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About the cover

The ties that bind:

This month's *STEP Journal* cover focuses on a challenge to the perception that OFCs have a negative impact on the Canadian economy. Could it be that stronger ties with offshore conduits will ultimately benefit the average Canadian taxpayer and bring rich returns to the public purse?

Damion Chew



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Qualified intermediary and withholding rules

J Richard Duke clarifies proper entity classification and corresponding tax forms for Americans to submit

The complexities of the withholding and Qualified Intermediary (QI) rules cause some banks and financial institutions to request the incorrect W-8 and W-9 series of forms when opening accounts for offshore trusts and offshore entities settled or formed by US persons. One of the primary problems is the lack of understanding of the legal classification versus tax classification of foreign entities under US Treasury Regulations (TRs). Some of the incorrect requests from banks result from not understanding that:

- if a bank provides that it will not invest in US securities, a W-9 is required of a US person;
- a foreign entity may be classified for legal purposes as one type of entity and may be classified for tax purposes as another type of entity;
- the filing of a form 8832 with the Internal Revenue Service (IRS) elects to change the tax classification;
- a limited liability company (LLC) is not the same as a corporation; and
- a 'disregarded entity' does not exist for US tax purposes.

The primary focus of the withholding rules and the QI status is to separate US beneficial owners from non-US beneficial owners. The various IRS forms W-9 and W-8 series must be obtained even though a foreign person (non-US) is the beneficial

owner and does not invest in the US. Also, a US beneficial owner must file a W-9 with a bank that states that no investments will be made in US securities.

Tax classification

Required QI documentation (W-9, W-8IMY, W-8BEN, etc.) with respect to US persons can be given to the bank only after the entities or trusts are classified for US tax purposes. Internal Revenue Code (IRC) section 7701 and the TRs thereunder require tax classification of foreign trusts and entities created by, or directly or indirectly funded by a US person as either:

- associations taxable as foreign corporations (separate entities);
- foreign partnerships (flow-through entities);
- disregarded entities; or
- trusts (foreign or domestic).

The tax classification of foreign entities is determined by 'default' rules under TRs based on the foreign statutes under which entities are formed. If the statute provides that no owner has personal liability (limited liability protection), the entity formed under that statute is classified, for tax purposes, as a foreign corporation. In general, international business company (IBC) statutes and the *Nevis Limited Liability Company Ordinance*, as well as other (LLC) statutes, provide that no owner has personal liability; thus, the tax classification



defaults to a foreign corporation. If the foreign statute provides that one or more owners has personal liability, the tax classification of that entity defaults to a foreign partnership (two or more owners) or a disregarded entity (one owner).

Some foreign statutes are not covered by the default rules requiring the organisations that are formed to be classified for tax purposes as either foreign trusts or foreign corporations. For example, a foreign foundation formed or funded, directly or indirectly, by a US person must be classified for tax purposes as a foreign trust or a foreign corporation. This tax classification is required so that the appropriate federal income tax returns can be filed with respect



to that entity or trust, and the appropriate W-9 (for a US grantor) and W-8 series of forms can be completed for the 'beneficial owner' (W-8BEN) or intermediary (W-8IMY).

Form 8832, also referred to as a 'check-the-box' form, is filed with the IRS to elect treating a foreign entity other than according to its default tax classifications. For example, a US person forming an IBC or Nevis LLC can file a form 8832, electing to treat an entity as a disregarded entity for tax purposes. A disregarded entity does not exist for tax purposes, but for legal purposes it is an IBC or foreign LLC that opens the bank account. Two or more persons forming an IBC or Nevis LLC can file a form 8832 electing to treat the entity as a foreign partnership for tax purposes.

Per se corporations

TR section 301.7701-2(b)(8)(i) lists certain foreign corporation and IBC statutes that are 'per se' corporations, meaning that a form 8832 cannot be filed to change the tax classification as a foreign corporation for an entity formed under one of these statutes. An example of a per se statute is the *Sociedad Anonima*, which must be classified for tax purposes as a foreign corporation.

The request by banks for articles of incorporation, by-laws and a list of the officers and directors is not proper for an LLC. The LLC is not a corporation for legal purposes, regardless of its classification for US tax purposes. An LLC is formed through articles of organization, includes an operating agreement, and generally has no officers and/or directors. The member or members, or a manager or managers, manage an LLC. A manager may or may not be a member.

Beneficial owners

The general rule is that a beneficial owner is the person who is the owner of the income for tax purposes and who beneficially owns that income. Thus, a nominee, agent or

custodian for another person is not the beneficial owner of the income.

Generally, the beneficial owners of income paid to a foreign partnership are the partners in the partnership, unless those partners are not the beneficial owners of the income. If the foreign partnership includes a non-US person, that person issues a W-8BEN. For example, partnership A that is a partner in partnership B is not the beneficial owner of income paid to the partnership B since partnership A is not the owner of income under US tax principles. The partners of partnership A are the beneficial owners.

The beneficial owners of income paid to a foreign simple trust (a trust in which all income is to be distributed currently, the trust beneficiaries, not the trust, being subject to income tax) are generally the beneficiaries of the trust. A typical foreign grantor trust is a foreign asset protection trust established by a US settlor. That settlor is treated as the 'grantor' and beneficial owner of the foreign trust if that trust has a US beneficiary. And a foreign trust has a US beneficiary unless the trust instrument states that no income or principal can be paid to or accumulated for the benefit of a US person, and, if that trust were to terminate (in any year), no income or principal can be paid to a US person. The beneficial owner of income paid to a foreign complex trust (a trust in which income may be accumulated and not distributed) is the foreign complex trust. The beneficial owner of income paid to a foreign estate is the estate itself.

A trust example: the bank requests a W-9 from the settlor and a W-8IMY from the trustee, as an intermediary, of an asset protection trust. After the death of the settlor, the trust becomes a foreign non-grantor trust, and the beneficial owner will be determined by whether the trust is a simple trust or complex trust.

Entities

A further example: the bank opening an account for an IBC or a Nevis LLC that is created or funded, directly or indirectly, by a US person must first request a copy of the form 8832, if any. If no form 8832 has been filed, the IBC and an LLC, such as the Nevis LLC that provides limited liability protection, are corporations for tax purposes. The IBC opens the account as a corporation and the LLC opens the account as an LLC (not a corporation), and each files a W-8BEN with the bank. If the form 8832 was filed electing to treat the IBC or LLC as either a disregarded entity (one owner) or as a foreign partnership (two or more owners), a W-9 must be issued by the shareholder or member for a disregarded entity, and each of the shareholders or members must issue a W-9 if the elected entity is a foreign partnership for tax purposes. A foreign partnership, as a flow-through entity, issues a W-8IMY. However, a disregarded entity does not issue a W-8IMY because it does not exist for tax purposes.

The foregoing is also true if the trustee of a foreign asset protection trust forms an IBC or LLC. That is, the bank must obtain a W-9 from the settlor and a W-8IMY from the trustee of the trust and must determine whether the IBC or LLC is classified for tax purposes as a foreign corporation, disregarded entity, or a foreign partnership in accordance with the previous paragraph.

Problems arise when practitioners are faced with completing corporate forms that request articles of incorporation, by-laws and the names of officers and directors, all of which are generally not applicable to an LLC. In order to facilitate proper and timelier account openings for foreign LLCs, it is recommended that banks have alternative requirements and account opening forms that meet the specifications of an LLC.

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