## Is a GmbH & Co KG a
## Corporation or Partnership for US Tax Purposes?

Every country seems to have its own version of a tax transparent entity in which investors (i.e., limited partners) have limited legal liability and the sponsor (i.e., general partner) has unlimited legal liability. The general partner, typically a corporate entity designed to shield the ultimate owners from ultimate legal liability, usually owns a nominal economic interest in the tax transparent entity.

In the US, this structure takes the form of a (tax transparent) Limited Partnership ("LP") where the general partner is a US corporation. Almost every state's commercial statute requires the general partner to have at least a nominal economic interest in the LP and, in most transactions, this interest is typically between .01% and 1%. The German version of this structure takes the form of a (tax transparent) "GmbH & Co KG" where the general partner is a small GmbH. But, unlike the US, German commercial law permits the GmbH to have a 0% interest in the GmbH & Co KG and this is typical in transactions.

Now consider the commonly encountered transaction structure of a GmbH & Co KG formed to invest in US real estate. (*Assuming* that the GmbH & Co KG is regarded as tax transparent for US tax purposes, this could be one sensible structure from a US tax perspective, although, especially in tiered structures, it can be cumbersome when dealing with US tax withholding on real property income and sales of real property.) The issue we are addressing here is the key, gating *assumption* that a GmbH & Co KG with a 0% general partner will be regarded as tax transparent for US tax purposes, which the authors believe is very possibly an incorrect assumption in the absence of affirmative steps. In particular, absent a simple election otherwise, we believe that the GmbH & Co KG may well be a corporation for US tax purposes. Our thinking is as follows.

The US tax law has specific rules on what is, and what is not, a corporation (nontransparent) or partnership (tax transparent) for US tax purposes. For an entity organized under US law (a domestic entity), the rules are relatively clear and easy to follow. The domestic entity is a "per se" (nontransparent) <u>corporation</u> if it is:

- an entity organized under a US federal or state statute that describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;
- an association as determined under Internal Revenue Service (IRS) regulations;
- an entity organized under a US state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;
- an insurance company;
- a US state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act or a similar federal statute; or
- an entity wholly owned by a US state or any political subdivision thereof, or a business entity wholly owned by a foreign government, etc.

If it is not one of the above, then, unless the domestic entity elects otherwise, the default classification of a domestic entity is transparent, viz.:

- a partnership if it has two or more members; or
- disregarded as an entity separate from its owner if it has a single owner.

But the US tax laws are different when the situation involves a foreign entity. A foreign entity is "per se" a (nontransparent) corporation if it is enumerated as such in applicable IRS regulations. This "per se" list is generally designed to capture entities that are or could be listed on a local stock exchange, and includes entities such as a German Aktiengesellschaft ("AG") or an Australian or United Kingdom Public Limited Company ("plc"). Absent enumeration on the aforementioned "per se" list, the default classification of a foreign entity depends on whether or not its members have limited liability. In particular, the default rules for US tax purposes are:

- a foreign entity is a (tax transparent) partnership if it has two or more members and at least one member does not have limited liability;
- a foreign entity is a (tax transparent) disregarded entity if it has a single owner that does not have limited liability; or
- a foreign entity is a (nontransparent) corporation if all of its members have limited liability.

Thus, applicable US regulations require that at least one *member* of the foreign entity have unlimited liability in order that the foreign entity itself be eligible for tax transparent status under US law. But, under US tax principles, is the GmbH general partner, with its 0% economic interest in the GmbH & Co KG, a "member" of that entity? If the GmbH general partner is a member, then the GmbH & Co KG defaults to a (tax transparent) partnership for US tax purposes; conversely, if the GmbH general partner is not a "member" under US tax principles then, absent a very simple election, the GmbH & Co KG is a (nontransparent) corporation for US tax purposes.

US tax law presupposes a classic understanding of partnership as two or more persons joining together for the joint production of income. Implicit in this definition is that each of the persons has an economic interest in the partnership. Else, how does a person share in the joint production of income?[1] Accordingly, absent an affirmative election otherwise, a GmbH general partner with a 0% interest in its GmbH & Co KG probably will not be viewed as a "member" under US tax principles, and thus the GmbH & Co KG, not having any "members" with unlimited legal liability, will default to a US tax status of (nontransparent) corporation rather than the desired (tax transparent) partnership.[2]

In light of the above, if you are planning to use a GmbH & Co KG, you have two principal options: (a) admit the GmbH (general partner) at the outset as a member with a real economic ownership interest (e.g., .01% or greater) in the GmbH & Co KG, or (b) check the box on IRS Form 8832 at the inception of the US investment -- which is a very simple thing to do. Thus, the well advised will file the IRS Form 8832 at the inception of the US investment.

What if you have an existing GmbH & Co KG that is "at risk" of being viewed as a corporation under US tax law because an election was not timely made? Well, you might have already thought of the following options:

(1) Bury your head in the sand, ignore the problem, and it will go away? The authors do not recommend this "ostrich solution".

[1] See, e.g., Private Letter Rulings 200201024, 199914006, 199911033 (an entity constituted with two "members", where one member has no economic interest in profits or losses and has limited or no management rights, is not a partnership under US tax law).
[2] Informal discussions with the IRS National Office suggest they agree with this conclusion.

(2) Give the GmbH an economic interest today and that will fix the situation going forward? The authors do not recommend this solution either. The character of a foreign entity is determined on the date the foreign entity is relevant for US tax purposes (e.g., at the inception of a US investment), and subsequent tinkering with the composition of the entity may not be enough to alter its US tax status going forward. Additionally, an affirmative election on IRS Form 8832 to change US tax status from a corporation to a tax transparent entity, though effective going forward, can have significant up front US taxable consequences on account of the status conversion.
(3) Fix the documents and no one will be the wiser? The authors strongly advise against this “backdating” strategy.
(4) Apply to the IRS for late filing relief? Under applicable relief procedures, a foreign entity can request the IRS to accept a late Form 8832 election, viz., permission to be considered a (tax transparent) partnership for US tax purposes retroactive to the date of the foreign entity’s formation or relevance for US tax purposes. This late filing relief does not come without risk or cost, and you should discuss this option with your tax counsel.

---



---

Patrick Williams is a Founding Partner in World Tax Partners LLP and a shareholder in Bennett Thrasher PC. He is the former National Partner in Charge of KPMG LLP’s Foreign Investment in U.S. Real Estate Tax Practice and KPMG LLP’s Atlanta Partner in Charge of Real Estate Tax Services.

Mr. Williams is a member of the Association of Foreign Investors in Real Estate (AFIRE) and the organization’s 2005-2008 Director of Tax and Legal Information, as well as a member of the Tax Policy Committee of the Real Estate Roundtable. He graduated from Clemson University with a Bachelors in Accounting and from Georgia State University with a Masters in Taxation. He is a member of the American Institute of Certified Public Accountants and the Georgia Society of Certified Public Accountants.

Ameek Ashok Ponda is a partner and codirector of Sullivan & Worcester’s Tax Department. He concentrates his practice in structuring corporate mergers and acquisitions, advising emerging companies on financing and business issues, designing REIT transactions and financial instruments, and working on cross-border financings and acquisitions.

Mr. Ponda is a member of the American, Massachusetts and Boston Bar Associations and a member of the National Association of Real Estate Investment Trusts. He is also a charter member and former Secretary of The Indus Entrepreneurs-Boston, and an Adjunct Professor at Boston University School of Law. He graduated from Harvard College and Harvard Law School, and received an LL.M. in Taxation from Boston University School of Law.