unclear to this author how an entity that cannot own property can be a party to a merger.

The release states that an authorized investment scheme is a simple contract, but not a "partnership contract," which apparently would connote legal personality. This is true even for a scheme that takes the form of a limited partnership. Why the written document evidencing the existence of a limited partnership is not a "partnership contract" is a riddle. It is evident from reading the release that to a person in the United Kingdom, "has no legal personality" really just means "is treated as tax transparent because we said so."

In many if not most non-U.S. jurisdictions, the taxation of partnerships is very close to a pure aggregate approach, with results that are not very different from those that would be obtained under U.S. tax rules if the arrangement were treated as the mere co-ownership of property. The concept of legal personality as used outside the U.S. might be seen as a proxy for distinguishing between what the U.S. entity classification rules would call a "business entity" and what the U.S. rules would call no entity at all. Put differently, it may be helpful to think of a partnership in a country employing the legal fiction of legal personality as nothing more than a co-ownership arrangement that carries on a business, leaving all true entities to be classified as corporations.

The implications of this theory might be profound in terms of how hybridity between taxing systems can arise. Suppose that individuals A and B, one resident in the United States and the other resident in a second country, jointly own a rental building (which might be in the

III. Entity Classification Outside the United States

Countries fall along a continuum in whether and how they take legal personality into account in entity classification. A few countries apply a per se rule that equates "personhood" or legal personality with tax opacity, and reserves transparent treatment for entities that lack legal personality. Japan is one example of such a country. A recent article discusses a Japanese Supreme Court decision that classified a Delaware limited partnership as a corporation for Japanese tax purposes.[46] The authors explained that the court employed a two-step test. It first asked whether the foreign entity was clearly the same as a Japanese corporation, and concluded that a Delaware limited partnership is not clearly the same. It then asked whether the foreign entity is an entity "to which rights and obligations are attributable." That is, the second step asks whether the entity has legal personality.

Others countries count legal personality as one factor in classifying entities, but not the sole factor. (Canada's approach was relaxed from the first, per se, approach to a factors test after the episode involving U.S. general partnerships described below in Part V. A of this article.) Still other countries, including but not limited to the United States, simply ignore the concept of legal personality.

One important difference between the U.S. tax approach to entity classification and the approach used in other countries is that other countries generally undertake the task only to classify *foreign* entities.[47] Many countries approach the task of classifying foreign entities by comparing enumerated characteristics of foreign entities with those of domestic entities and attempting to determine whether a foreign entity is "more like" a domestic entity treated as an opaque corporation or "more like" a domestic partnership treated as transparent. Countries that employ factors tests use these as a guide in making comparability determinations.

The assumption underlying the comparability approach is that it is possible to make analogies between a domestic entity and a foreign one. So, for example, if a German lawyer is trying to decide whether a particular U.S. limited liability company is more like an opaque German corporation or more like a transparent German partnership, she will examine the LLC law in question and usually also examine the particular provisions of the LLC Operating Agreement in an effort to ascertain whether the U.S. LLC is "more like" one or the other. An obvious shortcoming of this approach is that it is hardly useful when the entity encountered bears no resemblance at all to any local entity, such as a common law trust from the point of view of a civil law country like Germany. A country that insists on trying to ascertain whether, say, a U.S. partnership has legal personality based on its examination of U.S. law (as The Netherlands explicitly does, and Canada once did), is doomed to arrive at an imperfect answer, given that U.S. law doesn't accord significance to the concept.

Four "factors" regimes are worth mentioning here. Canada employs the four *Kintner* factors plus legal personality. As has already been noted, however, Canada takes the view that a partnership lacks legal personality even where it clearly owns assets in its own name, and can sue and be sued in its own name. It thus appears that Canada may be applying stricter tests to foreign entities than it does domestically. Alternatively, it may simply be that the legal personality factor is redundant of the *Kintner* factors.

Germany takes into consideration all four *Kintner* factors plus four more, reserving the right to consider other factors as it deems necessary. The four additional factors are:

1. Allocation of profits.
2. Provision of capital.
3. Profit distribution.
4. Formal requirements for organization.

Note the absence of any reference to legal personality in the German list. This may be because Germany, like the United States, has a long tradition of using partnerships to conduct business operations.

The Dutch tax authority publishes a list showing the presumptive tax classification of selected foreign entities. The Dutch base this list on a four-factor test, but the list is not considered final or definitive. Under Dutch rules, an entity is generally considered non-transparent if it possesses at least three out of four indicative factors, which are:

1. Whether the entity can hold legal title to the assets of the business (legal personality).
2. Limited liability.
3. Free transferability.
4. Whether capital is divided into shares.

Like the old *Kintner* regulations, the Dutch four factors are on the face of things weighted equally. However, a fairly recent Dutch court case involving a U.S. LLC seems to have adopted a per se rule. In that case, that country's Supreme Court ruled that a U.S. LLC was non-transparent for Dutch tax purposes.[48] Among other things, the court found that the business of the LLC was not conducted "for the risk and account of the members."

Following this case, the Dutch tax authority adopted a special rule pursuant to which an entity will be treated as opaque if (1) it owns its own assets, (2) it confers limited liability on all of its members, and (3) the business was not carried on at the risk and account of the members. The first of these factors restates the legal personality test.

When it comes to the tax treatment of a locally-formed entity such as a CV, the Dutch rules turn almost exclusively on the presence or absence of free transferability. A CV in which the partners can freely transfer their interests will be classified as "open" and generally taxed as a separate entity, whereas the absence of free transferability will cause the CV to be treated as a tax-transparent "open" partnership.[49]

Taking these two observations together, one can conclude that the Dutch entity classification rules are

47 England seems to be unique in that it does not have clear rules applicable to either domestic or foreign entities.

48 Supreme Court 2 June 2006, no 40919, BNB 2006/288.

49 These rules are surveyed by Molenaars, note 25, *supra*.

50 IFA Cahiers 2014 - Volume 99B: Qualification of taxable entities and treaty protection: United Kingdom reporters Baldwin and Kiranoglu.

51 Memec Plc v. IRC [1988] STC 754.

52 U.S. readers will recall the fussing in the 1980s when MLPs first began appearing in the public markets. There was a great deal of concern over provisions such as Section 704(c) and Section 754, which can render partnership interests not fungible. Although this problem has never been solved, the public markets appear to have adapted to it.

53 UKSC 44 (July 1, 2015).

54 Revenue and Customs Brief 15 (Sept. 25, 2015).

not as objective as they first appear. For foreign entities such as U.S. LLCs, there seems to be a hidden per se rule that turns on limited liability. For Dutch entities such as CVs, there seems to be a hidden per se rule that turns on free transferability. Perhaps the broader conclusion is that The Netherlands reserves the right to adopt tax classification rules that deviate from non-tax forms, just as the United States does.

The entity classification tests set out under English law appear at first to a U.S. observer to be vague, subjective, tautological and circular. A recent article[50] listed only three main questions pertinent to the analysis:

1. What is the nature of the entity?
2. What is the nature (income or capital) of a value flow from an entity?
3. Has the entity affected a value flow, so that UK tax law sees the value flow out of the entity as different from the inflow?

Fortunately we have a bit more to go on. An English court case involving a German "silent partnership" led the U.K. tax authority to issue guidance listing six factors to be taken into account in determining whether an entity is opaque or transparent for tax purposes.[51] These are:

1. Does the foreign entity have a legal existence separate from that of the persons who have an interest in it?
2. Does the entity issue share capital or something else, which serves the same function as share capital?
3. Is the business carried on by the entity itself or jointly by the persons who have an interest in it that is separate and distinct from the entity?
4. Are the persons who have an interest in the entity entitled to share in its profits as they arise; or does the amount of profits to which they are entitled depend on a decision of the entity or its members, after the period in which the profits have arisen, to make a distribution of its profits?
5. Who is responsible for debts incurred as a result of the carrying on of the business; the entity or the persons who have an interest in it?
6. Do the assets used for carrying on the business belong beneficially to the entity or to the persons who have an interest in it?

The first and last factors appear to this author to implicate the concept of legal personality. The first factor is tautological by its own terms. The last is a proper inquiry into traditional concepts of when legal personality can be said to exist.

It will have been noted that a factor used by The Netherlands and England, and by implication in Germany, is whether the entity has capital divided into shares. Other countries also employ this concept, and indeed it is encountered quite frequently. It may be thought that a hallmark of corporate status is that each share of a given class entitles the holder to exactly the same economics and is fungible with every other share of that class. Having capital divided into shares ensures fungibility, which is generally thought necessary to promote free transferability of interests.[52]

Another factor that seems important under German law, and is certainly important in the United Kingdom, is whether the owners of the entity are entitled to profits "as they arise." The clearest formulation of that factor is that if a board or similar body has to declare a dividend before an owner becomes entitled to anything, one is in the presence of a corporation. In contrast, the owners of a partnership own the profits whether or not they decide to distribute them. Given that this is so, it makes sense to tax them on the profits whether or not distributed, since they already belong to the partners.

However, there is a subtlety to the "as profits arise" test that can easily confuse taxpayers and tax administrators from different countries. Under the traditional formulation of a partnership lacking legal personality, its profits really did belong to the partners as they arose, because the partners had the right of partition. Since the partners owned the assets, they of course were entitled to the profits earned on those assets. In essence, the partnership, not being an entity separate from its partners, did not come between them and the fruits of their enterprise.

Although U.S. tax lawyers would readily agree that partners are taxable as profits arise, that is not the same thing as saying that they are entitled to the cash profits as they arise. Most partnership agreements provide for distributions to the partners only under certain circumstances. Indeed, it would be nearly impossible to run a business in partnership form if the cash profits actually belonged to the partners as they arose; for one thing, it would be difficult for a partnership to borrow. So it may well be the case that U.S. partnerships are not entities in which the owners are entitled to profits as they arise.

The significance of being taxable on profits as they arise is well illustrated by a fairly recent English case. The case, *Anson v. Commissioners for HMRC*,[53] concerned the U.K. tax classification of a U.S. LLC. It involved four decisions: first that of the First-tier Tribunal (the FTT), second on appeal by the government to the Upper Tribunal, third on appeal by the taxpayer to the Court of Appeal, and finally on appeal by the government to the Supreme Court. Following the Supreme Court's decision in favor of the taxpayer, which essentially treated the LLC as tax-transparent, the government issued a response in which is announced that the holding was limited to its facts and that the government would not change its approach to U.S. LLCs, generally treating them as corporations.[54]

Mr. Anson was a member of an LLC, taxable as a partnership in the United States, that was the management company for a U.S.-based investment fund. He was not a U.S. resident, and was resident in the United Kingdom only on a nondomiciliary basis. He paid U.S. tax on his income earned as a partner and sought credit for such tax against the U.K. tax he paid when the profits were remitted to him.[55] The Upper Tribunal had denied a foreign tax credit to Mr. Anson based on a finding that the LLC was a "body corporate" that paid no taxes and hence was not a qualified resident. The case turned largely on the "profits as they arise" factor. The Upper Tribunal was unconvinced that the owners of an LLC became entitled to profits as they arose—notwithstanding the fact that this is exactly what U.S. tax law provides. The judge was not interested in U.S. tax law, but in Delaware "corporate" law. He interpreted the LLC operating agreement as a contract, not the charter of a legal entity. According to a summary of the holding, the taxpayer/owner "must show that the contract is actually the source of the profit, rather than a mechanism to secure a right to a profit derived from another source. This in general will mean he has to show a proprietary right to the profits as they arise."[56]

This is difficult language for a U.S. English speaker to understand, but the gist of it has already been hinted at above. The court was looking to find in Delaware law some provision that made the members the owners of the entity's profits without more. Not surprisingly, the court did not find it. Delaware state law, of course, does not specifically provide that the entity's income belongs to its members "as it arises." The most that Delaware law provides, as the Supreme Court found, is a definition of the term "limied liability company interest" that refers to a member's share of the profits and losses of the LLC.[57] It is U.S. federal tax law that provides for this result.

The Supreme Court, like the FTT, recognized that there is a spectrum of legal personality within which entities fall. And the courts conceded that an LLC has more in the way of legal personality than an English partnership. Ultimately the Supreme Court upheld the FTT's findings that under Delaware law the profits of the LLC belonged to its members as they arose. This could be viewed as a rejection of the significance of legal personality to the entity classification issue. Alternatively, it could be viewed as a mistaken reading of Delaware law. In the latter case, the Supreme Court may have understood the emptiness of an exercise that would decide cross-border tax questions by relying upon concepts such as legal personality that have no significance in the other country.[58]

Having surveyed the ways in which entity classification rules incorporate the concept of legal personality, this discussion will now turn to the question of why many countries give effect to legal personality in distinguishing corporations from partnerships.

IV. Why is Legal Personality Linked to Tax Transparency?

As we have seen, some countries include the existence, or not, of legal personality as a factor in determining whether a foreign entity is tax transparent or not. Some countries appear to treat legal personality as a "super factor" leading invariably to corporateness and nontransparency. In either case, the question is why they do so.

A. Civil Law vs. Common Law? One possible theory is that civil law countries may be more likely than common law countries to link legal personality to opacity. It is fairly well understood that civil law countries place greater weight on the state's protection of creditors than do countries like the United States, where economic actors are expected to exercise their own due diligence and judgment. The intuition here might be that if a country is interested in protecting creditors from extending loans to entities that themselves cannot own property or be sued, it would deny legal standing to entities lacking legal personality. In the United States, if a lender wished to extend credit to a partnership borrower, it is expected to protect its interest by private contract, seeking security in partnership assets or through guarantees by one or more partners.

However, any such correlation is fairly easily refuted by noting that England, Canada, and Australia, all common law countries, seem to accord great weight to legal personality. Moreover, Germany, a civil law country, seems quite able to accord tax transparency to partnerships that possess what most would regard as legal personality. These observed facts refute any obvious linkage between civil law countries and linkage to legal personality.

B. Form over Substance? There may be a correlation between according meaning to legal personality and having a tax system that accords more weight to legal formalities than to economic substance. The whole concept of legal personality appears to have become a merely formal one that does not really explain why countries classify entities as they do. Perhaps there is nothing more to it than emphasis on form and the type of papers filed.

There are different kinds of formalism built into different tax systems. One kind of formalism that seems very closely linked to legal personality concepts is where a country's tax laws treat as the owner of assets the person who holds pure legal title, rather than the person we would see as having "the benefits and burdens of ownership." The Netherlands in particular appears to give great weight to how legal title to property is held, and does not employ the concept of benefits and burdens of ownership—tax ownership—in the way that the U.S. does. A Dutch CV, lacking legal personality, does not own its own assets. Instead, legal title to its assets is held by its general partner.

This is difficult for a U.S. tax lawyer to understand. If the CV does not own its assets, how is it able to conduct its business? How is it able to borrow? How can it meet payroll? Given that the CV has a business to run, it is tempting for a U.S. observer to suppose that, in substance, the general partner holds legal title to the CV's assets in trust for the real beneficial owners of the business, being all of the partners.

This suggests that there may be a link between giving effect to pure legal (as opposed to beneficial) ownership and recognition of the concept of legal personality.

C. Treating a Partnership as a Pure Aggregate. Although difficult to prove, observation suggests that countries

that condition tax transparency on the absence of legal personality tend to have tax rules that apply pure aggregate theory to partnerships. This does not seem surprising. If a tax system takes seriously the notion that a partnership lacks legal personality, it will view the relationship between the partners as very close to, if not identical to, co-ownership. This is not the way Subchapter K of the Code has evolved. Subchapter K is a blend of "aggregate" and "entity" principles for taxing partners, each of which co-exist with the notion that a partnership has a legal personality separate from its partners.

As has been noted, several countries look to whether the entity's interests take the form of "capital divided into shares," and some seem to equate this trait with legal personality. There are two ways of thinking about the significance of this factor. One is to posit that in most countries recognizing tax-transparent partnerships, it will be assumed that all allocations of income must be straight up, as they would be in a co-ownership arrangement. Thus, to have capital divided into shares permits non pro rata allocations by creating separate classes of shares.

The other way of thinking about capital divided into shares is to start from the observation that when an entity has capital divided into shares, non pro rata allocations of the entity's income to its owners is possible only by creating separate classes of shares. In a partnership, however, non pro rata allocations are possible and, at least in the United States, common, and as a tax matter it is actually impossible to have capital divided into shares.

Although the drafter of a partnership or LLC agreement can dress up the partnership interests as "units," U.S. tax law, at least, will give no effect to such drafting. A partner can have only one capital account for tax purposes, and all the partnership math is premised on one common basis in an indivisible partnership interest.

A recent ruling from the Chinese tax authorities supports the second approach.[59] A Taiwan corporation owned an interest in a foreign investment partnership (FIP) (set up in an unspecified country outside of China) through two wholly owned entities. One wholly owned entity was a Hong Kong company that was a 99% limited partner in the FIP. The other wholly owned entity was a Chinese company that held a 1% interest as general partner. The Hong Kong limited partner received a distribution from the FIP. It took the position that the distribution was a dividend from a company. But the Chinese tax authority took the position that the distribution was instead a distribution of business profits from a tax-transparent entity and thus not a "dividend."

The theory espoused by the Chinese tax authority in this case was the same theory that U.S. law would apply to a foreign partner under Section 875. But to apply that theory, one must first conclude that the underlying entity, in this case the FIP, is a partnership. In determining that the FIP was tax transparent, the Chinese tax authority cited three findings. First, it referred to the fact that in the case at hand, profit allocations were non pro rata, being based on the partnership agreement rather than on a straight up corporate model.

If having capital divided into shares is a hallmark of legal personality, then one might conclude that U.S. partnerships uniformly lack legal personality, despite being the legal owners of their own assets. Partnerships and LLCs in the United States are characterized by differences in capital accounts; it is very common for a partner to be awarded

55 Although the courts do not seem to mention it, it seems as if the real problem in this case was that Mr. Anson was subject to tax in the United Kingdom only on a nondomiciliary basis, a concept that does not exist in the United States. Thus, although he was taxed in the United States on the LLC's profits "as they arose," he did not report income on that basis in the United Kingdom by virtue of the nondom rules.

56 IFA Cahiers 2014 - Volume 99B: Qualification of taxable entities and treaty protection: United Kingdom reporters Baldwin and Kiranoglu, at 850.

57 Del. Limited Liability Company Act, Section 18-101(8).

58 For a good summary of the case, see Johnson, "The *Anson* Decision - Transparency and Opacity," Tax Notes Int'l 431 (11/2/2015).

59 For a description, see "Foreign Company Subject to 25 Percent Enterprise Income Tax," Tax Notes Int'l 33 (10/6/2014).

an interest in profits only, to have a preference on distributions or to have economic shares shift upon the meeting of prescribed milestones. This of course cannot be replicated in a corporation.

D. Legal Personality as a Proxy for Public or Widely-Held Ownership. There is evidence suggesting that when a country speaks in terms of legal personality being important to tax classification, what the country may really mean is that it is too difficult to treat publicly held or widely held entities as tax transparent. The concept of legal personality may be employed to distinguish those entities that are capable of having, or likely to have, many unrelated owners unknown to one another from entities whose owners are known to one another and thus capable of acting as something like mutual agents.

Although being widely held or publicly traded was not traditionally a factor in classifying entities for U.S. tax purposes, it is well understood that some of the traditional *Kintner* factors tended in this direction. In particular, free transferability and centralization of management are characteristics of widely-held companies and less often seen in closely held businesses. While these characteristics were eliminated by the check-the-box regulations, the elimination was made easier by the intervening enactment of Section 7704 of the Code, classifying certain publicly traded partnerships as corporations. Today, the list of "per se" foreign entities treated as corporations includes mainly those entities thought to be capable of being publicly traded.

The factor of free transferability seems highly correlated to the finding, in other countries, of legal personality. If I can transfer my ownership interest to a stranger, it is unlikely that my interest represents an interest in a close corporation among persons who know each other and have come together as partners. Moreover, free transferability is closely related to fungibility of interests, a factor usually deemed critical to a publicly traded corporations. The intuition behind free transferability is that where it exists, the entity is sufficiently remote from it owners that it is right to tax it as an entity separate from its owners; hence, "legal personality."

There is almost certainly a connection between the way in which a particular country classifies entities for tax purposes and they way in which it regulates publicly traded or widely held companies. A U.K. LLP, for example, is required to maintain audited public accounts; this is not true of a U.S. partnership. Although a U.K. LLP can be treated as tax transparent, it is said to possess legal personality. This seems to be a case of an entity that the state reserves the right to audit and regulate as a widely-held entity, but that can be a pass-through if it meets certain conditions.

E. Conclusion. To some extent, the theories set out above support the view that a corporation must have, or is characterized by, legal personality. This is consistent with the *Kintner* regulations, which were derived from traditional ideas of what distinguished a corporation from a partnership, which ideas were certainly related to the concept of legal personality. However, none of the theories set out in this Part IV seems capable of explaining why so many countries continue to insist that a partnership must lack legal personality. And this seems to be the central paradox—just because we can all agree that an entity treated as a corporation has legal personality, why must it be that an entity treated as a partnership must therefore *lack* legal personality? Why can't a partnership have legal personality, but differ from a corporation in other ways?

Countries have in fact made strides in de-emphasizing legal personality, at least as applied to foreign entities. But as long as the conceit survives, taxpayers and their advisors will struggle with the practical consequences.

V. Practical Problems with Legal Personality (Or the Lack Thereof)

A. Qualification Conflicts. It is a perfectly legitimate exercise of a taxing state's powers to decide upon whatever entity classification rules, including a per se rule based on legal personality, seem best to its own purposes, so long as those rules are applied internally. A given country may decide that the existence or non-existence of legal personality is important in distinguishing entities that are opaque from those that are transparent for tax purposes. But

when these criteria are applied to foreign entities, and the foreign country's rules incorporate no such distinctions, one is sure to encounter hybridity.

In 2000, a Canadian government official discovered that a general partnership formed under Delaware's newly-revised version of RUPA possessed legal personality. In July of 2000, Canada announced that Delaware general partnerships would henceforth be treated as corporations, with the result that—because partnerships do not pay taxes at the entity level—treaty benefits would be denied to U.S. persons investing in Canada through such partnerships.[60] Predictably, uproar ensued. It was pointed out that all U.S. partnerships, regardless of the state in which they were formed and regardless of whether they were general or limited partnerships, possessed legal personality in the sense "discovered" by Canada in 2000. And that this had been true long before the 1980 tax treaty between the U.S. and Canada was signed.

Following this incident, Canada relented. In November of 2000, it was announced that henceforth Canada would

not apply the legal personality criterion to partnerships formed under U.S. uniform partnership laws.[61] It took ten years for a new protocol to the treaty to be approved, extending the same courtesy to U.S. limited liability companies (but only to the extent owned by U.S. residents). Ironically, after the new protocol was adopted, the Tax Court of Canada decided, at least on the facts before it, that the protocol wasn't needed. In *TD Securities (USA) LLC v. Her Majesty the Queen*, 2010 TCC 186 (4/8/2010), the court held that a U.S. LLC must be considered to be a resident of the U.S. for purposes of the treaty. In so deciding, the court respected the LLC as a separate legal entity having a legal personality distinct from its members. It thus tested residence for treaty purposes at the entity level. However, it sensibly overcame the objection of Canada that the LLC was not taxable at the entity level, and therefore could not qualify as a resident under the treaty, by holding that the LLC "must be considered to be liable to tax in the US by virtue of all of its income being fully and comprehensively taxed under the US Code albeit at the member level."[62] In essence, then the court determined that having separate legal personality was irrelevant to the tax classification of an LLC, albeit only for the limited purposes of the U.S.-Canada treaty. In this sense, the Canadian case is similar to the *Anson* case in England.

As noted earlier, most countries that apply comparability tests to determine the entity classification of non-local entities are not so rigid as to insist that legal personality is the sole determinative factor. Nevertheless, the application of any type of comparability test risks creating hybridity absent taxpayer planning.

B. Treaty Benefits. A common question is whether an "entity" lacking legal personality in its home country may claim benefits under a tax treaty, such as protection from taxation absent a permanent establishment. One might suppose that such an entity could never be a resident of its own country. However, this seems not to be the rule in practice. Many U.S. tax treaties specifically provide for benefits to accrue to entities, such as a French fonds commun de placement, that very clearly lack legal personality at home. Yet absent a specific rule in the treaty, this question will often be unclear.

C. Misallocation of Income. In a recent German case, seven doctors organized a practice in Abu Dhabi as a partnership. Before the venture was established, one of the partners retired. Under traditional partnership principles prevailing in Germany, the partner's retirement dissolved the partnership.[63] Nevertheless, a new partnership was formed to continue the business. Following the legal fiction that a partnership terminates when a partner retires, the court treated the start-up expenditures incurred by the prior partnership as sunk costs that could not be recovered by anyone—as expenses of a "failed" enterprise. There is no indication that the court considered the possibility that the expenditures incurred by the prior partnership might be taken into account by the reconstituted or "successor" partnership, very probably because the notion of predecessor or successor partnerships would not occur to anyone who believed that a partnership must lack legal personality.

Here, as it does generally, U.S. tax law looks to economics and substance, not to legal fictions. Doing so not only gets the right result, it can protect the IRS against whipsaw by taxpayers. For example, in *Madison Gas & Electric Co.*,[64] the taxpayer argued that it should be entitled to deduct certain costs associated with a joint venture, on the ground that had it incurred those costs in its own trade or business, they would have been deductible as ordinary and necessary business expenses associated with the expansion of its existing business. The Tax Court and Seventh Circuit disagreed, finding that the venture was a deemed partnership. Since a partnership is an entity separate from its partners with its own distinct business, the costs incurred by the taxpayer as a partner of the deemed partnership were treated as costs of the partnership in establishing a new business, and were required to be capitalized.

Thus, in this type of case, income may be allocated differently for U.S. and non-U.S. tax purposes, resulting in mismatches of the type that government are trying to minimize.

D. U.S. Estate Tax Issues. Although U.S. federal income tax principles generally ignore the concept of legal personality, U.S estate tax rules might give the concept some effect. A nonresident alien decedent is subject to U.S. estate tax only on property located within the U.S. The situs of corporate stock is the place of incorporation of the issuer. With respect to partnerships, however, it is unclear—and has been so for many years—whether a nonresident's estate includes the partnership interest itself or looks through the partnership to its assets, and if the former, how to determine the situs of a partnership interest.[65]

60 The Canadian revenue authority issued a technical interpretation (TI) referring to the earlier TI cited at note 22, *supra*. See "Revenue of DRUPA," 8 Canadian Tax Highlights 57 (August 29, 2000).

61 See "Revenue's New DRUPA Position," 8 Canadian Tax Highlights 89, 12/27/2000. See also Johnson & Lille, note 23, *supra*, at ¶ 2.2.

62 2010 TCC at 247.

63 BFH, decision of 12/26/2014, I R 56/12, BStBI.II 2014, at 703. This citation and the text are taken from Kramer, "German Tax Treatment of Expenses for a Foreign PE That Fails, Tax Notes Int'l 709 (11/24/2014). That author was focused on a different issue and did not notice the irony of his title—the permanent establishment did not in fact fail; all that occurred was that one partner retired.

64 633 F. 2d 512, 46 AFTR2d 80-5955 (CA-7, 1980), aff'g 72 TC 521 (1979).

65 For further background on the great uncertainty in this area, see Cassell, Karlin, McCaffrey, and Streng, "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests," 99 Tax Notes 1683 (6/16/2003).

The position of the IRS appears to be that it is the partnership interest, and not the partnership's assets, that is subject to being included in the estate.[66] The IRS also appears to believe that the situs of the partnership interest is the place where the partnership conducts its business. There is no indication of what rule to follow if the business of the partnership is conducted in more than one country, as for example would be common in law firms and other service partnerships.[67]

It is likely that the situs of a partnership interest would not be determined the way the situs of stock is determined, by the place of formation of the issuer. The reason for the different treatment is not so much that a partnership lacks legal personality, but rather that a partnership, because it is not subject to tax at the entity level, is relatively indifferent to its place of incorporation. In theory all partnerships could be established in the Cayman Islands, effectively negating any estate tax based on place of formation. However, the "residence" of a partnership is generally where its business is carried on, at least for certain income tax purposes,[68] so a place of residence rule is similar to what appears to be the current position of the IRS.

To the extent one takes the view that a partnership has legal personality, and that this is somehow meaningful, it might follow that a partnership interest of a nonresident should never be subject to estate tax at all. The theory would be that the interest in the partnership is intangible property similar to stock, but that unlike stock of a corporation, it has no situs other than the domicile of the decedent. The opposite approach would be to disregard the existence of the partnership entirely and tax a nonresident as if he or she owned a proportionate share of all partnership assets. The obvious difficulty with this approach is that it would be very difficult to apply and to audit in the case of widely-held partnerships with assets all over the world.[69]

There exists law suggesting that whether the situs determination is made with respect to the partnership interest or with respect to the underlying assets of the partnership may turn on whether the partnership has legal personality, at least in the sense that the partnership can continue even after the death of a partner. This is another area where differences in the source and taxing rules of different countries can lead to double taxation or double nontaxation.

E. Payments by Partnerships. If an entity such as a partnership cannot own its own assets, it seems to follow that the source of any payment by such an "entity" must be determined as if the payment were made by the partners. A pure aggregate theory would similarly treat a payment by a partnership as a payment by its partners. This approach can lead to somewhat odd source rules.

In Canada, for example, where partnerships are said to lack legal personality, a payment made in form by a partnership is sourced by the residence of its partners. Where source derives from the residence of the payor, such as interest, this approach means that if some partners are Canadian resident and other are not, a payment by the partnership has mixed source.[70] Similar rules apply in Belgium, another country that conditions tax transparency on the lack of legal personality.

In contrast, in the U.S., where a payment by a partnership is generally respected as a payment by a separate entity, the payment in this case would be sourced by the residence of the partnership. It must be noted, however, that U.S. source rules in this instance are somewhat confused, owing to the fact that the "residence" of a partnership is often irrelevant. That is, while a partnership may be an entity, it is still tax transparent such that its residence should by rights be irrelevant.[71]

F. Attribution of Activity. A country that insists that a partnership lacks legal personality is likely to treat anything the partnership does as being done by the partner. While this is an approach that U.S. tax law generally follows even where a partnership possesses what everyone would agree is separate legal personality,[72] the approach might be taken much further. For example, under Canadian law, if a partnership lacking legal personality borrows, that borrowing may be imputed to the partners for non-tax purposes.[73] Since under certain Canadian statutes it is illegal for certain types of entities to borrow, this can pose real practical issues. The problem, I am told, would not exist where it is clear that a partnership has separate legal personality, as it then would be considered to be borrowing in its own name.

G. How Does U.S. Law Apply? It is sometimes asked whether an entity can be a "business entity" eligible to check the box under U.S. entity classification rules if the foreign country under whose laws it is created does not recognize it as an "entity" and insists that it is a mere contractual arrangement without legal personality. The answer is that U.S. principles should apply, and that the entity is an entity and can make an election. It should be clear that what constitutes a "business entity" for purposes of U.S. classification rules is a matter of U.S. law only.

The IRS has issued several private rulings stating that foreign entities such as a fonds commun de placement, not treated locally as entities at all, are business entities that can check the box to be classified as corporations or as partner-

66 Rev. Rul. 55-701, 1955-2 CB 836. Because this ruling was interpreting a treaty, it is unclear whether it represents the view of the IRS more generally.

67 Perhaps fortunately for partners of global firms, an interest in a services partnership rarely has any ascertainable value, and what value it might have would almost always be zero at death.

68 Section 861(a)(1)(B).

69 The author and many others have criticized Rev. Rul. 91-32, 1991-1 CB 107, on this and other grounds. See, e.g., Blanchard, "Rev. Rul. 91-32 May Be Granted Authority – 20-Plus Years Late," 41 Tax Mgmt Int'l J. 237 (May 2012).

70 IFA Cahiers 2014 - Volume 99B: Qualification of taxable entities and treaty protection: Canada reporters Bunn and Johnston, at 182. Notwithstanding that Canada applies this pure aggregate approach to payments by partnerships, Canada will not accord treaty benefits to foreign corporations that receive Canadian source dividends through a partnership, insisting that the shares of the Canadian corporation are "owned" by the partnership and not, as the treaty requires, by the foreign corporation. *Id.* at 183. Note also that the anti-hybrid provisions of Article IV(7) of the U.S.-Canada tax treaty apply only when a payment by a hybrid is treated "the same as" a payment by a non-hybrid. It is reputed to have been a surprise to the Canadian competent authority when it discovered that, under U.S. tax rules, a payment of interest by a partnership is "the same as" the payment of interest by a corporation, such that the anti-hybrid rule did not apply in the case of a hybrid treated as a partnership in the United States.

71 For some tax fun and games with the "residence" of a partnership, see NYSBA Tax Section Report 1124, "Differences in Tax Treatment of Domestic and Foreign Partnerships" (2006).

72 See, e.g., Sections 875 and 512(c).

73 Wildenburg Holdings Ltd. v. Ontario, 98 DTC 6462 (Ontario Court of Justice), upheld 2001 DTC 5145 (Ontario Court of Appeal).

74 Regs. 1471-5(e)(1)(ii), -5(e)(3).

75 As noted above, the Dutch classification chart treats similar entities formed in different states differently. Other countries do the same, whether formally or informally.

ships. In effect, these are deemed partnerships. (A recent deemed partnership ruling, PLR 201305006, entailed the difficult question of whether a deemed partnership is domestic or foreign.)

The principal conundrum faced by U.S. tax advisors confronted with entities that the foreign country believes lack legal personality is that the foreign country does not regard the entity as actually owning its own assets. Instead, the general partner or trustee or some similar actor is treated as the legal owner of those assets. Because U.S. tax rules applicable to most types of entities, including all partnerships, are written on the assumption that the partnership and not the partners is the tax owner of partnership assets, some odd questions can arise. Two of these are described below.

1. FATCA. FATCA requires the identification of "foreign financial institutions" (FFIs) as well as "non-financial foreign entities." The terms "institution" or "entity" are not generally defined. One type of FFI is a "custodial institution," defined as an entity that "holds, as a substantial portion of its business . . ., financial assets for the benefit of one or more other persons."[74] If an investment fund is set up in a country like Guernsey, where the general partner is treated as the legal owner of the fund's assets, the question arises whether the general partner is an FFI by reason of holding financial assets for the benefit of the limited partners (or the partnership itself).

These types of questions should be resolved by adopting the U.S. view of an arrangement, not the local view. In the case of a Guernsey partnership, for example, one would conclude that the partnership itself is clearly an FFI. That conclusion depends upon an assumption that the partnership actually owns its own assets, which is true if and only if U.S. principles are applied to this simple case.

2. Section 956. Suppose a U.S. multinational sets up a CV in The Netherlands and makes a check-the-box election to treat it as a corporation for U.S. tax purposes. This makes the CV a "controlled foreign corporation" (CFC). The CV will have at least two partners, usually one general partner and one limited partner, both of which will be 100% owned by the U.S. multinational. In most cases, the two partners will be disregarded entities.

A pledge of any assets of a CFC to support debt of its U.S. parent triggers a deemed dividend under Section 956, although the U.S. parent may pledge up to 66% of the stock of a CFC without triggering that rule. Therefore, it is common for the U.S. parent to pledge 65% of the interests in each of the general and limited partner entities owning the CV. From a U.S. tax perspective, this is the equivalent of the U.S. parent pledging 65% of the stock of the CV, a CFC.

The U.S. parent might become concerned when Dutch counsel announces that the general partner entity "owns" all the assets of the CV. If that fiction were respected for Section 956 purposes, the pledge of 65% of the stock of that entity would be a pledge of assets, rather than a pledge of stock. It would give rise to a Section 956 inclusion to the full extent of the earnings and profits of the CFC.

Again, it seems relatively clear that in applying Section 956, the U.S. would not respect foreign legal fictions that are inconsistent with U.S. legal fictions.

VI. Self-Help

Given that U.S. partnerships invariably possess what other countries believe to be legal personality, it is worth asking whether legal personality is something that can be expunged from a U.S. partnership, or from any entity formed in a country that has similar rules, simply by drafting its governing documents. Other countries seem to believe that there are relevant differences among various state laws governing the formation of limited partnerships, limited liability companies, LLPs and LLLPs.[75] Many countries take into account the relevant organizational documents of a U.S. entity to determine how to classify it for local tax purposes.

Tax lawyers in the U.S. are often asked to draft partnership agreements or LLC operating *(Coninued on page 48)*

(Coninued from page 21) agreements in a way that will support the conclusion that the partnership or LLC has, or lacks, legal personality from the point of view of another country. For example, in order to make an LLC look more clearly like a U.S. body corporate, the lawyer might be asked to draft an operating agreement to provide for certificated units and the ability to have a board declare dividends—concepts that are essentially meaningless from a U.S. commercial or tax law point of view.

It is more difficult to remove legal personality from a U.S. entity through drafting. Recognizing this fact, Delaware, the leader amongst U.S. states in adapting its commercial laws to international business, has gone so far as to enact a provision whereby a general partnership may effectively elect to eschew legal personality. The law states:

> Partnership as entity
>
> (a) A partnership is a separate legal entity which is an entity distinct from its partners *unless otherwise provided in a statement of partnership existence or a statement of qualification and in a partnership agreement.*[76]

This provision of Delaware law was enacted in 1999. The evident intent of the "unless otherwise provided" language was to allow the partners to provide in their agreement that the partnership was *not* an entity distinct from its partners. Some Delaware lawyers recall that Delaware did this to accommodate concerns of non-U.S. investors needing an entity lacking legal personality. Whether this "presto change-o" provision is effective is unclear. Nevertheless, tax advisors from several countries have relied upon it to get comfortable that the U.S. partnerships they invest in lack legal personality.

Conclusion

Stepping back from this extended discussion of legal personality and factors in classifying entities, some observations seem clear. It is very noticeable that the *Kintner* factors applied by U.S. tax rules prior to the adoption of the check-the-box regulations were nearly identical to the factors that other countries employed to determine whether an entity should be treated as tax transparent or as tax opaque. It is also obvious that those factors relate to traditional notions of legal personality.

In some countries, an entity lacking enough of the *Kinter*-type factors, such as a partnership, is said to lack "legal personality." But it is unclear why the reverse should be true: just because an entity *has* legal personality does not mean it *must* be classified as an opaque corporation. Rather, the existence of the *Kintner* factors indicates nothing more than the fact that the entity is an entity. Its tax classification is another matter.

Why should the presence or absence of this elusive concept called "legal personality" have anything to do with tax or with entity classification? Way back in 1928, Bryant Smith took on the artificiality of the legal personality fiction. At that time, there was at least a lingering notion that a partnership did not have legal personality. Assuming for the sake of argument that this might be true as a general matter, Smith wrote:

> It is not the part of legal personality to dictate conclusions. To insist that because it has been decided that a corporation is a legal person for some purposes it must therefore be a legal person for all purposes, or to insist that because it has been decided that a partnership is not a legal person for some purposes it cannot therefore be so for any purposes, is to make of both corporate personality and partnership impersonality a master rather than a servant, and to decide legal questions on irrelevant considerations without inquiry into their merits. Issues do not properly turn upon a name.

Legal personality was originally invented as a means to an end. It should be limited to that role. It was not invented to be of use for tax classification purposes, and should not be used for such purposes. ●

76 6 Del. C. § 15-201 (2014) (emphasis added).