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Abstract

The application of the separate interests test has thus far been attempted only with foreign entities; its acceptance in light of the recent Ninth Circuit decision in the MCA case remains uncertain. In domestic entity classifications, a mechanical analysis continues to be utilized. This Note will introduce the separate interests test, discuss its inconsistencies, and demonstrate how its application may lead to a different result. It will then explore the implications of applying the test retroactively and exclusively to foreign entities. Because the problem addressed by the application of the separate interests test could be more effectively resolved by legislative action, recommendations will be made for possible legislative changes. These changes would prevent United States controlled foreign entities from avoiding United States taxes by adhering to the mechanical approach of I.R.C. 7701. After reviewing the history of I.R.C. 7701 and its regulations, which apply to both foreign and domestic entities, Part I discusses the separate interests test introduced in Revenue Ruling 77-214 and adopted by the district court in MCA v. United States. The Ninth Circuit court, in overruling the district court, leaves the separate interest test as viable law since it distinguishes the MCA facts from those of Revenue Ruling 77-214. Part II criticizes the test and concludes that legislative change will achieve a more effective and just solution to United States tax avoidance by US controlled foreign entities.

THE SEPARATE INTERESTS TEST: A NEW HURDLE IN FOREIGN ENTITY CLASSIFICATION

INTRODUCTION

United States taxpayers transacting business abroad frequently[1] need to ascertain whether their foreign entities will be classified as corporations or as partnerships under Internal Revenue Code (I.R.C. or Code) Section 7701.[2] Particularly, when a foreign entity controlled by a United States controlled foreign corporation (CFC)[3] is found to be a corporation under this section, it is gov-

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1. Foreign entity classification is important to determine whether the entity is governed by Subpart F and thus whether foreign earnings are subject to tax when remitted as dividends or when earned by the entity. I.R.C. §§ 951-964 (1982). *See also* Opening Brief for Plaintiffs-Appellants at 21 n.23, MCA Inc. v. United States, 685 F.2d 1099 (9th Cir. 1982) [hereinafter cited as MCA Appellant Brief]. Entity classification is also relevant when deciding whether transfers of property to foreign entities are taxable, and if so, at what time and to what extent; whether loss or income is recognized currently or deferred until distributed to the United States' taxpayers other than pursuant to Subpart F; whether gain or loss on a sale is to be taxed as a capital or as an ordinary item; whether liquidation is a taxable event; and whether foreign entities are engaged in business and subject to tax in the United States. I.R.C. §§ 951-964 (1982). Entity classification is also determinative in ascertaining the source and taxability of income derived through a foreign entity; the allocation of income and deductions for purposes of computing the taxable income of foreign entities; the treatment of foreign exchange items in determining current income and earnings and profits of foreign operations; and the treatment of foreign entities under tax treaties between the United States and foreign countries. *Id. See* New York State Bar Association Committee on Foreign Activities of United States Taxpayers, *Report on Foreign Entity Characterization for Federal Income Tax Purposes*, 35 TAX L. REV. 169 (1979-80) [hereinafter cited as *Tax Section Report*].

2. I.R.C. § 7701 (1982). The Internal Revenue Code defines partnership and corporations as follows:

> (a) When used in this title [Internal Revenue Code], where not otherwise distinctly expressed or manifestly incompatible with the intent thereof
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> . . . .
>
> (2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.
>
> (3) *Corporation.*—The term "corporation" includes associations, joint-stock companies, and insurance companies.

Id. See also infra notes 24-48 and accompanying text.

3. I.R.C. § 957 (1982). A controlled foreign corporation is defined in pertinent part in the I.R.C. as follows:

> (a) *General Rule.*—For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent of the

erned by Subpart F[4] of the Code and its income is taxable when earned.[5] Conversely, when an entity controlled by a CFC is found to be a partnership, its income is exempt from the Subpart F provisions and is taxable when repatriated.[6] International tax counsel, therefore, must consider not only the particular laws and business climate of the foreign state in which a client wishes to establish a corporation or a partnership, but also the United States tax implications of the type of foreign entity recommended.[7] The incongrui-

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> total combined voting power of all classes of stock entitled to vote is owned . . . by United States shareholders on any day during the taxable year of such foreign corporation.

Id. For a more detailed discussion of controlled foreign corporations and the separate interests test, see *infra* notes 68-147 and accompanying text.

4. I.R.C. §§ 951-964 (1982). *See infra* notes 78-91 and accompanying text.

5. Subpart F income is defined in I.R.C. § 952 (1982). Income of a foreign corporation controlled by a CFC, *see supra* note 3, is taxable when earned as a result of the interconnection of a number of Subpart F sections. I.R.C. § 952 includes as Subpart F income "the foreign base company income (as determined under section 954)." I.R.C. § 952(a)(2) (1982). Foreign base company income (FBCI) is defined in § 954 and includes "the foreign personal holding company income for the taxable year (determined under subsection (c) and reduced as provided in subsection (b)(5))." I.R.C. § 954(a)(1) (1982). Foreign Personal Holding Company Income (FPHCI) is defined in § 954(c) and includes

> (3) *Certain income derived in active conduct of trade or business.* —For purposes of paragraph (1), foreign personal holding company income does not include—
>
> (A) rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (within the meaning of subsection (d)(3)) . . . .

I.R.C. § 954(c)(3)(A) (1982). A related person is defined in § 954(d)(3) as follows: "(3) *Related person defined.*—For purposes of this section, a person with respect to a controlled foreign corporation, if— . . . (B) such person is a corporation which controls, or is controlled by, the controlled foreign corporation . . . ." I.R.C. § 954(d)(3)(B) (1982).

Therefore, if a foreign entity is a corporation, the income received by the CFC from that foreign entity is Subpart F income, taxable to the United States domestic parent in the year earned. Only if the related person's income exceeds 70% of the CFC's entire income does it trigger the operation of Subpart F. The Code would then require taxation of the income of the related person, as well as the entire income of the CFC. I.R.C. § 954(b)(3)(B) (1982). A *de minimus* rule is put forth in I.R.C. § 954(b)(3)(A) which provides that if the FBCI is less than 10% of the CFC's gross income, no part of the gross income shall be treated as FBCI includable in Subpart F income.

6. Partnership income does not meet the requirements of a "related person" under Subpart F. I.R.C. § 954(d)(3) (1982). Therefore, the income of the partnership is not taxable until repatriated to the United States parent corporation in the form of dividends. *See* I.R.C. § 61(7) (1982). *See infra* notes 84-97 and accompanying text.

7. For general discussions on taxation of United States foreign controlled companies, see 1 R. RHOADES & E. STEINBERG, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 3.01-.06 (1979); M. MOORE & R. BAGLEY, U.S. TAX ASPECTS OF DOING BUSINESS ABROAD 115-46 (1978).

ties in foreign entity classification motivate taxpayers to seek assurance that prior interpretations of the I.R.C. can be relied upon. The "separate interests test," introduced by a Revenue Ruling[8] and recently reviewed by a court,[9] has caused taxpayer confusion and created controversy in the area.

The separate interests test does not follow prior interpretations of I.R.C. § 7701[10] and its regulations.[11] The Internal Revenue Service (I.R.S. or Service), in applying the test, looks beyond an entity's legal structure to its ownership.[12] The test considers the relationship among the entity's owners to determine whether their interests are unified or separate.[13] A finding of either a unified interest, or lack of separate interests, among the entity's owners results in an entity's being classified differently than a taxpayer may have anticipated.[14] Through application of this test, certain entities with related owners which had been organized to be classified as partnerships under I.R.C. § 7701 have been reclassified as corporations.[15] A determination of this type frustrates United States taxpayers' attempts to achieve tax deferral on their foreign source income through entity classification.[16]

The application of the test has thus far been attempted only with foreign entities;[17] its acceptance in light of the recent Ninth Circuit decision in the *MCA* case remains uncertain.[18] In domestic entity classifications, a mechanical analysis continues to be utilized.[19] This Note will introduce the separate interests test, discuss its inconsistencies, and demonstrate how its application may lead to

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8. Rev. Rul. 77-214, 1977-1 C.B. 408. *See infra* notes 98-112 and accompanying text.

9. MCA Inc. v. United States, 502 F. Supp. 838 (C.D. Cal. 1980), *rev'd*, 685 F.2d 1099 (9th Cir. 1982).

10. *See supra* note 2.

11. Treas. Reg. §§ 301.7701-1 to -2, T.D. 6797, 1965-1 C.B. 553, T.D. 7515, 1977-2 C.B. 482.

12. Rev. Rul. 77-214, *supra* note 8, at 408-09; *MCA*, 502 F. Supp. at 844-46.

13. Rev. Rul. 77-214, *supra* note 8, at 408-09; *MCA*, 502 F. Supp. at 844-46.

14. *See, e.g.*, Rev. Rul. 77-214, *supra* note 8, at 408-09; *MCA*, 502 F. Supp. at 838-40.

15. *See, e.g.*, Rev. Rul. 77-214, *supra* note 8, at 409; *MCA*, 502 F. Supp. at 846.

16. *See, e.g.*, Rev. Rul. 77-214, *supra* note 8, at 409; *MCA*, 502 F. Supp. at 846.

17. The test has been applied only twice. Both Rev. Rul. 77-214, *supra* note 8, and the district court in *MCA*, 502 F. Supp. 838, are concerned with the application of the separate interests test to a foreign entity. For further discussion see *infra* notes 98-147 and accompanying text.

18. *MCA*, 685 F.2d at 1104-05.

19. *See* Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159 (1976). In both cases, the court upheld the literal interpretation of Treas. Reg. §§

a different result. It will then explore the implications of applying the test retroactively and exclusively to foreign entities.[20] Because the problem addressed by the application of the separate interests test could be more effectively resolved by legislative action, recommendations will be made for possible legislative changes. These changes would prevent United States controlled foreign entities from avoiding United States taxes by adhering to the mechanical approach of I.R.C. § 7701. After reviewing the history of I.R.C. § 7701 and its regulations, which apply to both foreign and domestic entities, Part I discusses the separate interests test introduced in Revenue Ruling 77-214[21] and adopted by the district court in *MCA v. United States*.[22] The Ninth Circuit court, in overruling the district court, leaves the separate interests test as viable law since it distinguishes the *MCA* facts from those of Revenue Ruling 77-214.[23] Part II criticizes the test and concludes that legislative change will achieve a more effective and just solution to United States tax avoidance by United States controlled foreign entities.

I. *THE SEPARATE INTERESTS TEST*

In classifying foreign entities, one must consider I.R.C. § 7701, its accompanying regulations, and their interaction with United States tax laws pertaining to foreign source income, particularly Subpart F.[24] To better understand the Service's introduction of the separate interests test, it is necessary first to examine I.R.C. § 7701 and its accompanying regulations.

A. *Domestic Entity Classification and I.R.C. § 7701*

The historical development of classifying domestic entities for tax purposes highlights the inconsistencies between I.R.C. § 7701

301.7701-1 to -2. 524 F.2d at 745; 66 T.C. at 185. See also *infra* notes 52-67 and accompanying text for further discussion of *Zuckman* and *Larson*.

20. *See infra* notes 68-147 and accompanying text.

21. *Supra* note 8, at 408.

22. 502 F. Supp. 838 (C.D. Cal. 1980). The separate interests test is not found in either the I.R.C. or the Regulations. The *MCA* case is a "judicial authorization" to use this test when looking "behind mere formalities to make an independent determination" of entity classification. Hamilton, *MCA—Classification of Foreign Entities as Associations or Partnerships*, 7 INT'L TAX J. 292, 296 (1981) [hereinafter cited as Hamilton]. *See also* Hamilton, *MCA, Inc.—Classification of Foreign Entities as Associations or Partnerships*, 59 TAXES 303 (1981) (for a similar discussion of the case).

23. *MCA*, 685 F.2d at 1103.

24. I.R.C. §§ 951-964 (1982). *See infra* notes 84-97 and accompanying text.

and its regulations and is helpful in understanding the current confusion in the area. Methods of classifying domestic entities developed from the interplay of judicial decision and legislative codification. The seminal Supreme Court case of *Morrissey v. Commissioner* [25] put forth the six characteristics to be examined in evaluating whether an entity is to be taxed as a corporation.[26] The *Morrissey* characteristics were first codified in the Internal Revenue Code of 1939[27] and later appeared as I.R.C. § 7701 in the reorganized Internal Revenue Code of 1954.[28] Prior to *Morrissey*, the I.R.S. had resisted taxpayers' attempts to classify unincorporated entities as corporations, especially when the entity sought pension advantages comparable to those of corporations.[29] The 1960 amendments to the regulations under I.R.C. § 7701 were drafted with the intent to make it difficult for an entity to qualify as a corporation.[30] The I.R.S. was concerned with limiting the availability of pension advantages and other fringe benefits.[31]

The Service promulgated the 1960 amendments in reaction to its inability to convince the Ninth Circuit in *United States v. Kintner* [32] to adopt a bias against finding an unincorporated entity

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25. 296 U.S. 344 (1935). In *Morrissey*, the Supreme Court held that a trust was taxable as a corporation. The Court found the beneficiaries' extent of control over the trust was substantial enough to make corporate tax treatment appropriate. *Id.* at 359-60.

26. *Id.* Treas. Reg. § 301.7701-2, *supra* note 11, defines the six characteristics as follows:

> There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on 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.

Id. § 301.7701-2(a)(1).

27. I.R.C. § 3797(a)(1)-(3) (1939). It took the Internal Revenue Service almost 25 years to incorporate the characteristics of limited liability and free transferability of interests into its regulations. *See* I.T. 3930, 1948-2 C.B. 126.

28. Fisher, *Classification Under Section 7701—The Past, Present, and Prospects for the Future*, 30 TAX LAW. 627, 629 (1977).

29. *Id.* Fisher has summarized the IRS's position as follows:

> As is generally known, the Service was greatly concerned in the years before and after the enactment of the Code of 1954 that unincorporated entities, mostly in the form of professional partnerships, were qualifying as corporations, thereby taking advantage of the benefits of qualified pension and profit-sharing plans. Repeatedly, and with equal lack of success, the government attacked professional organizations that sought corporate benefits.

Id.

30. *See id.* at 630.

31. *See infra* notes 32-39 and accompanying text.

32. 216 F.2d 418 (9th Cir. 1954). In *Kintner*, the Articles of Association of an organization of medical doctors provided that the entity would terminate upon the death of the last

a corporation. In *Kintner*, the court held that an association of medical doctors was a corporation for federal tax purposes.[33] The *Kintner* regulations were drafted to ensure that these entities would not be classified as corporations in the future.[34] The regulations were thus slanted toward the finding of a partnership to prevent entities from obtaining corporate advantages.[35] These regulations were codified as Treasury Regulation § 301.7701-1 to 2.[36] They provide that an entity will qualify as an association taxable as a corporation,[37] if a predominance of six characteristics exists, causing the entity to more closely resemble a corporation than a partnership or trust.[38] These six corporate characteristics are: (1) the

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survivor of the original members. *Id.* at 420. Only the individual members were held liable to third persons for professional misconduct. *Id.* The association was organized to collect all professional receipts, and to pay clinic operating expenses, members' salaries, staff wages and all payroll and federal corporation taxes. *Id.* The court held the entity to be a corporation for federal tax purposes. *Id.* at 428.

33. *Id.*

34. Fisher, *supra* note 28, at 630. The *Kintner* regulations differed significantly from the previous regulations accompanying I.R.C. § 7701 in their treatment of continuity of life and centralization of management. *Id.* Prior to these amendments, the regulations did not require that continuity of life be defined by the interpretation of dissolution under local law. *Id.* at 630-31. The *Kintner* regulations changed the meaning of centralized management by requiring that the entity rely upon the continuing and exclusive authority of the persons in control to make management decisions for the business. *Id.* at 631. Unlike the prior law, the *Kintner* regulations "draw a distinction between the ability of a member to bind an organization . . . and the mutual agency relationship that exists in a partnership which, at least in theory, enables each partner to bind the partnership notwithstanding that there may be an internal management agreement." *Id.* (footnote omitted). The author also notes that, "[t]hese Regulations—clearly a direct reaction by the Service to its inability to withhold corporate classification from professional service organizations—constitute the very root of the classification problem that remains with us today." *Id.* at 630 (footnote omitted).

35. *Id.* "No matter how the regulations are read, the bias toward partnership classification is unmistakable . . . . More than any other aspect of these regulations, the preponderance test puts a partnership thumb on the corporate resemblance scale." *Id.*

36. *See supra* note 11.

37. The Treas. Reg. § 301.7701-2, *supra* note 11, uses the term association. The Code and regulations employ this term to refer to a business organization with corporate characteristics sufficient to require its taxation as a corporation. Treas. Reg. § 301.7701-2, *supra* note 11. "The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity. The resemblance points to features distinguishing associations from partnerships as well as from ordinary trusts." *Morrissey*, 296 U.S. at 357. This Note uses the term corporation instead of association because corporation is the preferred term in the entity classification literature.

38. Treas. Reg. § 301.7701-2, *supra* note 11. The Code provides the following test: "An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteris-

existence of associates; (2) intent to carry on business for profit; (3) centralized management; (4) continuity of life; (5) free transferability of interests; and (6) limited liability.[39]

Two characteristics, the existence of associates and an intent to carry on business for profit, are generally common to both partnerships and corporations and are not useful in distinguishing these entities.[40] The regulations thus indicate that the existence of a preponderance of the remaining four characteristics is required to tax an entity as a corporation rather than as a partnership.[41] One

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tics, all characteristics common to both types of organizations shall not be considered." *Id.* § 301.7701-2(a)(3).

39. Treas. Reg. §§ 301.7701-1 to -2, *supra* note 11.

40. Treas. Reg. § 301.7701-2(a)(2), *supra* note 11. The Treasury Regulations discuss these two characteristics as follows:

> Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations . . . . [C]haracteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership . . . since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships . . . .

Id.

41. *Id.* "[T]he determination of whether an organization which has . . . [associates and the objective to carry on business for profit] is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability." *Id.*

An explanation of these last four characteristics is essential to an understanding of the separate interests test. Treas. Reg. § 301.7701-2, *supra* note 11.

Centralized Management exists in corporations where the management is concentrated in the directors and the appointed officers.

> An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed . . . . Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization.

Treas. Reg. § 301.7701-2(c)(1), (3), *supra* note 11. Shareholders are limited to choosing the directors. Larson v. Commissioner, 66 T.C. 159, 176 (1976), *acq.* 1979-1 C.B.1. The existence of this corporate characteristic, therefore, is determined by whether the corporation is managed representatively, i.e., by directors acting as the shareholders' representatives. Zuckman v. United States, 524 F.2d 729, 738 (Ct. Cl. 1975).

Limited Liability exists where the individual members are not personally liable for the debts of the corporation. "An organization has . . . limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization." Treas. Reg. § 301.7701-2(d)(1), *supra* note 11. Personal liability of a member exists where a tort victim or a creditor has recourse to his personal assets when the assets of the organization are insufficient to satisfy the claim. 524 F.2d at 740.

Continuity of Life exits where the substitution of members in an organization does not effect a dissolution.

court,[42] which has upheld the literal interpretation of these regulations, has described them as a mechanical approach necessary "to impart a degree of certainty to a subject otherwise fraught with imponderables."[43]

While this mechanical and biased definition has limited the availability of corporate fringe benefits,[44] it has also inspired the

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> An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution . . . . (2) For purposes of this paragraph, dissolution of an organization means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law.

Treas. Reg. § 301.7701-2(b), *supra* note 11. The continuity of an entity, upon substitution of one member for another, indicates that events personally affecting particular members do not necessarily have effects on the entity. The entity stands regardless of the identity of its particular members. 66 T.C. at 173.

Free Transferability of Interests is closely related to the corporate characteristic of continuity of life.

> Free transferability of interests [exists] . . . if each of [the entity's] members or those members owning substantially all of the interests in the organization have the power, without the consent of other members to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization . . . . Furthermore, although the agreement provides for the transfer of a member's interest, there is no power of substitution and no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization.

Treas. Reg. § 301.7701-2(e), *supra* note 11. Except in cases where the restrictions of an organization (i.e., rights of first refusal) provide otherwise, when continuity of life exists, the individual member's ownership interest is freely transferable. Free transferability of interests, therefore, means that a member's share of ownership in an entity can be disposed of without reference to the wishes of the other members. The free transferability of "substantially all" the shareholders' interests is generally necessary. 66 T.C. at 182. The *Zuckman* court had previously determined that:

> [S]o long as a member has the power, *unconditional* as between that member and the remaining members, to fully substitute a non-member for himself in the organization, the existence of a mere formal or nominal condition will not prevent such member's interest from being freely transferable within the meaning of the regulation.

524 F.2d at 743.

In domestic entities, the characteristic of free transferability is determined by local law. There is no power of substitution and no free transferability if, under the local law, the transfer of an interest dissolves the old entity and forms a new one. *See id.* at 743-44.

42. Larson v. Commissioner, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1.

43. *Id.* at 172. "The regulations discuss each major corporate characteristic separately, and each apparently bears equal weight in the final balancing." *Id. See infra* notes 58-61 and accompanying text.

44. One commentator notes:

> The single purpose of the revision [i.e., of the *Kintner* regulations] was to prevent

creative search for tax advantages available only to partnerships.[45] Many partnerships obtain tax advantages by the allocation of income or losses to their individual partners.[46] This practice has recently led taxpayers and the I.R.S. to reverse positions on the issue of corporate classification, with the I.R.S. now seeking to classify partnerships as corporations.[47] The *Kintner* regulations, however, have remained the law; a law which courts, at least with respect to domestic entities, have felt constrained to enforce.[48]

Judicial adherence to the *Kintner* regulations, despite the new I.R.S. preference for classification as corporations, is demonstrated in *Zuckman v. United States*[49] and *Larson v. Commissioner.*[50]

> doctors and other professionals, for whom the ordinary business corporation form had . . . been considered unsuitable, from qualifying their operating organizations . . . as corporations . . . . Doctors and other professionals have long since ceased to be concerned with the 1960 regulations. Instead, they incorporate under professional association laws that the states have tailored to their peculiar circumstances . . . . Although their purpose has evaporated, the 1960 regulations remain in effect, stacking the cards in favor of partnership status.

Peel, *Definition of a Partnership: New Suggestions on an Old Issue,* 79 WIS. L. REV. 989, 989 (1979).

The recently promulgated Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Pub. L. No. 97-248, 1982 U.S. CODE CONG. & AD. NEWS (96 Stat.) 324 (to be codified in scattered sections of 26 U.S.C.), includes a provision which seriously impairs the existing tax benefits of incorporating professionals. *Id.* § 250(a) (to be codified at 26 U.S.C. § 269(A)). "The new law provides the I.R.S. with the necessary reallocation weapons, where the professional service corporation is formed for the primary purpose of evading taxes or securing retirement benefits not otherwise available. I.R.S. can reallocate any tax attributes to employee-owners who own more than 10% of the professional service corporation." PRENTICE HALL HANDBOOK ON THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 REVENUE PROVISIONS § 213 (1982).

45. Fisher, *supra* note 28, at 633. The I.R.S. "[a]s a result of its single-minded determination to tax professional associations as partnerships," had unwittingly given taxpayers and their "innovative tax counsel" the tax benefits of allocating their proportionate share of partnership losses to offset personal income, thereby often significantly reducing personal income and taxes. *Id.* Fisher indicates that the historical success of tax shelters is also due to Treas. Reg. § 1.752-1(e) (1960) which (prior to its reversal by Congress in the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.)) allowed partners to deduct partnership losses by their proportionate share of liabilities for which no partner was personally liable. Fisher, *supra* note 28, at 633 n.23. See I.R.C. §§ 465, 704(d) (1982) for limitations of these deductions promulgated under the Tax Reform Act of 1976.

46. Fisher, *supra* note 28, at 633.

47. *Id. See Zuckman*, 524 F.2d at 745; *Larson*, 66 T.C. at 185. *See also* Eustice, *The Tax Reform Act of 1976: Corporate Changes Revisited,* 33 TAX L. REV. 115, 127-30 (1977).

48. See *infra* notes 181-83 and accompanying text for a discussion of attempts at legislative change of the *Kintner* regulations.

49. 524 F.2d 729 (Ct. Cl. 1975).

50. 66 T.C. 159 (1976).

These two cases confirmed that, under the regulations, an entity's tax status would be determined simply by looking for the remaining four characteristics in the structure of the organization, thus protecting "organizations cast in the form of limited partnerships from the dulled classification sword of the Service."[51] In *Zuckman*, the court mechanically applied the *Kintner* regulations to find that a real estate development group, organized as a limited partnership with a corporation as the sole general partner, was taxable as a partnership because no corporate characteristics existed.[52] The court was presented with and rejected an innovative precursor to the separate interests test.[53] The government unsuccessfully urged that the entity, organized under the Uniform Limited Partnership Act (ULPA), was constructively owned by the general partner.[54] It was argued, therefore, that the corporate characteristics of centralized management[55] and continuity of life[56] existed in addition to limited liability. The court, adhering to the letter of the regulations, refused to look beneath the entity's structure at the unity of controlling economic interests and to reclassify the limited partnership as a corporation.[57]

Similarly, in *Larson*, the court applied the regulations to uphold partnership status for a United States limited partnership whose sole general partner was a corporation.[58] A determinative

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51. Fisher, *supra* note 28, at 633. One commentator refers to the recent period of confusion in the area of entity classification of domestic limited partnerships as "[t]his decade of uncertainty." Roberts, *Simplification Symposium Overview: The Viewpoint of the Tax Lawyer*, 34 TAX L. REV. 5, 15 (1978-79).

52. 524 F.2d at 744.

53. *See id.* at 744-45.

54. *Id.* at 738-39.

55. *Id.* at 739.

56. *Id.* at 734.

57. *Id.* at 735, 738-39, 745. Specifically, the court found that continuity of life was not present in the entity because "the mere reservation in the limited partnership agreement of a power in the remaining general partners to continue the business on a general partner's withdrawal, constitutes only a 'contingent continuity of existence,' insufficient to satisfy the regulation's corporate standard." *Id.* at 735. The court then found that centralized management was not present in the entity's structure since "[t]he express language of the regulation neither directly nor otherwise contemplates application of a constructive ownership rule. Absent such a rule . . . [the general partner's] interest in . . . [the partnership's] capital and profits would ordinarily preclude a finding that the latter possessed centralized management." *Id.* at 739. The court also found that the characteristics of limited liability and free transferability of interests did not exist. *Id.* at 742, 744.

58. 66 T.C. at 173-86. In *Larson*, plaintiffs were owners of limited partnership interests in two real estate syndicates set up under the California Uniform Limited Partnership Act, CAL. CORP. CODE §§ 15501-15532 (West 1977). The sole general partner in each of these

factor in the court's analysis was the nonexistence in the entity's structure of the corporate characteristic of limited liability.[59] The court found that having a corporation as the general partner was not merely a subterfuge to prevent the finding of limited liability; it found, instead, that the corporation's existence had justifiable business motives.[60] The dissenting opinions argued that the majority had "simplistically" applied the *Kintner* regulations to the facts of the case without giving adequate consideration to the underlying economic realities.[61]

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syndications was a corporation. The partnerships were found to possess the corporate characteristics of centralized management and free transferability of interests and to lack the corporate characteristics of continuity of life and limited liability. 66 T.C. at 185. They were thus held taxable as partnerships as defined in I.R.C. § 7701(a)(2). *Id.*

The court, in analyzing the nonexistence of limited liability stated that "the record indicates that the limited partners did not use GHL [the general partner] as a screen to conceal their own active involvement in the conduct of the business; far from being a rubber stamp, GHL was the moving force in these enterprises." *Id.* at 181. The majority, although criticized by the dissent for "mechanically" applying the *Kintner* regulations, appears to have given some weight to the actual ownership structure of the entity, at least in determining the nonexistence of the corporate characteristic of limited liability. *Id.*

Judge Dawson's concurring opinion stated: "over the years since the original adoption of the *Kintner* regulations, the four basic tests created therein have become the established rules through which the Commissioner [of the I.R.S.] on the one hand and tax planners on the other have been able to operate with some degree of certainty . . . ." *Id.* at 186.

In his dissent, Judge Raum disagreed with what he saw as a "simplistic" and "mechanical" application of the regulation to the facts at hand. *Id.* at 191-92. Judge Drennan agreed with Judge Raum and, in a separate dissent, questioned the overall validity of the regulations. *Id.* at 192. Judge Quealy, (dissenting) added that "it is the duty of the Court to decide a case in accordance with the law, and where the law is clear, the regulations must give way to the law." *Id.* at 202. He commented further that the regulations appeared to be based on "erroneous concepts" and thus should not prevent the court from looking at the organization as a whole rather than merely on the regulations' "formalistic standards." *Id.* at 208-09.

An earlier decision, Outlaw v. United States, 494 F.2d 1376 (Ct. Cl.), *cert. denied*, 419 U.S. 844 (1974), classified an entity as a corporation by finding that two corporate characteristics not enumerated in the regulations were significant, 494 F.2d at 1385. Subsequent courts have not followed this decision. *See, e.g.*, *Zuckman*, 524 F.2d at 745; *Larson*, 66 T.C. at 185.

59. *Larson*, 66 T.C. at 179-82.

60. *Id.* at 181.

61. *Id.* at 191. "A hospitable reading of those regulations—with a view to bringing the result within the principles of *Morrissey* upon which the regulations were based—would lead to a correct disposition of this case." *Id.* One author has commented that "[i]n the balancing of equity and predictability, it is submitted that the dissenting judges failed to give due weight to the need for predictability by taxpayers and the tax bar during the 15-year period that the regulations were outstanding. And the Treasury must also be faulted in failing to reflect its entirely justifiable dissatisfaction with the existing regulations by amending the regulations." Roberts, *supra* note 51, at 15.

In its appeal, the government argues that a foreign entity is even more difficult to classify than a domestic entity since the foreign laws are not analogous to the Uniform

A recent Revenue Ruling, 75-19,[62] pertaining to classification of domestic entities is consistent with these courts' refusal to look beyond the legal structure of the entity.[63] This Revenue Ruling determined that a partnership, formed by four domestic subsidiaries of a domestic parent corporation, was taxable as a partnership since it did not possess a preponderance of corporate characteristics.[64] The Ruling made no reference to a separate interests or unified economic interests analysis, which would have probably changed the result.[65]

Up to now, courts have resisted I.R.S. pressures to apply a less mechanical interpretation of the *Kintner* regulations in order to find that an unincorporated entity was taxable as a corporation.[66] With regard to domestic entities, the conflict between the amendment's original intent and the current I.R.S. desire to hamper tax avoidance schemes has, for now, been decided in favor of strict adherence to the letter of the regulations.[67]

B. *Foreign Entity Classification and Subpart F*

Classification of foreign entities has been more complicated than that of domestic entities because of the interrelationship between I.R.C. § 7701 and the laws affecting United States controlled foreign entities,[68] such as Subpart F[69] of the I.R.C. The recent

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Limited Partnership Act (ULPA). "Since these foreign laws create entities which do not track our domestic forms, the entities fail to provide the concomitant guaranties [sic] that they are economically and in practice functioning as labelled under foreign law." Appellate Brief for Appellee at 28 n.13, MCA Inc. v. United States, 502 F. Supp. 838 (C.D. Cal. 1980), *rev'd*, 685 F.2d 1099 (9th Cir. 1982) [hereinafter cited as MCA Appellee Brief].

62. 1975-1 C.B. 382.

63. Fisher has commented that "[t]he pervasiveness of the four basic tests, as a general rule, should limit the relevance of any additional factors to assisting in the determination of whether corporate resemblance exists with respect to one or more of these characteristics." Fisher, *supra* note 28, at 645. Another commentator suggests that "[f]rom Revenue Ruling 75-19 it is clear that a taxpayer may choose the form of domestic organization to fit both his business needs and his tax objectives. Where the taxpayer is willing to take on all the burdens as well as the benefits connected with his choice in the foreign area, the same free choice should prevail." *Tax Section Report*, *supra* note 1, at 208.

64. Rev. Rul. 75-19, *supra* note 62, at 383.

65. *See supra* notes 98-147 and accompanying text.

66. *Tax Section Report*, *supra* note 1, at 191. *See supra* notes 49-57 and accompanying text.

67. *Foreign Corporations-U.S. Income Taxation*, 156-4th TAX MGMT. (BNA) Foreign Income Portfolios at A-7 (1977). The actual language of the regulations, however, has not changed, despite changes in the approach.

68. *See Tax Section Report*, *supra* note 1, at 192-97.

69. For the definition and history of the Subpart F provision, see *supra* note 4 and *infra* notes 85-97.

introduction of the separate interests test by the I.R.S. in a Revenue Ruling[70] and the test's treatment in one case[71] has added inconsistencies and complexities to foreign entity classification.[72]

A juridical entity[73] established under foreign law was once recognized as a corporation for United States tax purposes, without reference to the criteria of the I.R.C. and its regulations.[74] In 1954, however, the United States Tax Court used the *Morrissey* characteristics to find that a Venezuelan *Sociedad anonima*[75] was a corporation for United States tax purposes.[76] More recent cases and rulings have gone further and held that another country's characterization of its entity is irrelevant to that entity's United States tax classification.[77] Revenue Ruling 73-254,[78] which confirmed the latter approach, is "almost redundant" in view of prior holdings.[79] This ruling held that although an organization may have a different tax status under foreign law than under United States law, the Code governs for United States tax purposes.[80]

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70. Rev. Rul. 77-214, *supra* note 8, at 408.

71. *MCA*, 502 F. Supp. 838, *rev'd*, 685 F.2d 1099 (9th Cir. 1982).

72. *See Tax Section Report*, *supra* note 1, at 192 (general discussion of inconsistencies and complexities in foreign entity classification).

73. A juridical entity is one which is established by and conformed to the laws and practices of the country where it is established. *See* BLACK'S LAW DICTIONARY 765 (5th ed. 1979) (definition of juridical).

74. *Tax Section Report*, *supra* note 1, at 192. *See also* General Counsel's Memorandum 9067, 10-1 C.B. 337 (1931) (declared obsolete in Rev. Rul. 67-406, 1967-2 C.B. 420, 424), and General Counsel's Memorandum 18718, 1937-2 C.B. 476 (declared obsolete in Rev. Rul. 70-59, 1970-1 C.B. 280). In Puerto Rico v. Russell & Co., 288 U.S. 476 (1933), the Supreme Court recognized that a *sociedad en comandita* (limited liability company) was a juridical entity. Haussermann v. Burnet, 63 F.2d 124 (D.C. Cir.), *aff'd*, 289 U.S. 729 (1933) upheld the separate status of a Philippine *sociedad anonima* (limited liability entity).

75. *Sociedad anonima* is defined as an anonymous company, one which is established with limited liability. Buckley v. Commissioner, 22 T.C. 1312, 1324 (1954), *aff'd*, 231 F.2d 204 (2d Cir. 1956).

76. *Id.*

77. *Tax Section Report*, *supra* note 1, at 194-95. *See also* Arundel Corp. v. United States, 102 F. Supp. 1019, 1021-22 (Ct. Cl. 1952); Abbot Laboratories Int'l Co. v. United States, 160 F. Supp. 321, 328 (N.D. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959) (for United States income tax purposes, United States tax law governs, notwithstanding conflicting foreign laws).

78. 1973-1 C.B. 613.

79. *Tax Section Report*, *supra* note 1, at 195.

80. Rev. Rul. 73-254, *supra* note 78, at 613. In Elot H. Raffety Farms, Inc. v. United States, 511 F.2d 1234, 1239 (8th Cir. 1975), *rev'g*, 369 F. Supp. 653 (E.D. Mo. 1973), the court made a perfunctory analysis to determine that a Mexican entity, *sociedad de responsibilidad limitada*, an association with limited liability, was a corporation. 511 F.2d at 1239. This short analysis implies that the court was either reluctant to accept the policy of Rev. Rul. 73-254 or that it believed "that limited liability is the deciding characteristic in finding

One I.R.S. response to growing confusion in classifying foreign entities for United States tax purposes was the issuance of Exhibit 500-7 of the *Internal Revenue Manual, Guidelines on Foreign Forms of Business Organization.*[81] Although only preliminary, Exhibit 500-7 lists approximately two hundred forms of foreign business organizations and attempts to classify many of them as either partnerships or corporations.[82] The I.R.S. is careful to point out that this list is not to be "construed as the position of the Service" and that classification depends on the circumstances of each case.[83] Just as taxpayers eventually sought noncorporate classification of domestic entities for its tax benefits, United States taxpayers have attempted to circumvent the classification of their foreign entities as corporations in order to evade Subpart F coverage.[84]

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corporate status for a foreign juridical entity." *Tax Section Report, supra* note 1, at 196. Reference is made in the case that a "[t]axpayer may not escape liability in a foreign nation's courts under one theory and then seek an advantage in this nation's courts by contending its opposite." 511 F.2d at 1239.

81. *Reprinted in* 1 INTERNAL REVENUE MANUAL (AUDIT) (CCH) Ch. 673 at 7283-58.

82. *Id.* Some examples of this are: Bolivia-*Sociedad anonima* (SA) . . . Corporation; Greece-Public Company Limited . . . Corporation; Italy-*Societá in accomandita per azioni* (SApA) . . . Quasi-Corporation; Netherlands-*Beslogen Vennootschap* (BV) . . . Corporation-*Naamioze Vennootschap* (NV) . . . Corporation. *Id.* at 7283-58 to 61.

83. *Id.* at 7283-24. *See also Tax Section Report, supra* note 1, at 196.

The status of foreign entities under tax treaties is another factor to be considered in classifying them. In Rev. Rul. 76-435, 1976-2 C.B. 490, a United States limited partnership was classified as an association taxable as a corporation under the German tax treaty. This classification was determined by the finding of a preponderance of corporate characteristics. Recent private rulings, Private Letter Rul. No. 7852027 (Sept. 27, 1978), *rev'd*, Private Letter Rul. No. 7935019 (May 29, 1979) and also Private Letter Rul. No. 7908004 (Aug. 28, 1978), *amended by* Private Letter Rul. No. 7937054 (June 14, 1979), have applied the *Kintner* regulations to classify two German *Gesellschaft mit beschränkter Haftung* (GmbH) as associations for purposes of German treaty provisions and the United States tax laws. Both private letter rulings looked at the relationship of the members, and one of them, Private Letter Rul. No. 7908004 (Aug. 28, 1978), applied Rev. Rul. 77-214 in finding the entity to be a corporation. In general, however, tax conventions between the United States and foreign countries may establish a different definition of a "corporation" for tax treaty purposes. This definition is primarily used in characterizing the nature of payments made to the owners of the entity. *U.S. Tax Treaties with the European Member Countries— Corporate Aspects,* 41-3rd TAX MGMT. (BNA) Foreign Income Portfolios at A-10 (1974).

84. Some general examples of the Service's attempts to prevent tax avoidance are:

I.R.C. §§ 269 (acquisitions made to evade or avoid income tax), 367 (transfers to controlled foreign corporations), 482 (intercompany pricing), 551-558 (foreign personal holding companies), 679 (taxing grantors on income from certain foreign trusts), 864(b)(2)(A)(ii) (directed at foreign mutual funds conducting business in the United States), 904(f) (effecting a recapture of specified foreign losses), subpart F (dealing generally with foreign base companies), 1246 (concerning foreign invest-

Before the enactment of Subpart F in 1962,[85] United States shareholders could not be taxed on the income of a CFC until the income was repatriated in the form of dividends.[86] This enabled United States shareholders to avoid taxes by deferring payment of dividends from their foreign corporations. In a 1961 tax message,[87] President Kennedy called for the removal of this type of tax deferral:

> Recently more and more enterprises organized abroad by American firms have arranged their corporate structures—aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven—so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.[88]

To eliminate this type of tax avoidance by deferral, the Revenue Act of 1962, through Subpart F, specified the types of income which would be taxable when earned.[89] Subpart F income includes income arising from insurance abroad of United States risks, from

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ment companies), 1248 (sale or exchange of stock in controlled foreign corporations), 1249 (recharacterizing income on patent transfers), 1491 (imposing an excise tax on transfers to foreign entities).

Tax Section Report, *supra* note 1, at 209 n.148.

85. Revenue Act of 1962, Pub. L. No. 87-834, § 12(a) 76 Stat. 96, 1006-27 (codified at I.R.C. §§ 951-964 (1982)).

86. *Controlled Foreign Corporations, Sec. 956*, 232-2d TAX MGMT. (BNA) Foreign Income Portfolios at A-1 (1977). Before the enactment of Subpart F, tax deferral was possible because shareholders of a controlled foreign corporation were only taxed on the earnings and profits of the corporation when a dividend was received by the domestic parent. If the controlled foreign corporation decided to accumulate or reinvest the earnings in the foreign country rather than make distribution, the United States shareholder was not taxed. General Elec. Co. v. United States, 610 F.2d 730, 734 n.8 (Ct. Cl. 1979); *see also* Koehring Co. v. United States, 583 F.2d 313, 317 (7th Cir. 1978).

87. President Kennedy's tax message to Congress on April 20, 1961, 1962 U.S. CODE & AD. NEWS 3381 [hereinafter cited as Kennedy Tax Message] (*cited in* Estate of Lovett v. United States, 621 F.2d 1130, 1136 (Ct. Cl. 1980)).

88. Kennedy Tax Message, *supra* note 87, at 3381.

89. *Id.* "Tax haven operations was a reference to a certain category of activities such as trading, licensing, and insurance which could be easily organized such that the resulting income would be collected and taxed in certain countries with low tax rates." *General Electric*, 610 F.2d at 734 n.9. *See also Controlled Foreign Corporations-Sec. 955*, 109-2nd TAX MGMT. (BNA) Foreign Income Portfolios at A-1 to A-5 (1970) (discontinued due to code amendment); *Foreign Personal Holding Companies*, 103-2nd TAX MGMT. (BNA) Foreign Income Portfolios at A-1 to A-10 (1978).

passive investments, and from sales and service subsidiaries separately incorporated from the producing companies.[90]

Subpart F income, however, is limited to the income of a "related person"[91] of a foreign corporation controlled by United States shareholders.[92] The I.R.C. defines a "related person," with respect to a CFC,[93] as a *corporation* which controls or is controlled by the CFC, or a *corporation* which is controlled by the same person(s) which control the CFC.[94] The United States controlled

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90. Kennedy Tax Message, *supra* note 87, at 3382. I.R.C. § 953 (1982) defines insurance risk as "[i]ncome of a controlled foreign corporation [which derives] from premiums or other consideration for reinsurance of, or the issuing of insurance or annuity contracts on, property in or residents of the United States." 6 STAND. FED. TAX REP. (CCH) ¶ 4382G.01 (1982). Passive investments are assets which generate passive income (e.g., interest, dividends and royalties). Kennedy Tax Message, *supra* note 87, at 3305. Subpart F income includes income from passive investments which have been transferred to a controlled foreign corporation with the intent of avoiding United States taxation on their investment income. *Id.* at 3385. The I.R.S.'s intention is to shift the income from sales and service subsidiaries out of the domestic parent and into the foreign controlled corporation. *Id.* at 3386-87. Congress has amended the definition of Foreign Base Company Income to include "foreign base company oil related income for the taxable year (determined under subsection (h) and reduced as provided in subsection (b)(5)). Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 212(a), 1982 U.S. CODE CONG. & AD. NEWS (96 Stat.) 324 (to be codified at 26 U.S.C. § 954(a)(5)). *See also id.* § 212(d), (b)(2), (c) (to be codified at 26 U.S.C. § 954(b)(4), (8), 954(h)).

91. I.R.C. § 954 defines a "related person" as follows:

> For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if—
> (A) Such person is an individual, partnership, trust, or estate which controls the controlled foreign corporation;
> (B) Such person is a corporation which controls, or is controlled by, the controlled foreign corporation; or
> (C) Such person is a corporation which is controlled by the same person or persons which control the controlled foreign corporation.

I.R.C. § 954(d)(3) (1982).

92. Subpart F imposes special tax treatment only on a "controlled foreign corporation." I.R.C. § 957 (1982).

More specifically, a CFC is a foreign corporation where the total combined voting power of more than 50% of all qualified stock is actually (I.R.C. § 958(a) (1982)) or constructively (I.R.C. § 958(b) (1982)) owned by United States shareholders on any day of the foreign corporation's taxable year (I.R.C. § 957(a) (1982)). See I.R.C. § 957(b) (1982) for special 25% rule for corporations which insure United States interests.

For CFC purposes, stock actually owned is defined as "(A) Stock owned directly, and (B) stock owned with the application of paragraph (2). (2) Stock Ownership Through Foreign Entities—For purposes of subparagraph (B) paragraph (1) stock owned, directly or indirectly, by or for a foreign corporation . . . shall, for purposes of applying such sentence, be treated as actually owned by such person." I.R.C. § 958(a) (1982).

93. *See supra* note 3.

94. I.R.C. § 954(d)(3)(B)-(C) (1982). See *supra* note 91 for full I.R.C. definition of related person.

foreign entity which is found to be a partnership is not taxable as a corporation and therefore avoids the tax disadvantages of Subpart F treatment. To prevent tax avoidance by having entities attempt classification as partnerships, the I.R.S. introduced the separate interests test in Revenue Ruling 77-214.[95] The separate interests test not only fills the Subpart F gap[96] but also calls for a more flexible application of the I.R.C. corporate characteristics.[97]

Revenue Ruling 77-214 is the first official pronouncement in which the I.R.S. looked beyond the legal structure of a foreign entity.[98] The Revenue Ruling and the results of its application are not paralleled in the area of domestic entity classification.[99]

The subject of the ruling was a *Gesellschaft mit beschränkter Haftung* (GmbH)[100] owned by two German subsidiaries which, in turn, were wholly-owned by a United States parent corporation. The entity classification for United States tax purposes began with an examination of the legal relationships among the parties,[101] pursuant to Treasury Regulation § 301.7701-1 and Revenue Ruling 73-254.[102] The characteristics common to both corporations and partnerships were not included in the analysis, because the ruling noted that they were characteristics of a GmbH under German law.[103] The GmbH was found to have the corporate characteristics of centralized management and limited liability.[104] A "straightforward" application of the *Kintner* regulations would have made the existence of the two remaining characteristics, free transferability of interests and continuity of life dispositive. The GmbH's memo-

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95. *Supra* note 8, at 408.

96. It appears that the interaction between I.R.C. § 7701 and Subpart F in some cases provides tax deferral results which are unsatisfactory to the I.R.S. The application of the separate interests test changes this outcome by reinterpreting existing law. *See infra* notes 98-147 and accompanying text.

97. *Id.*

98. Rev. Rul. 77-214, *supra* note 8, at 408-09. *See infra* notes 100-12 and accompanying text.

99. *See supra* notes 26-67 and accompanying text.

100. GmbH is translated as an association with liability. AKTIENGESETZ 1965; THE GERMAN STOCK CORPORATION LAW 493 (R. Mueller & E. Galbraith trans., eds. 1966).

101. *Supra* note 8, at 408.

102. *Supra* note 78. The I.R.S held that, although the local law of the foreign jurisdictions must be applied to determine the legal relationship among members of an entity, the Code and Regulations sections of I.R.C. § 7701 will be applied to determine the taxable nature of the entity. *Id.*

103. *Supra* note 8, at 408-09.

104. *Id.* at 408.

randum of association[105] specifically provided for "dissolution upon the occasion of the bankruptcy of a quotaholder [shareholder] and for no transfer of quotas without the prior written approval of all quotaholders,"[106] thereby implying that continuity of life or transferability of interests did not exist. The GmbH fell into the partnership category, at least superficially.

The ruling, however, proceeded to look at the relationship of the parties.[107] The I.R.S. found that transferability of interests existed, reasoning that "since two wholly-owned domestic subsidiaries own . . . [one hundred percent] of the quotas of the GmbH, it is apparent that the controlling parent could make all the transfer decisions for its wholly-owned subsidiaries, *despite any provision* in the memorandum of association that might indicate otherwise."[108] The ruling similarly found that continuity of life existed. "[B]oth quotaholders are wholly owned by the same corporate parent- . . . [therefore] there are no *separate interests* to compel dissolution should an event of dissolution occur."[109] The ruling, by finding the nonexistence of separate interests among the GmbH's shareholders, concluded that two of the corporate characteristics of continuity of life and free transferability of interests were present even though the legal documents of the GmbH provided otherwise.[110]

Prior to the issuance of 77-214, most international tax counsel assumed that the United States tax classification of a foreign entity would be made by mechanical adherence to the criteria set forth in the I.R.C. and its regulations.[111] As a result of the separate interests test, international tax counsel must now carefully analyze not only the legal structure of a United States controlled foreign entity under the *Kintner* regulations, but also its ownership.[112]

Revenue Ruling 77-214 was followed by the district court in *MCA Inc. v. United States*,[113] where the court looked beyond the

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105. A GmbH's memorandum of association is similar to the United States articles of association. *See id.* at 408-09.

106. *Tax Section Report, supra* note 1, at 200. *See* Rev. Rul. 77-214, *supra* note 8, at 408.

107. *Supra* note 8, at 409.

108. *Id.* (emphasis added).

109. *Id.*

110. *Id.*

111. *See Tax Section Report, supra* note 1, at 200.

112. That Rev. Rul. 77-214 was issued only three months before the I.R.S. assessed MCA for additional taxes is not seen as a coincidence by some. *See* MCA Appellant Brief, *supra* note 1, at 24 n.26.

113. 502 F. Supp. 838 (C.D. Cal. 1980).

surface of the corporation's structure to its controlling economic interests.[114] Both MCA Inc. (MCA) and Paramount Pictures Corporation (Paramount) are major United States producers of motion picture films.[115] In 1970,[116] Paramount and MCA formed a joint venture to distribute their films internationally.[117] The joint venture was in the form of a Dutch corporation, Cinema International Corporation, N.V. (CIC), with principal offices in Amsterdam.[118] Paramount and MCA each owned forty-nine percent of CIC's stock; the remaining two percent was held by Stichting, a Netherlands trust fund established for the benefit of CIC employees.[119] CIC owned a ninety-five percent interest in the local distribution outlets.[120] The remaining five percent was held by Proetus, B.V., a Netherlands corporation wholly owned by Stichting, the CIC employee trust fund.[121] Stichting's holdings were made up entirely of CIC and Proetus stock.[122] Thus, Stichting and CIC together owned one hundred percent of the local distribution outlets.[123]

Film distribution in foreign countries requires that the marketing, servicing and other related activities[124] be conducted predomi-

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114. *Id.* at 846.

115. *Id.* at 839-40. Films by both MCA and Paramount are regularly distributed throughout the world. Approximately 50% of revenues from film distribution in the industry is derived from foreign distribution of United States films. M. MAYER, THE FILM INDUSTRIES 74 (1978). For 1972 and 1973, the pertinent years for the *MCA* case, the gross income of United States Major Motion Picture Film Companies from foreign film distribution was U.S.$388.8 and U.S.$415.5 million. THE AMERICAN FILM INDUSTRY 402 (T. Balio ed. 1976). Distribution gross from domestic markets was U.S.$426.4 and U.S.$390.5 million. *Id.* For additional background on MCA, see *MCA: Superstar,* 144 FORBES, Nov. 1, 1974, at 20; Schayten, *How MCA Rediscovered Movieland's Golden Lode,* FORTUNE, Nov. 1976, at 122; *Reshaping a Sluggish MCA,* BUS. WK., Aug. 10, 1981, at 72-73.

116. THE AMERICAN FILM INDUSTRY, *supra* note 115, at 408.

117. The joint venture was formed to engage more efficiently and economically in international film distribution. 502 F. Supp. at 840. For a detailed survey of the legal and financial aspects of foreign film distribution, see M. MAYER, *supra* note 115, at 74-80. *See also* THE AMERICAN FILM INDUSTRY, *supra* note 115, at 387-409. For a general overview, see P. BAUMGARTEN & M. LEAVY, LEGAL AND BUSINESS PROBLEMS OF FINANCING MOTION PICTURES (1976); D. LEEDY, MOTION PICTURE DISTRIBUTION, AN ACCOUNTANT'S PERSPECTIVE (1980).

118. 502 F. Supp. at 840.

119. *Id.* See *infra* note 134 and accompanying text for a discussion of fiduciary roles in the Netherlands.

120. 502 F. Supp. at 844.

121. *Id.*

122. *Id.*

123. *Id.*

124. Activities related to film distribution include negotiation with exhibitors, and advertising the motion pictures within the foreign country. *See* M. MAYER, *supra* note 115, at 74-80.

nantly in the country of distribution.[125] Because mere branch offices of a foreign corporation are often the object of discrimination,[126] CIC established each outlet as a separate entity, formed and taxable under the local laws.[127] In addition, the outlets were structured as partnerships to avoid United States taxes on foreign controlled corporations.[128]

The court agreed that the distribution outlets were structured to have more noncorporate than corporate characteristics and were classifiable as partnerships pursuant to Treasury Regulation § 301.7701-2.[129] It went on, however, to consider the government's argument that the local outlets' structure and method of operation

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125. 502 F. Supp. at 840.

126. *Id.* Local law sometimes bars foreign corporations from engaging in film distribution. *Id.* Often foreign corporations are discriminated against in not being considered eligible for membership in the local film board. *Id.* Another difficulty is their inability to comply with local law and regulations. *Id.* Foreign film distributors may also be subject to unfavorable quotas. *Id. See, e.g.,* M. MAYER, *supra* note 115, at 78. "A leading impediment to foreign distribution is a collection of financial and legal measures imposed in foreign jurisdictions—frequently aimed at preventing or limiting remittances of net proceeds of U.S. films to the United States . . . . Vast sums, for instance in India and Pakistan, remain earned but not remitted." *Id.* at 77.

> In the motion picture industry there are three main problems related to international trade in films. The first is an import tax levied on imported films to discourage their use; alternatively tax rebates are given to theaters for the showing of domestic films. Another concern is dubbing requirements. In some cases local laboratories are required to do dubbing work. In some cases dubbing into local language is prohibited to reduce competitiveness of foreign films. Finally, some countries impose quantitative restrictions on the number of days or number of foreign films which can be shown in domestic theatres.

OFFICE OF THE U.S. TRADE REPRESENTATIVE, U.S. GOV'T INVENTORY OF SELECTED IMPEDIMENTS TO TRADE IN SERVICES app. at 6-7 (1981). *See* Cohen & Morante, *Elimination of Non Tariff Barriers to Trade in Services: Recommendations for Future Negotiations*, 13 LAW & POL'Y INT'L BUS. 495, 500 (1981). *See generally* Comment, *Liberalization of International Trade in the Service Sector: Threshold Problems and a Proposed Framework Under the GATT*, 5 FORDHAM INT'L L.J. 371, 384-87 (1981-82).

127. 502 F. Supp. at 840. "These outlets distribute the films in their respective geographic territories, performing such tasks as importing, checking, storing, and distributing film prints, arranging for advertising and promotion of films, and all other aspects of local film distribution." *Id.*

128. *Id.* In its reply brief, MCA claimed an "undisputed legal right" to structure the distributorships as partnerships. Quoting Judge Learned Hand in Helvering v. Gregory, 69 F.2d 809, 810 (2d. Cir. 1934), *aff'd,* 293 U.S. 465 (1935), MCA argued that it was within its rights to avoid taxation, in the absence of sham or fraud. MCA Appellant Brief, *supra* note 1, at 11. Classification as a corporation would make the outlets a "related person" with respect to CIC while classification as a partnership would not. *See supra* notes 91-97 and accompanying text.

129. 502 F. Supp. at 843. See *supra* notes 39-43 and accompanying text for the I.R.S. definition of corporate characteristics.

"so closely parallels that of a corporation as to defeat their nominal characterization as 'partnerships.' "[130] The government's main argument was that "while the local outlets are made to appear as if they are owned and controlled by two separate interests, CIC and Proetus, there is no meaningful possibility that either of these interests would ever act independently of the other."[131] The court agreed, finding that, although there was an intent to create the appearance that the outlets were owned by separate and independent partners, CIC and Proetus, the actual operations of these partners were "sufficiently interwoven as to cast doubt on their separateness and independence."[132] By applying the separate interests test, the court found two corporate characteristics, continuity of life and free transferability of interests, to be present in the outlets.[133] Twelve of these outlets also possessed one of the other two distinguishing corporate characteristics, limited liability.[134] These

130. 502 F. Supp. at 843.

131. *Id.* at 844.

132. *Id.*

133. *Id.* at 846.

134. *Id.* at 847. In analyzing CIC's structure, the court first noted that two of the directors of CIC, Bluhdorn and Wasserman (who were the chief executive officers of Paramount and MCA respectively), were also two of the three trustees of Stichting, the third trustee being jointly chosen by them. *Id.* at 844. The court noted that Proetus was merely a conveyance of Stichting. In a detailed analysis of the Articles of Association of the trust, the court discovered that the trustees had "enormous discretion in the operation of the Trust," and in the disposition of the assets. *Id.* at 845. The court further found a lack of "separate interests" between CIC and Stichting existed by determining that the stock held by the Trust could not be sold without CIC's approval. *Id.*

The court found that if it were in the Trust's interest to sell its stock, two outcomes would be possible. Wasserman and Bluhdorn, as the two controlling trustees of Stichting, would simply refrain from initiating a sale of the stock. Even if Stichting's trustees did consider selling, CIC's interests in the stock were carefully protected by using "an elaborate system of clearances" giving them, *inter alia*, rights of first and second refusal. *Id.*

Before selling stock to a third party, Stichting's trustees had to provide CIC with a written offer at a price set by a predetermined formula. In addition to the right of first refusal, CIC was entitled to purchase the stock if a bona-fide offer was made by a third party. And, if CIC again failed to act, the Trust provided that the sale to such third party must be made within sixty days from CIC's second refusal or the trustees would not be permitted to make the sale. *Id.* The court found that the Trust's responsibilities to CIC and the degree of control which both entities could potentially exercise, the one on the other, made them "so interwoven as to represent a single interest." *Id.* at 845-46. See MCA Appellant Brief, *supra* note 1, at 35-37 for an opinion of the duties and liabilities of a trustee (*bestuurder*) of a foundation (*stichting*) under Netherlands law. The Trust's two percent interest in CIC was viewed as crucially important in resolving the outcome of any deadlock which might exist between MCA and Paramount as joint venturers. 502 F. Supp. at 845. It also noted that CIC's interest in controlling the Trust by means of an "interlocking directorate" prevented outside interference with the mutual dependency of the Trust and CIC. *Id.* The court also found that the duty of the trustees to maximize the value of the Trust's assets was not

twelve outlets were then classifiable as corporations under I.R.C. § 7701, and therefore were related persons within the meaning of Subpart F.[135] The combined income of these twelve outlets represented over seventy percent of CIC's entire gross income.[136] As a result, CIC, which was a controlled foreign corporation under the Code,[137] was required under Subpart F to report all of its outlets' gross income when earned.[138] The court therefore upheld the I.R.S. assessment of MCA for the taxes due on the earnings of CIC's twenty-nine[139] distribution outlets.[140]

The Ninth Circuit, reversing the district court's opinion,[141] held that the distributorships were classifiable as partnerships since

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inconsistent with their duties as directors of CIC. *Id.* Furthermore, "[t]he meetings of the trustees were normally held either immediately before or after the board meetings of CIC. These meetings were generally held in a hotel room or lobby where the CIC board had met and lasted less than an hour." *Id.* at 844.

Once the court had determined that a single interest existed, it found that the distributorships necessarily had to be viewed as corporations. The approach taken was very briefly dealt with by the court:

> The government contends that the corporate characteristics of "free transferability of interests" is present because if either CIC or Proetus had wished to sell its interest in a local outlet, the other would not have objected or interfered. Similarly, as to the "continuity of life" if "the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization." The government maintains that if no separate interests exist which would demand termination upon the occurence of one of these events, then a local outlet might well survive such occurrences—again, as would a corporation.

Id. at 846. The court extended the reasoning of Rev. Rul. 77-214. *See supra* notes 98-112 and accompanying text. The court, after quoting Justice Holmes, agreed with the intent of the Ruling, stating that it was necessary to "delve below the mere formal veneer of the so-called 'partnership' entity to consider its *actual* structure and manner of operation and decision-making . . . . [U]pon close examination, the partnership veil of the local outlets proves rather evanescent." 502 F. Supp. at 847. The court upheld the IRS's additional tax assessment of U.S.$868,170, denying MCA a refund and granting the government's motion for summary judgment. *Id.*

135. 502 F. Supp. at 847. *See supra* note 5.

136. 502 F. Supp. at 847. The *de minimus* rule at the time of the *MCA* case provided that if the FBCI was less than 30% of the CFC's gross income, no part of the gross income would be treated as income to the FBCI under Subpart F. Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1006-10. The current minimum is 10%. I.R.C. § 954(b)(3)(A) (1982). *See supra* note 5.

137. *See supra* note 5.

138. 502 F. Supp. at 847.

139. The lower court incorrectly states that there was a total of 21 outlets. 502 F. Supp. at 843. MCA's counsel and the Ninth Circuit state that there are 29 outlets. MCA Appellant Brief, *supra* note 1, at 8 n.11; MCA v. United States, 685 F.2d 1099, 1101 (9th Cir. 1982).

140. 502 F. Supp. at 843.

141. *MCA*, 685 F.2d at 1105 .

CIC and Stichting were separate interests as a matter of law.[142] The court, analyzing the ownership structure of the distributorships, emphasized the fiduciary role of Stichting's Board of Trustees.[143] It found that, while there was a "commonality of . . . business interests, there is a potential for legitimate conflict of interest between [CIC and Stichting] . . . in the management of the distributorships."[144] The court concluded that, "although we agree with the government that CIC and Stichting are likely, as a practical matter, always to act in concert in their management of the distributorships, we cannot conclude as a matter of law that their interests will never diverge."[145]

The Ninth Circuit, therefore, distinguished the facts of *MCA* from those in Revenue Ruling 77-214.[146] Arguably, this decision does not preclude the application of the separate interests test in a factual pattern where there is no possibility of legitimate conflict of interest among the related parties. The court noted, however, that legislative change in this area would be more appropriate.[147]

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142. *Id.* at 1104. The court began its analysis by recognizing that "CIC and Stichting, unlike the corporations in Rev. Rul. 77-214, are beneficially owned by parties with separate and distinct economic interests—CIC principally by MCA and Paramount, and Stichting personally by individual employees of CIC." *Id.* at 1103. The court further noted that the fiduciary duty of loyalty of the Stichting trustees was one which "regardless of the breadth of their discretion . . . [is] a duty to exercise their powers in good faith and without concern for their own personal interests or for those of third parties." *Id.* Since the parties had not given written notice of intent to raise Netherlands law of fiduciaries, the court was "under no obligation to apply Netherlands law." *Id.* at n.12. Citing the law of the forum state, the court held that, under California law, the fiduciary duty of trustees was one which a court would review for unreasonableness, arbitrariness, capriciousness, or bad faith. *Id.* at 1103. The court, in reaching its decision, reasoned that

> MCA and Paramount may have gone to the brink of permissible control over Stichting; but the government offers no evidence that the Messrs. Wasserman and Bluhdorn [sic], in their capacities as Stichting Trustees, have gone over the brink . . . . Nor do we think that the tax consequences of a legitimate business transaction should turn on an unsupported assumption that certain parties to the transaction will act in breach of their fiduciary duties and, indeed, unlawfully. Thus, we conclude that the disputed provisions, which restrict the transferability of distributorship interests and limit the continuity of distributorship life, have legal effect. We hold that under § 301.7701-2 the distributorships must be classified as partnerships for domestic tax purposes.

Id. at 1104.

143. *Id.* at 1103-04.

144. *Id.* at 1103.

145. *Id.* at 1104.

146. *Id.* at 1103.

147. *Id.* at 1105. *See infra* notes 181-83 and accompanying text.

II. *CRITICISM OF THE SEPARATE INTERESTS TEST*

While the outcome of the application of the separate interests test may be desirable from the viewpoint of both the I.R.S. and the United States government,[148] the test itself lacks consistency and logical cohesiveness.[149] An application of the separate interests test requires the finding of a single economic interest in the I.R.C. § 7701 characteristics of transferability of interests and continuity of life; it does not do so, however, for the remaining four characteristics.[150] As one commentator notes,[151] this incomplete application casts doubt upon the logic of the test's analysis, since the application of the test to the remaining characteristics may lead to a different result.[152] A finding of a single economic interest in an entity's ownership apparently has no effect on the existence of the corporate characteristic of limited liability. An entity attempting classification as a partnership will seek to avoid the appearance of limited liability in its ownership structure. The finding of a unified economic interest among the entity's members will arguably have no effect on the continuing nonexistence of limited liability.

The test's application to the characteristics of joint profit motive, centralized management, and associates, however, could determine the outcome of the classification.[153] Certain unresolved problems arise when the separate interests test is applied to these characteristics. Associates and their *joint* motive for profit are deemed to be the two essential characteristics of all business entities, other than the so-called one man corporation and the sole proprietorship.[154] The term "associates" implies a plurality of ownership. Where the ownership of the entity is found to be a single economic interest, there is arguably an absence of associates and

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148. The application of the test appears thus far to have generated greater tax revenue in both cases. *See MCA*, 502 F. Supp. at 847; Rev. Rul. 77-214, *supra* note 8, at 408.

149. *Tax Section Report, supra* note 1, at 201.

150. *Id.* at 201-02.

151. *Id.*

152. *See supra* notes 148-51 and *infra* notes 153-62 and accompanying text.

153. *Tax Section Report, supra* note 1, at 201-02.

154. Treas. Reg. § 301.7701-2(a)(2), *supra* note 11.

> Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association.

Id.

their joint motive for profit. This absence could result in the entity's being classified as a branch of the parent corporation rather than as a partnership or corporation.[155] A branch, like a partnership, falls outside the Subpart F provisions.[156]

A different method of finding the existence of associates has been recommended by one commentator.[157] Under this method, the Code's requirement for associates can be met if the foreign entity has associates "at any level, either at the level of its immediate owners, its intermediate corporate owners or the ultimate shareholder level."[158] This approach, therefore, looks for the existence of associates throughout the corporate structure rather than at the level of the particular entity to be classified.[159] This broader method would appear to mitigate problems which arise when a more complete application of the separate interests test is used. The I.R.S. has thus far not attempted to clarify what would be the outcome of the test's application to these characteristics.[160] It apparently became aware of the problems of applying the separate interests test to the

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155. *Tax Section Report, supra* note 1, at 202. A counterargument could be made that a single economic interest exists among all the associates, and therefore that the existence of the characteristic (and a joint profit motive) is preserved when the test is applied. *Id.*

156. A branch is not a "related party" as defined by I.R.C. § 954(d)(3). *See supra* note 91. *See also Tax Section Report, supra* note 1, at 208.

157. *Tax Section Report, supra* note 1, at 207-08.

158. *Id.* at 208.

> It has also been suggested that a foreign entity be treated as fulfilling the requirement for associates if it has the capacity for associates. That is, if the foreign organizational form can be established with *either one* or *more* than one owner, it would be considered to satisfy the associates test even though, in fact, it *had only one* owner.

Id. at 208 n.144 (emphasis added).

159. *Id.* at 207-08.

160. *See Tax Section Report, supra* note 1, at 202-06. The government's brief in *MCA* argues that the outlets did not have centralized management. Quoting *Zuckman*, the brief notes:

> although CIC owns 95% of the outlets, and clearly operates them, this is not, under *Zuckman*, what centralized management means . . . . [I]f there is a great number of partners, there is a presumption that the managing partner acts in . . . a representative way, and centralization of management is present. When there are few partners, or where one partner has *de facto* control, this "would in itself effectively rule out any possibility of representative management."

MCA Appellees Brief, *supra* note 61, at 23 (citations omitted). The government made this argument because it felt that de facto control of the outlets by MCA and Paramount through their control of CIC, Stichting and Proetus bestowed the characteristics of continuity of life and free transferability of interests upon the outlets. See *supra* note 41 for further discussion of centralized management.

characteristics of associates and joint profit motive soon after the publication of Revenue Ruling 77-214, but no satisfactory resolution has been offered.[161]

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161. *Tax Section Report, supra* note 1, at 210. The I.R.S. issued five Private Letter Rulings: Private Letter Rul. No. 743060 (July 28, 1977), Private Letter Rul. No. 7743077 (July 29, 1977), Private Letter Rul. No. 7747083 (Aug. 26, 1977), Private Letter Rul. No. 7748038 (Aug. 31, 1977), Private Letter Rul. No. 7802012 (Oct. 11, 1977), all concerning foreign entities owned by United States parent corporations. For a summary of these and other private letter rulings through November 21, 1979, see *Tax Section Report, supra* note 1, at 222-38. In all of these rulings, the I.R.S. concluded that the parent corporation was either the beneficial or true owner of the entire foreign interest and therefore lacked both associates and anyone with whom to divide the profits, the second essential corporate characteristic. *See id.* Therefore, the entity was to be treated as a foreign branch of the domestic parent. If this approach had been consistently applied, it would have led the I.R.S. to refuse to recognize the existence of United States wholly-owned foreign subsidiaries altogether.

On November 11, 1977, one month after the issuance of the last letter ruling, the I.R.S. issued new rulings to the same five taxpayers, withdrawing the previous rulings, offering only that the prior holdings are "not in accord with the views of the Service concerning the proper tax classification of foreign organizations that have only one beneficial owner." Private Letter Rul. No. 7806055 (Nov. 11, 1977); Private Letter Rul. No. 7806056 (Nov. 11, 1977); Private Letter Rul. No. 7806057 (Nov. 11, 1977); Private Letter Rul. No. 7806058 (Nov. 11, 1977); Private Letter Rul. No. 7806062 (Nov. 11, 1977).

The taxpayers were told that the foreign entities would be treated as corporations beginning four months from the issuance of the withdrawal. *Tax Section Report, supra* note 1, at 203.

Subsequent letter rulings have not provided further clarification. An Italian *Società a responsibilità limitata* (S.r.l.) was held to be an association taxable as a corporation where it was jointly owned by a United States corporation and its wholly-owned United States subsidiary. Private Letter Rul. No. 7841008 (June 20, 1978). In this letter ruling, another wholly-owned United States subsidiary of the same parent joined as a quotaholder. The I.R.S. found that no separate interests existed to compel dissolution and, therefore, found continuity of life. *Id.* Similarly, since the ruling found that if the United States parent had the power to make all transfer decisions for members, free transferability of interests existed. *Id.* The ruling found that centralized management existed as well, since the *società* was managed by a board of directors whose decisions did not have to be ratified by the other members. *Id.* It is interesting to note that the ruling applied the separate interests test only to the characteristics of continuity of life and free transferability of interests, although it appears to have been indirectly applied to centralized management because of the facts. *Id.*

In dealing with the retroactive application of the ruling to 1974 and 1975 taxable years, the ruling commented that the "I.R.S. [will not] grant relief under Section 7805(b) . . . because [the parent corporation did not] request [it and the] . . . ruling . . . [was not] issued until more than one year after . . . [its] conversion." *Id.* This comment seems to imply a desire on the Service's part to penalize those who fail to ask for timely determinations. For similar decisions, see Private Letter Rul. No. 7843006 (July 18, 1978), where the ruling looked at the common ownership of a Greek limited liability company (EPE) to classify it as a corporation; Private Letter Rul. No. 7936050 (June 8, 1979), where the domestic parent was found to have "substantially all of the interests" of the United States parent wholly-owned new company (a Chilean *limitada*, limited liability company) upon liquidation of the old company (a Chilean joint-stock company); the new company was held to be a corporation for federal tax purposes. *Id.* There is one ruling where separate interests test did not apply to similar facts and a conflicting ruling was given. Private Letter Rul. No. 7934096 (May 24,

The application of the separate interests test to the corporate characteristic of centralized management is less complex. The finding of a single economic interest implies that there is control of the entity by a unified management. It could be argued therefore that the corporate characteristic of centralized management exists if the foreign entity's management is controlled by such a unified economic interest.[162]

Taxpayers have not failed to notice the problems with the separate interests test. The large number of requests for private letter rulings to clarify Revenue Ruling 77-214 indicates the considerable degree of confusion and uncertainty in the area of tax planning for United States affiliated foreign entities.[163]

Retroactive application of the test to a taxpayer's detriment, as attempted in the *MCA* district court decision,[164] is also open to criticism.[165] Although the I.R.S. has the power to apply its rulings retroactively,[166] it has stated a policy preference for nonretroactive application where a new ruling would have adverse tax consequences to taxpayers.[167] This statement of I.R.S. policy justifiably encourages reliance by taxpayers on the present Service rules and regulations. Until the issuance of Revenue Ruling 77-214, taxpayers, especially those cognizant of the I.R.S. policy of nonretroactiv-

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1979). A French *société en nom collectif* (s.n.c.) was held taxable as a partnership for United States tax purposes even though the members of the partnership were a United States corporation and its two wholly-owned subsidiaries. *Id.* The separate interests test was not mentioned in the ruling. See *Tax Section Report, supra* note 1, at 205 for further discussion of the difficulty in finding consistent application of the separate interests test in letter rulings.

162. *See Tax Section Report, supra* note 1, at 206. "[I]f a single economic interest holds all of the ownership and control, there is only one management voice and the foreign entity's management is centralized in the single owner." *Id.*

163. *Id.* at 210. "[A] degree of uncertainty . . . impels taxpayers to seek the assurance of a private ruling and places a heavy administrative burden on the Service in granting rulings." *Id.* See *supra* note 161 for a discussion of a number of conflicting letter rulings.

164. *See supra* notes 107-33 and accompanying text.

165. *Tax Section Report, supra* note 1, at 212.

166. I.R.C. § 7805(b) (1982). "*Retroactivity of regulations or rulings*—The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect." *Id. See also* MCA Appellant Brief, *supra* note 1, at 21.

167. Treas. Reg. § 601.601(a) (1982). "Where Revenue Rulings revoke or modify rulings previously published . . . the authority of Section 7805(b) of the Code ordinarily is invoked to provide that the new rulings will not be applied retroactively to the extent that the new rulings have adverse tax consequences to taxpayers." Treas. Reg. § 601.601(d)(2)(v)(c) (1981) Rev. Proc. 78-24, §§ 7.01(3), (5), 1978-2 C.B. 503. "[T]he criteria for limiting a revocation or modification to only prospective applications are more stringent." *Tax Section Report, supra* note 1, at 213.

ity, could have expected the mechanical rules of the *Kintner* regulations to be uniformly applied. Yet, these regulations were not applied in either Revenue Ruling 77-214 or in the *MCA* district court opinion.[168] This shaking of taxpayer certainty has been criticized as a violation of due process rights.[169] In response to this criticism, it has been argued that the holdings in Revenue Ruling 77-214 and in the *MCA* district court opinion involved no unfair surprise.[170] The taxpayers involved were aware of the intent of Subpart F and were merely attempting clever avoidance of the spirit of the I.R.C. provisions.[171] This attempt at tax avoidance should not be protected from what arguably amounts to a more rational interpretation or, at most, an extension of Subpart F and related provisions.[172] Further, the I.R.S. is ultimately bound not by its policy statement favoring nonretroactivity, but by the provisions of the Code itself, which grant the Service wide discretion to make retroactive applications.[173]

The area of foreign entity classification is problematic.[174] Any mechanism, rule or policy which creates greater certainty in this area would be appreciated by business concerns and tax practitioners. As a step toward greater definiteness, a firm rule requiring prospective application is very desirable.[175]

In addition, questions of fairness arise with respect to the exclusive application of the separate interests test to foreign entities.[176] Although some policy justifications for this exclusivity may exist,[177] any abuse of the classification rules involving foreign entities would be more effectively remedied by changing the law which

168. The Ninth Circuit distinguished the case from Rev. Rul. 77-214 on the facts. *MCA*, 685 F.2d at 1103.

169. *See Tax Section Report*, *supra* note 1, at 212-14.

170. MCA Appellee Brief, *supra* note 61, at 12.

171. *See id.* at 12-13.

172. *Id.*

173. *Tax Section Report*, *supra* note 1, at 213. *See also* Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110 (1939) (holding that the Commissioner improperly reversed long-standing regulations retroactively); Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactively*, 43 TAXES 756, 761-63 (1965).

174. *See supra* notes 68-147 and accompanying text.

175. *Tax Section Report*, *supra* note 1, at 214-15.

176. *Id.* at 208-09.

177. *Id.* at 209. "If there are policy justifications for the use of a different standard, the policies should be stated and dealt with in a specific and limited fashion." *Id.* For the rationale in support of Subpart F, namely prevention of tax avoidance by United States controlled foreign corporations, see *supra* notes 84-97 and accompanying text.

allows the specific abuse to exist.[178] In the case of *MCA*, for example, the addition of partnerships to the Subpart F definition of "related person" would have remedied any future attempts at tax avoidance by similarly structured United States controlled foreign entities.[179]

Alternatively, the I.R.S. could clarify the area of foreign entity classification by

> promptly publish[ing] a list of foreign business organizations that always would be classified as corporations if the list were confined to at least a single form of organization for each principal jurisdiction, minimizing the necessity of making decisions on hybrid entities and minimizing the risk of including any flexible forms or organizations that may be in use by some taxpayers to achieve partnership treatment.[180]

This I.R.S. publication would assure United States taxpayers that at least the listed classifications will not be challenged.

Recently, the Service has tried unsuccessfully to amend the *Kintner* regulations.[181] A proposed new amendment of the regulations provides that, where limited liability exists with regard to all members of an entity under local law, the entity is per se a corpora-

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178. See *Tax Section Report*, *supra* note 1, at 209 n.148 for examples of changes in the law to remedy abuses involving United States affiliated foreign entities. See also *infra* note 207 for Ninth Circuit court's similar comments in *MCA*.

179. *See supra* notes 98-147 and accompanying text.

180. *Tax Section Report*, *supra* note 1, at 210-11.

181. Fisher, *supra* note 28, at 627. On January 5, 1977, the I.R.S. published proposed regulations under I.R.C. § 7701(a)(3) which established criteria and rules of operation for distinguishing partnerships from corporations. Prop. Treas. Reg. §§ 301.7701-1 to -3, 42 Fed. Reg. 1038 (1977). Most importantly, the regulations rejected the preponderance test and also provided a means by which the I.R.S. could "reclassify an organization whenever it undergoes a sufficiently material change with respect to at least one of the *Morrissey* characteristics that might affect the determination of its overall corporate resemblance." Fisher, *supra* note 28, at 647. The regulations were withdrawn soon after their publication, adding to the confusion in the area. *Id.* See also Peel, *supra* note 44, at 1000, wherein the author notes:

> The Treasury responded to the airing of the deficiencies in its regulations in *Larson* by publishing proposed regulations on January 5, 1977 . . . . [T]he proposed changes were not published over Secretary of the Treasury Simon's signature, and he ordered the notice of proposed rulemaking withdrawn on the following day. According to contemporaneous news reports, the proposed regulations had been published without the Secretary's knowledge and had aroused protests from the Department of Housing and Urban Development and other real estate interests who were concerned that the threatened withdrawal of the tax benefits of direct ownership would hurt real estate investment.

Id.

tion.[182] The amendment is designed to deal with "limited liability" entities currently classified as partnerships. The outcome of this legislation is uncertain; as of this date no hearing has been held, although some experts have volunteered comments.[183]

Because the I.R.C. § 7701 regulations interact with numerous and varied areas of the United States tax law, an attempt to revise them is certain to be both difficult and controversial.[184] The I.R.S. has historically encouraged and initiated legislative changes in the tax law, filling gaps where abuses were found to exist.[185] Changing the *Kintner* regulations would have many unforeseen repercussions because of the interrelationship between the regulations and other areas of the tax law.[186] In an area as complex and far-reaching as entity classification, any broad change or illogical test adds rather than diminishes confusion. The problems of the separate interests test are better resolved in a more limited manner. Focusing legislative changes on Subpart F and other areas of tax law which interact with I.R.C. § 7701 and its regulations is a more expedient solution to the abuses in the area than amending I.R.C. § 7701 itself. Absent a drastic change in the concepts underlying I.R.C. § 7701, legislation amending Subpart F is preferable to the separate interests test.

In the event that no legislative change is made, United States taxpayers should consider the separate interests test in structuring their foreign business operations.[187] Effective tax planning is a par-

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182. Classification of Limited Liability Companies: Notice of Proposed Rulemaking, 45 Fed. Reg. 75709-10 (1980). The proposed amendment states as follows:

> Section 301.7701-2 is amended . . . [as follows] 301.7701-2 *Associations*
>
> (a) Characteristics of Corporations . . . . (2) . . . However, such an organization will be classified as an association if under local law no member of the organization is personally liable for debts of the organization. For purposes of the preceding sentence, only liability arising solely from membership in the organization shall be taken into account; liability of a member as a guarantor on an obligation of the organization shall be disregarded.

Id. Thus, under the proposed regulations, whenever limited liability exists, the entity will be automatically classified as corporation. *See id.*

183. The hearings, scheduled for early 1981, were never held. 45 Fed. Reg. 75709-10 (1980). The outcome of this legislation is still unknown, though most of the opinions given by outside experts have been strongly against its promulgation. Per telephone interview with assistant in office of Paul A. Francis, attorney in I.R.S. Office of Chief Counsel (May 31, 1982).

184. *See Tax Section Report*, *supra* note 1, at 209.

185. *See id.*

186. *See supra* note 1.

187. *See* Hamilton, *supra* note 22, at 299.

ticular dilemma for United States businesses which must establish foreign juridical entities to avoid discrimination abroad, and which seek tax deferral at home.[188]

Different methods have been suggested by tax counsel to United States taxpayers wishing to achieve tax deferral through entity classification.[189] To avoid classification of foreign entities as corporations under the separate interests test, United States parent corporations may consider sharing their ownership interests with unrelated third parties.[190] A determination of what percentage of outside ownership would satisfy the I.R.S. is essential to this strategy.[191] A degree of unrelated ownership satisfactory to the I.R.S. may well be greater than the amount of control that a United States parent would be willing to divest.

An alternative method for avoiding corporate classification is the creation of "separate interests throughout the ownership chain."[192] If both United States corporations in *MCA* had formed distribution outlets, separate interests might have been found without inquiring into the directors' fiduciary roles.[193] The mutual distrust and competitiveness of the two entities might have made such planning impractical. The I.R.S., however, may still view such a structure as an attempt to avoid Subpart F treatment comparable to that of *MCA*.

A third recommendation is to have foreign entities' charter include provisions to the effect that there is no free transferability of interests or continuity of life in the entity, regardless of "unanimous agreement to the contrary."[194] An example of this type of provision would be one where the death, insanity, bankruptcy, retirement, resignation, or expulsion of a member causes dissolution despite any agreement by the members to continue the entity.[195] The I.R.S.

188. *Tax Section Report, supra* note 1, at 208.

189. *Hamilton, supra* note 22, at 299.

190. *Id.*

191. *Id.*

192. *Id.*

193. In MCA Appellant Brief, *supra* note 1, at 26, counsel states that "[h]ad MCA, Paramount, CIC, and the employee trust been able to anticipate the new 'separate interests' requirement, they could have altered their conduct simply by causing MCA and Paramount each to acquire a direct minority ownership interest in the distributorships." *Id.* This presumably would have made the distributorships unrelated persons in some counsel's opinion, but perhaps not in that of the I.R.S. See *MCA*, 685 F.2d at 1103-04, for a discussion of a fiduciary's duty of loyalty.

194. Hamilton, *supra* note 22, at 299.

195. *Id.*

might view such a provision as illusory, inserted only with intent to avoid United States taxes. While the recent Ninth Circuit decision in *MCA* has left the future of the separate interests test uncertain, it is apparent that separate interests will always be found where the related owners have a fiduciary duty which is distinct from their management function. Despite a commonality of ownership, any business structure which has this divergence of responsibilities would most likely withstand any I.R.S. challenge.

CONCLUSION

The separate interests test has, thus far, been formally considered in only one case.[196] The test has been applied solely to foreign entities affiliated with United States shareholders;[197] comparable domestic entities are still scrutinized by the mechanical application of the *Kintner* regulations, which are slanted against finding that unincorporated entities are corporations.[198] The test's analysis is incomplete because it fails to apply the finding of a single economic interest to all the corporate characteristics put forth in I.R.C. § 7701.[199] A complete application of the test might lead to results inconsistent with the Service's intent to tax certain income of United States controlled foreign corporations when earned.[200] For example, using the separate interests test to ascertain the presence of associates may cause an entity to be classified as neither a corporation nor a partnership. Rather, it is taxable as a branch of the United States parent, and thereby avoids Subpart F provisions.[201] In recognition of the need for fairness and predictability in tax matters, only a prospective application of the test should be allowed in the future. This would provide taxpayers with a reasonable length of time to restructure their international operations.[202]

As the Ninth Circuit indicates, the separate interests test is not the most appropriate or effective way to end the current confusion in foreign entity classification.[203] Although legislative attempts have

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196. *See supra* notes 113-47 and accompanying text.
197. *See supra* notes 98-112 and accompanying text.
198. *See supra* notes 32-48 and accompanying text.
199. *See supra* notes 148-62 and accompanying text.
200. *Id.*
201. *See supra* note 155 and accompanying text.
202. *See supra* notes 164-75 and accompanying text.
203. *See supra* notes 176-78 and accompanying text.

been unsuccessful,[204] the need for statutory change is clear. Modification or amendment of the *Kintner* regulations is a difficult and arduous undertaking. A more immediate alternative to the separate interests test would be statutory changes in Subpart F which would prevent tax avoidance abuses through foreign entity classification. It is suggested that a broadening of the Subpart F definition of "related person" to include noncorporate entities would effectively prevent avoidance of Subpart F by structuring United States foreign controlled entities as partnerships rather than corporations, pursuant to I.R.C. § 7701. The government, in its *MCA Brief for the Appellee* [205] went so far as to argue that the word "corporation" in the definition of related person is "not significant in the overall scheme of Subpart F and should be understood in a manner which furthers its purposes."[206] The Ninth Circuit disagreed. It commented that a broad reading of the term "related person" without actual statutory change is not a proper manner of dealing with what appears to be a legislative oversight.[207]

While awaiting statutory revisions, the implications of the separate interests test must be taken into consideration by taxpayers and their counsel. United States taxpayers wishing to structure their

204. *See supra* notes 184-85 and accompanying text.

205. MCA Appellee Brief, *supra* note 61, at 8-9.

206. *Id.*

207. The Ninth Circuit in *MCA* stated:

> The government asserts that in enacting subpart F Congress was more concerned with the nature of the income than the form of the entity generating the income, and that CIC's distributorship income is precisely the kind that Congress intended to tax currently under I.R.C. § 951(a).
>
> We find this argument unpersuasive. Although we agree that CIC's distributorship income is apparently the kind that Congress intended to tax currently *if* received from a controlled *corporation*, we decline the government's invitation to depart from the plain language of the statute. Congress wrote the statute unambiguously to apply to subpart F income received from controlled "corporations" only. If the omission of income received from controlled partnerships has indeed created an unjustified loophole in the tax laws, the remedy lies in new legislation, not in judicial improvisation . . . .
>
> . . . [The section 301.7701-2] regulations, which were originally designed to limit the availability of corporate tax status . . . prescribe a mechanical and formalistic test, *see Larson*, 66 T.C. at 172, permitting taxpayers to select a form of business organization with certainty about the attendant tax consequences. If the test has proven unsatisfactory, or if the Commissioner determines that the test should not apply to foreign entities, the Commissioner is free to promulgate a new regulation that taxpayers can rely on in planning their foreign business ventures.

MCA, 685 F.2d at 1104-05 (citations omitted).

foreign controlled entities to avoid Subpart F taxation may well empathize with the Greeks' mythological Io, who, a target of Hera's jealousy, was condemned to "wandering, and in fearsome lands."[208]

Diane Francesca Krausz

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208. E. HAMILTON, MYTHOLOGY, TIMELESS TALES OF GODS AND HEROES 78 (1942).