Entity Classification Advice May Aid Pre-Immigration Planning

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By Andrew Velarde

Recent advice from the IRS could prove a boon to pre-immigration planning for nonresident aliens related to the interaction of the entity classification rules and the check-the-box rules.

In generic legal advice (AM 2021-002), released April 2, the IRS determined that a foreign eligible entity has a tax classification during a period when a classification is irrelevant and that the 60-month limitation rule may not apply.

Under the classification regime, eligible entities can choose their federal tax classification or otherwise default to a classification. For a foreign eligible entity whose classification has never been relevant, its initial determination is the default classification when it becomes relevant. Classification is relevant when it affects tax liability or information reporting. A foreign entity will not have a classification until it becomes relevant.

Under the 60-month limitation rule, if the entity chooses to change its classification, it is generally precluded from changing it again for 60 months, but the rule does not apply to an election by a newly formed eligible entity.

Severiano Ortiz of Kozusko Harris Duncan said that as part of tax planning, a foreign person could make an entity relevant by making a classification election on Form 8832, “Entity Classification Election." That election would only be relevant for five years, however. Another way to make it relevant would be to invest in a U.S. publicly traded partnership, he added. Those planning techniques are important in a pre-immigration context because an NRA with a foreign corporation coming to the United States could be viewed as a U.S. tax person with a direct ownership interest in a controlled foreign corporation or a passive foreign investment company, he said.

According to Ortiz, a common pre-immigration strategy to avoid that potential compliance burden is to make a check-the-box election to create a passthrough entity the day the person becomes a U.S. person.

What About Basis?

But another issue affects basis, which could involve a less common but still important planning technique, Ortiz said. As an example, he posited an NRA that had developed a business with a tax basis of zero that is now worth millions. If that individual comes to the United States and then sells the business while a U.S. person, that person would not get a step-up in basis and would be subject to tax.

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"That catches a lot of people off guard," Ortiz said. "On the pre-immigration front, across the board with most practitioners, usually their focus is on compliance and not so much on the basis step-up."

To trigger step-up in value, one planning technique used is to trigger a section 331 liquidation, Ortiz said. Since a classification election can only be done every five years, NRA planners had feared that the initial election was not treated as a deemed liquidation and so would not receive a step-up in basis if the entity had not yet been relevant, he said. To address that in the pre-immigration context, planners would look to make the entity relevant (first piece) so that the IRS would apply the default entity classification elections to treat it as a corporation. This could include having the not-relevant entity invest in something that produced U.S. effectively connected income or making an entity classification election, he added.

Then the planners would trigger a deemed liquidation through a subsequent entity classification election (or initial election if the entity became relevant through something other than making an entity classification election), Ortiz said. Whether the election made to trigger the deemed liquidation was the first one filed or the second (a change) would then determine whether the taxpayer would have to wait five more years before being permitted to make another change, assuming it wanted to for some other purpose, he said.

"This rule basically says that you don't have to do that first piece anymore. The announcement is saying even though [the entity] is not relevant and has never been relevant . . . we are applying those default classification rules anyway," Ortiz said. "The IRS is saying . . . when you make that election the day they come to the United States, which takes place the day before, that's going to be treated like an automatic change, which would then presumably trigger that liquidation. But for purposes of whether to apply the five-year limitation, it will be treated as if the taxpayer made an initial election so as not to have to wait another five years."

The legal advice lays out two sets of similar facts involving two NRA individuals who formed a foreign business entity eligible to make a classification election under reg. section 301.7701-3(c). The first individual then acquired all the interest in the entity and subsequently became a U.S. citizen. Later, the entity made a valid election — effective to the date the individual became a U.S. citizen — to be classified as an association. The facts are the same in a second scenario, except the first individual did not become a U.S. citizen.

"A lot of people that don't understand the basis step-up that just want to get their clients out of CFC or PFIC rules . . . they'll just do the one election anyway when [the NRA] comes to the United States the day before. So now they are inadvertently, in the positive way, getting their clients a step-up in basis without even realizing it," Ortiz said, adding that some practitioners may feel uncomfortable not taking the first step of making an entity relevant, given the level of the guidance.

According to Ortiz, one question left unanswered in the advice is whether an NRA planner filling out a Form 8832 should check that they are making an initial classification election or a change in the classification.

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