THE CHAMBER'S

INTERNATIONAL TAX JOURNAL

MARCH - 2020 | CTCITJ. III | NO. 3

HEAVEN BE OUR GUIDE

Estd. 1926

ज्ञानं परमं बलम्

A Quarterly Journal of
THE CHAMBER OF TAX CONSULTANTS

Contents

March

Pass-Through Entities in The US - Entity Selection and Treaty Benefits

Bijal Ajinkya, Ashish Mehta & Ipshita Bhuwania, Advocates

1. A "pass-through" or fiscally transparent entity is one which does not itself possess an identity distinct from its owners for tax purposes. In the US, examples of these fiscally transparent entities include sole proprietorships, partnerships and S- corporations.

The scope of this article extends to the following:

1.1. Overview of fiscally transparent entities in US and check-the-box entity selection

1.2. Limited Liability Corporations in US– Overview and Taxation

1.3. Partnerships in US– Overview, Types and Taxation

1.4. Corporation: S-corporation vs C-corporation – Overview and Taxation

1.5. Pass-Through Entities: Availing Benefits under the India-US DTAA

1.6. Entity Selection for Inbound Investor

1.7. Conclusion

2. ABBREVIATIONS USED IN THE ARTICLE:

- Authority for Advance Ruling – **AAR**
- Association of persons – **AOP**
- Base Erosion and Profit Shifting – **BEPS**
- Deputy Commissioner of Income Tax – **DCIT**
- Double Taxation Avoidance Agreement – **DTAA**
- Effectively Connected Taxable Income – **ECTI**
- Electing Small Business Trust – **ESBT**
- Fixed or determinable annual or periodical – **FDAP**
- Income Tax Act, 1961 – **IT Act**
- Income Tax Appellate Tribunal – **ITAT**
- Limited Liability Corporation – **LLC**
- Limited Liability Partnership – **LLP**
- Limited Partnership – **LP**
- Non-Resident Alien – **NRA**
- Organization of Economic Cooperation and Development - **OECD**
- Tax Cuts and Jobs Act 2017 – **TCJA**
- United States of America – **US**

3. OVERVIEW

3.1. The issue of whether a fiscally transparent foreign partnership can be regarded as a resident of the country where the partnership is based / incorporated often arises in cross-border partnership taxation. The problem arises in case of a hybrid entity which would be regarded as a separate entity under a particular country's domestic law, yet it may be viewed as fiscally transparent in another country.

3.2. For instance, partnerships in the US are pass-through entities and are not taxed at the partnership level but in the hands of the partners. This contrasts with India, where a partnership is recognized as a separate taxable entity and undergoes taxation on its income, while share of profits up streamed from partnership is exempt from taxation in the hands of the partners.

3.3. This mismatch of tax treatment is an issue which arises quite often in the case of US pass-through entities. For US federal tax purposes, certain business entities automatically are classified as corporations. Other business entities may choose how they are classified for federal tax purposes. A business entity with at least two members can choose to be classified as either an association taxable as a corporation or a partnership, and a business entity with a single member can choose to be classified as either an association taxable as a corporation or disregarded as an entity separate from its owner (i.e. sole proprietorship).

3.4. This election is colloquially referred to as "checking the box". An eligible entity uses Form 8832 to elect how it will be classified for federal tax purposes. However, per se entities (entities which are public limited companies) are not eligible for check the box and cannot be treated as partnership.

4. LIMITED LIABILITY CORPORATIONS

4.1. Overview of LLC

4.1.1. An LLC is an unincorporated hybrid form featuring the limited liability of a corporation and tax advantages of a partnership. An LLC is an entity in itself and therefore has all the benefits of being a legal entity such as being able to enter into contracts, litigate, be a general or limited partner, and appoint agents to manage its affairs.

4.1.2. Owners of LLCs are referred to as members and have limited liability for business debts even if they participate actively in the management of the entity. Individuals, including NRAs, corporations and partnerships may be members. There are no limits on the total number of members. Members are governed by an *inter se* operating agreement which is similar in nature to a partnership agreement. It addresses *inter alia* profit/loss ratios, capitalization rules, voting rules, member rights, transfer of interest, dissolution, admission or withdrawal of a member and death of a member.

4.2. Taxation of LLC

4.2.1. The key advantage of an LLC is that members obtain corporate benefits without the double taxation of income. An LLC may be classified for federal income tax purposes as either a partnership, a corporation, or an entity disregarded as an entity separate from its owner. A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for federal income tax purposes. However, an LLC with only one member is by default taxed like a sole partnership. Otherwise, the owners of the LLC may decide to be taxed as a corporation. An LLC has the option to choose between being taxed as a C-corporation or an S-corporation. This has been discussed further in sections below.

4.2.2. Owners of a partnership or corporation may even choose to convert their entity into an LLC. In case of a partnership, the prior tax elections of an existing partnership continue and the partners retain their basis and ownership in the LLC. However, if a C- or S-corporation converts to an LLC, such a corporation is treated as having liquidated prior to forming the LLC and such a transaction could be a taxable event for both the corporation and the shareholders.

4.2.3. Depending upon the state in which one's business is located, state income taxes apply to the LLC. For example, some states tax LLCs directly on their income rather than (or in addition to) taxing the owners on their share of the income.

5. PARTNERSHIPS IN THE US

5.1. An unincorporated organization with two or more members is generally classified as a partnership for federal tax purposes if its members carry on a trade, business, financial operation or venture and divide its profits. However, a joint undertaking merely to share expenses is not a partnership. For example, co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

5.2. Types of partnerships

5.2.1. General partnerships are typical partnerships which have only general partners who are responsible for the management, affairs of the partnership and are responsible for the liabilities of the partnership and for each of the other partners. They may be understood as being akin to the partnerships established under the Indian Partnership Act, 1932.

5.2.2. An LP has both general partners and limited partners. The limited partners, unlike general partners, typically do not actively participate in the management of the LP and are comparable to investors in a business. While a general partner in LP typically has unlimited personal liability, a limited partner's liability is limited to the amount of his or her investment in the LP. While the concept of LPs is relatively unknown in India, they are quite popular in countries such as the US and United Kingdom.

5.2.3. An LLP is a general partnership with limited liability. It is a common form among professionals including accountants, lawyers and physicians. There are subtle yet significant differences between an LLP and a general partnership. While in the latter, a general partner is jointly and severally liable for all partnership debt, a partner in an LLP is generally jointly and severally liable only for contractual liabilities. Secondly, an LLP partner is personally liable for only their own malpractice and not of the other partners'. States in the US either follow "full shield protection" (i.e. protection from vicarious liability for all partnership debts and obligations) or "partial shield protection" (i.e. a partner's vicarious liability is limited for claims based on negligence or misconduct of some partner).

5.3. Taxation of Partnerships

5.3.1. Partnerships themselves are not actually subject to federal income tax. Instead, they are pass-through entities. However, in India, a partnership is a taxable entity in itself and is taxed at the partnership level. In the US however, owners of a partnership are taxed upon their share of the partnership's taxable income, regardless of how much is distributed. A partner is not, however, taxed upon distributions he receives from the partnership, so long as those distributions do not exceed the partner's tax basis in the partnership. Tax basis refers to the amount of money a person has invested in an asset.

6. CORPORATIONS

6.1. As mentioned above, a corporation may choose to be taxed as either an S-Corporation or C-corporation.

6.2. S-Corporation

6.2.1. An S-corporation is a pass-through entity. In order to obtain S-corporation status, the corporation must meet certain criteria. The criterion that is important from the perspective of this article is that eligible shareholders must be US individual residents, certain tax-exempt organizations, and certain trusts and estates. Charities, employee benefit trusts, and single-person LLCs may also qualify. Ineligible shareholders include partnerships, corporations, LLPs, most LLCs, and most retirement plans.

6.2.2. Taxation of S-Corporation

6.2.2.1. Since an S-corporation is a fiscally transparent entity, there is no federal income tax levied at the corporation level. The pass-through nature of the income means that the corporation's profits are only taxed at the shareholder level, thus avoiding the double taxation of C-corporation income. It is significant to note that any compensation (e.g., wages/salary) that the S-corporation pays is not considered to be pass-through income. It is only allocations of profit from the S-corporation that are considered as pass-through income.

6.2.2.2. There are two principal exceptions to the general pass-through treatment of S-corporations. Both are applicable only if the S corporation was previously a C-corporation. The first applies when the C-corporation has appreciated assets - net built-in gains that are subject to corporate-level tax. The second applies when the C-corporation has accumulated earnings and profits – it will be subject to corporate tax on excess net passive investment income if more than 25% of its gross receipts for the year are passive investment income.

6.3. C-Corporation

6.3.1. A C-corporation has a separate legal identity distinct from its shareholders. This can be used to cap any risks that may be inherent in a branch or partnership. Use of a C-corporation also prevents US profits and losses from flowing up to the shareholders. Such corporations are established in accordance with the law of the state of incorporation. Although the corporate laws of most states are similar, those of certain states (Delaware, for example) are more flexible than others.

6.3.2. Taxation of C-Corporation

The profits earned by a C-corporation are subject to tax in the US at graduated rates. Corporate profits or dividends – if they are paid out to shareholders—are taxed twice: once at the corporate level and once at the shareholder level.

7. PASS-THROUGH ENTITIES: AVAILING BENEFITS UNDER THE INDIA-US DTAA

7.1. Article 1 of the India-US DTAA clarifies that the convention applies only to persons who are resident of one or both contracting states, unless otherwise provided. Article 4 of the India-US DTAA determines who is a resident of a contracting state. Only one who is liable to tax under the laws of that state is deemed a resident for the purposes of Article 4. Without qualifying as a resident, one may not claim benefits under the India-US DTAA. Article 4(1)(b) of the India-US DTAA states:

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that

   (a) this term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and

   (b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only

> to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.

7.2. If an entity is typically not taxed in a contracting state, they would not be 'liable to tax'. Consequently, they would not be considered as 'resident'. In the absence of qualifying as 'resident', applicability to DTAA is not available. In absence of access to the DTAA, treaty benefits such as tax credit, tax exemption, reduced rate of tax, or other treaty benefits, or safeguards may not be available.

7.3. There is no specific reference to fiscally transparent entities under the India-US DTAA. However, in this context, it is significant to note that the OECD Model Tax Convention on Income and Capital (2017) inserted paragraph 2 to Article 1, which reads as follows:

> For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

7.4. The OECD Commentary takes the view that in the case of fiscally transparent entities, to the extent that the entity or arrangement qualifies as a resident of a contracting state, the newly inserted paragraph will ensure that the benefits of the treaty also apply to the share of the income that is attributed to the entity or arrangement under the domestic law of that State (subject to any anti-abuse provision such as a limitation-on-benefits rule).

7.5. Treatment in India

7.5.1. Taxation of Partnerships and Partners under Indian law

7.5.1.1. In India, a partnership firm is governed by the provisions of the Indian Partnership Act 1932 while an LLP is similarly governed by the provisions of the Limited Liability Partnership Act 2008. A partnership (or LLP, as the case may be) must be evidenced by an instrument and the individual shares of the partners be specified in that instrument. Thus, in case a foreign partnership fails to establish that it bears the same key features as a partnership established under the Indian Partnership Act 1932, the Indian tax department may view a foreign partnership as an AOP. This would lead to the AOP being denied any deduction by way of any payment of interest, salary, bonus, commissions or remuneration made by such partnership to its partners.

7.5.1.2. Further, as per Section 28 of the IT Act, any income which is payable to a partner by a partnership firm (which may consist of interest, salary, bonus, commission or remuneration), excluding any deductions is taxed as 'gains from business or profession' in the hands of such partner, and is tax deductible for the purposes of computing tax liability of the concerned partnership firm. Thus, subject to the limits prescribed under the IT Act, any sum of monies paid by a partnership to its partners is available for deduction from the taxable income of the partnership itself.

7.5.1.3. Section 9(1)(i) of the IT Act deems all income to accrue or arise from India, whether directly or indirectly, through or from a business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India. Accordingly, a foreign partnership which is treated as resident outside India is liable to tax in India only on its India-sourced income.

7.5.2. Indian Decisions on Offshore Fiscally Transparent Entities

7.5.2.1. The issue of a fiscally transparent entity being eligible to the benefits of a tax treaty has been a matter of judicial debate in India for a number of years, with there being no finality on India's position.

7.5.2.2. The Hon'ble ITAT in *Linklaters LLP vs. ITO, International Taxation reported in [2010] 40 SOT 51 (Linklaters LLP),* in the context of the India-UK DTAA, held that an LLP incorporated in the UK is eligible to claim treaty benefits even though it is treated as a fiscally transparent entity in the UK, as the profits of the LLP are taxable, albeit in the hands of the partners. It was held that the UK LLP was a "resident" of the UK as it was, in fact, "liable to tax" in the UK in terms of Article 4(1) of the India - UK DTAA and tax treaty benefits could not be denied solely based on that fact that the profits of the LLP were taxable not in its hands but in the hands of its partners.

7.5.2.3. It is pertinent to note that later there was an amendment in the India-UK DTAA in terms of introduction of a protocol to provide that the treaty benefits shall be available to a UK partnership firm proportionately to the extent such income is taxable in the hands of its partners in UK.

7.5.2.4. Similarly, in *Astt. DIT vs. Chiron Behring GmbH & Co reported in [2013] 29 taxmann.com 199*, the Bombay High Court in the context of the India-Germany DTAA held that a limited partnership firm organised in Germany would be entitled to beneficial provisions of the India - Germany DTAA, as it is liable to pay "trade tax" in Germany and is therefore a "resident" under Article 4 of the India - Germany DTAA.

7.5.2.5. The AAR in *In Re Schellenberg Wittmer, reported in (2012) 76 DTR 293 / 253 (Schellenberg Wittmer)*, has taken a contrary view and held that the applicant in that case which was a Swiss-based legal partnership firm was not a "resident" within the meaning of the India - Switzerland DTAA because it was not a taxable entity in Switzerland. The reasoning of the AAR was as follows:

> "Article 4 provides that for the purposes of the Convention, resident of a contracting State means any person who under the laws of that State is liable to taxation in that State by reason of his domicile, i.e. residence, place of incorporation, place of management, or any other criteria of similar nature. The partnership can be said to be domiciled in Switzerland or having its place of residence in Switzerland.
>
> The inquiry then would be whether it is a 'person' within the meaning of the Convention. A person is defined in clause (d) of Article 3 of the DTAC. It is an inclusive definition. It reads:

> 'the term person includes an individual, a company, a body of persons or any other entity which is taxable under the laws in force in either contracting State.' On a reading of this definition it seems clear that the expressions, 'body of individuals or any other entity' at least is qualified by the expression 'which is taxable under the laws in force in either contracting State.' In other words, if the body of individuals or any other entity is not a taxable entity in the concerned State, it will not be a person.
>
> The partnership is one formed in Switzerland. Under Swiss law, it is not taxable entity. There is no definition of a person in Swiss law corresponding to section 2(31) of the Income-tax Act, which confers the status of a 'person' on a partnership. If so, going by the inclusive definition in clause (d) of Article 3 of the DTAC, it cannot be held that the partnership is a taxable entity in Switzerland. Therefore, the partnership which receives the income cannot claim the benefit of the DTAC between India and Switzerland."

7.5.2.6. The Supreme Court in the case of *P & O Nedlloyd, reported in [2016] 73 taxmann.com 192*, rejected the special leave petition filed by the revenue, against the decision of the Calcutta High Court, wherein it was held that a UK partnership firm, is eligible to the benefits of the tax treaty. The Calcutta High Court had observed as under:

> "Once it is found the said partnership is a firm under section 2(23)(i), it becomes a person under section 2(31)(iv), attracting the operation of paragraph 2 of article 3 of the said convention. Such conclusion is inescapable as the revenue must bring a charge of Income-tax against a person under section 4 of the Income-tax Act, 1961. The revenue in treating the said partnership as an assessee and seeking to assessee income of it which had escaped assessment is for the purpose of charging tax on the income of the said partnership, treating it as a person liable to be charged with the levy of Income-tax under the said section. In doing so the revenue has to treat the said partnerships as a person within the definition provided under section 2(31)(iv). Thus, the revenue's case the said partnership is not covered by the said convention fails."

7.5.2.7. In light of the above ruling of the Supreme Court, it may now be safe to contend that a partnership firm is eligible to claim the benefits of a tax treaty. However, assuming that a foreign LLP is declared to be ineligible to claim benefit under the applicable tax treaty owing to the fact that it is fiscally transparent and the income is actually taxed in the hands of the partners, the next question that arises for discussion is whether, the partners are eligible to claim the benefit of the applicable tax treaty.

7.5.2.8. While the OECD Commentary supports the view that a pass-through entity can look through to its owners for purposes of applying the respective treaty benefits, India (which is not a member of the OECD) has not agreed to this by stating a reservation; instead, India takes a position that tax treaty benefit should be allowed only where the income is derived by a person which is a resident of the treaty partner jurisdiction. The AAR in *Schellenberg Wittmer*, refused to be guided by the view of the OECD and held that the partners are not eligible to claim the benefit of the tax treaty. The AAR held:

> "As far as the partners are concerned, they are not the recipients of the income. Their right is only to share the profits of the partnership. Since they cannot be said to receive any income from Siemens India Limited on the basis of the agreement relied on, it cannot be said that they being residents of Switzerland could invoke the DTAC to be taxed in terms of Article 14 of the DTAC regarding the particular income..."

The AAR also held that the argument that the partners are residents of Switzerland and their incomes from the partnership are taxable in Switzerland is of no avail since what is under consideration here is not the income, the partners receive from the partnership but the income derived by the firm from an Indian entity."

7.5.2.9. In refusing to be guided by the view of the OECD, the ruling of the AAR is at variance with the observation of the Apex Court in *Union of India vs. Azadi Bachao Andolan reported in 2003 (263) ITR 0706 SC* that held that in a case tax treaty is silent on any aspect then the OECD can be relied upon in interpreting provisions of the DTAAs.

7.5.2.10.In a decision in the case of *ING Bewaar Maatschappij I BV (ING BV) vs. DCIT (Income tax appeal number: 7119/MUM/2014)*, the Mumbai bench of the ITAT held that in a situation where all investors / beneficiaries of a tax transparent entity are taxable in the Netherlands, the benefit of India-Netherlands DTAA shall be allowed to the income accrued to such tax transparent entity, assessed in the hands of ING BV, in its representative capacity. The ITAT held that principally, where a taxpayer is the representative assessee of a tax transparent entity (such as a trustee) the status of the beneficiaries/ constituents of such tax transparent entity is relevant to determine the eligibility to benefits of the DTAA. The ITAT placed heavy reliance on the legal position stated in the ruling of Linklaters LLP and held that so long as the income is liable to tax in the Netherlands, the benefit under the DTAA cannot be denied.

7.5.2.11.It is also pertinent to note that in an AAR ruling in case of in case of General Electric Pension Trust (US) AAR No. 659 of 2005, it was observed by the AAR that the said trust had earned certain profits in India on account of sale of portfolio investments which were taxable as business income. The said trust was not liable to tax in the US on account of exemptions from taxation available to it under the US local tax laws (Section 501(a) of the U. S. Internal Revenue Code) and hence could not have been eligible to be treated as a resident of US for the purpose of India – US DTAA (Article 1(1) read with Article 4(1)(b) of India-US DTAA).

7.5.2.12.Recently India has again stated its reservation on applicability of treaty benefits on a pass-through basis in Multilateral Convention to Implement BEPS (which adopts the OECD view).

7.5.2.13.In the absence of an express provision which qualifies the partners of a fiscally transparent partnership firm/LLP to claim benefit under the tax treaty, it is difficult to comment as to whether the judiciary would deem the partners to be eligible to claim treaty benefit. Given the divergent judicial views and India's position on the residency provisions under the DTAAs, the issue continues to be in speculation, and it would be helpful for India to clarify its position by way of an administrative circular.

7.6. Treatment in US

7.6.1. US Decisions on Offshore Fiscally Transparent Entities

7.6.1.1. Whether fiscally transparent entities would be entitled to benefits under the India-US DTAA is a grey area. However, international cases dealing with US hybrid entities appear to be consistent.

7.6.1.2. In *TD Securities (USA) LLC vs. Her Majesty 2010 TCC 186 (TD Securities)* referred to in Linklaters LLP AAR case, the issue centred on whether a US LLC, which had a single member and had elected to be fiscally transparent under the check-the-box regulations was eligible for the benefits of the US-Canada DTAA. The Court stated that the criterion for residence under Article 4 was based on the actual taxation of income in the residence state and not the modality of taxation. The Tax Court of Canada held that the US LLC was eligible for benefits under tax treaty as the tax was payable by the US resident LLC member.

7.6.1.3. In BFH, IR 48/12 in June 2013, the German Federal Tax Court held that a US S-corporation is entitled to the tax treaty benefit as the income of the US S-corporation was taxed at the level of its US resident shareholders. The court held that the S-corporation qualified as the beneficial owner of the dividend under German law, notwithstanding that it was fiscally transparent under US law. The S-corporation had a legal structure similar to a corporation and therefore for the purposes of German tax law was a company within the meaning of German-US DTAA. Although it was not a company resident in the other contracting state under the DTAA as it was not itself liable to tax in the US, the income was deemed to be derived by a resident of the US to the extent that it was taxable in the hands of the shareholders who were resident in the US. The S-corporation was therefore deemed to be a 'treaty-eligible person' and the income was deemed to be derived by a US resident person.

7.6.1.4. In 2015, the UK Supreme Court decided the case of *Anson vs. Commissioners for HMRC [2015] UKSC 44 (Anson)*, in which the issue was how a taxpayer's interest in a US LLC should be treated under UK tax law. The Court's decision has received a great deal of attention in the UK, as it contradicts, to a certain extent, HMRC's historic position that an LLC should be treated as "opaque" for UK tax purposes. *Anson* is similar to *TD Securities* in the sense that it challenges the traditional view that an LLC and its income must be treated as being distinct from that of its members. However, the UK Supreme Court's reasoning was not based on the view that an LLC is not a corporation or that LLCs should be treated as fiscally transparent entities for general UK tax purposes, but rather on the particular wording used in DTAA, the LLC Act and the LLC Agreement.

7.6.2. Denial or Eligibility of Treaty Benefits

7.6.2.1. The general understanding of treaty provisions is that a treaty reflects a source country's agreement to relieve taxation with the expectation that the residence country will exercise its right to tax the income at home, or vice versa. Where hybrid entities frustrate that expectation, US took measures to deny treaty reduced withholding taxes.

7.6.2.2. US Code § 894(c) (introduced in 1997) denies treaty benefits to hybrid entities, i.e. entities that are fiscally transparent for US tax purposes, such as a US partnership but not fiscally transparent under the laws of the other country such as India, if

(i) such item is not treated as an item of income of such foreign person for purposes of the taxation laws of the foreign country;

(ii) the foreign country does not impose tax on a distribution of such item of income from the fiscally transparent entity to the foreign person; and

(iii) the relevant treaty does not contain a provision addressing the applicability of the treaty in the case of an item of income <u>derived</u> through a partnership.

7.6.2.3. In the case of reverse hybrids, i.e. an entity that is fiscally opaque in the US but is fiscally transparent in the other contracting state, payment by a domestic reverse hybrid entity to a related foreign person holding an equity interest in the entity is recharacterized as a dividend distribution by the entity for the purposes of the applicable treaty to the extent of the lesser of (1) the amount of the payment or (2) the interest holder's proportionate share of dividends distributed by the related domestic entity to the hybrid entity.

7.6.2.4. Treasury regulation section 1.894-1(d)(1) provides that an item of income received by an entity that is fiscally transparent qualifies for reduced withholding tax under a treaty only to the extent that the *"income is derived by a resident of the applicable treaty jurisdiction."* For this purpose, the item of income may be derived by the entity receiving the item of income, by the interest holders in the entity, or by both.

7.6.2.5. The above legal stipulations apply as follows. For instance, in the case of a US LLC which 'checks-the-box' to be taxed as a partnership – this entity is not fiscally transparent under the laws of India. If there is a foreign partner of this US LLC resident in India, the US LLC will be required to withhold taxes, as explained in sections above. However, there is a mismatch because the source country (US) believes that the income is derived by the partner while India believes that the income is derived by the partnership. In this case, section 894(c) will operate to prevent the foreign partner resident in India from claiming any benefits under the India-US DTAA.

7.6.2.6. A US LLC opened by a non-US resident or NRA can arguably allow for earnings that are not taxed in the US. If income is ECTI, then US tax treaty benefits are available. Paragraph V of the Protocol to the India-US DTAA allows for ECTI to avail treaty benefits. Thus, the hybrid entities rule under section 894(c) is typically seen as affecting only FDAP or passive income.

7.6.3. Further, it is important to note that as a general rule, states are not party to tax treaties between the US and foreign nations.

That means that a foreign corporation may be subject to state tax even though it is not subject to US federal tax pursuant to a tax treaty.

8. ENTITY SELECTION

8.1. An inbound investor in the US may choose to invest in an LLC. An LLC offers the main advantage of there being no restriction of ownership, in the sense that members of LLCs can be non-US citizen/residents This comes along with the minimal formality of an LLC and the ability draw out profit as a distribution without it being subject to self-employment tax.

8.2. However, as noted above, there is little clarity on whether partners of a US LLC who are resident in India would qualify for treaty benefits.

8.3. In the case of inbound investment into an S-corporation, an important legislative change has been brought about by the TCJA in 2017. While traditionally S-corporations have not permitted an NRA to be a shareholder, TCJA changed this position. Now, an NRA who is a beneficiary of an ESBT may be a shareholder of an S-corporation. An ESBT may have individuals, estates and certain types of charitable organizations as beneficiaries.

8.4. Under prior law, an NRA was not eligible to be a potential current beneficiary of the ESBT without the S-corporation risking a loss of status since it would have foreign investor. TCJA eliminates this risk by expanding the circumstances in which a trust can hold shares in an S-corporation. This enables a nonresident or NRA to be a current potential beneficiary of an ESBT. A "potential current beneficiary" refers to a person who has a present, remainder, or reversionary interest in the trust.

8.5. To be an ESBT, the trust must make a timely election. The election can be made and remains valid if no beneficiary acquires an interest in the ESBT through a purchase. Generally, an ESBT is treated as two separate trusts for tax purposes; the portion of the ESBT that reflects shares of stock in one or more S-corporation(s) is treated as one trust (the S portion) and the portion reflecting all other assets is treated as a second trust (the non-S portion). However, for administrative purposes, an ESBT is treated as a single trust.

8.6. Although the ESBT poses a complex structure, it nevertheless provides a foot in the door for foreign investors who have been looking to invest in an S-corporation.

9. CONCLUSION

9.1. Fiscally transparent entities are those where no distinction is drawn between the entity and its owners. Thus, income and profits derived by the entity are passed through to the owners. Indian tax law does not recognize domestic pass through treatment other than for investment fund vehicles and hence, to that extent, hybrid entities classification is comparatively an alien concept in India. On the other hand, check the box regulations in the US allow for entities in the US to choose to become fiscally transparent for domestic tax purposes. However, this raises unique problems for a foreign partner or shareholder of such an entity. The primary question that arises is whether such an entity can claim benefits under the relevant DTAA.

9.2. Unfortunately, there is no conclusive case law under the India-US DTAA which lays down the law for how such an entity or its cross-border owners must be treated, and particularly whether they will be entitled to treaty benefits. However, case laws which deal with similar issues arising in both US and India's treaties with other countries lend guidance.

9.3. Both countries appear to differ from the OECD view on the matter of fiscally transparent entities. While India's position may be treated as crystallized as to whether an offshore fiscally transparent entity may be recognized under the DTAA, whether the partners of such an entity are eligible to treaty benefits is still up for debate. In the case of US, though case laws cited here are encouraging in respect of availing treaty benefits, section 894(c) of the Internal Revenue Code creates a substantial hurdle for offshore owners of hybrid entities to claim treaty benefits.

9.4. An inbound investor to the US, particularly one who is resident in India, must be cognizant of not just the domestic but also the cross-border tax treatment of pass-through entities. While LLCs have always been accessible for foreigners, the TCJA allows a foreign investor an opportunity to invest in an S-corporation.