

REG-110385-99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations addressing certain transactions that occur within a specified period of time before or after a change in entity classification. The proposed regulations prevent, in limited circumstances, the use of changes in entity classification to alter a taxpayer's Federal tax consequences. Under these regulations, a change in classification by a foreign eligible entity that was originally classified as an association taxable as a corporation (and, but for this regulation, would be classified as an entity disregarded as an entity separate from its owner) will be invalidated in certain limited circumstances. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by February 28, 2000. Requests to speak (with outlines of oral comments) at the public hearing scheduled for January 31, 2000, must be submitted by January 10, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-110385-99), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-110385-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/regslst.html. The public hearing will be held in room 2615, Inter-

nal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Mark D. Harris, (202) 622-3860 (not a toll-free number); concerning submissions and the hearing, LaNita VanDyke, (202) 622-7180 (not a toll-free number).

Supplementary Information:

Background

This document proposes to amend the current Procedure and Administration Regulations (26 CFR Part 301) relating to the classification of entities for Federal tax purposes. On December 18, 1996, the IRS and the Treasury Department published final regulations (61 FR 66584) relating to the classification of business organizations under section 7701. The regulations (the check-the-box regulations) replaced the increasingly formalistic entity classification rules with a simpler, elective regime. The new rules were designed to ease administrative burdens for taxpayers and the government. They were not, however, intended to change the application of substantive Internal Revenue Code (Code) provisions.

In the preamble to the check-the-box regulations, the IRS and Treasury expressed concern about potential improper uses of the check-the-box regulations involving partnerships:

[I]n light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.

On October 28, 1997, the IRS and Treasury issued a notice of proposed rulemaking (62 FR 55768) under section 7701. These regulations specify the tax consequences resulting from an election to change the Federal tax classification of an eligible entity (the conversion regulations). The conversion regulations also provide that the tax consequences of an elective change in the classification of an entity for Federal tax purposes are determined under all relevant provisions of the

Code and general principles of tax law, including the step transaction doctrine. Those final regulations are issued elsewhere in this issue of the Federal Register.

As indicated in the preamble to the check-the-box regulations, the IRS and Treasury have been monitoring the manner in which taxpayers have used the check-the-box regulations since their enactment. The focus has been to determine whether taxpayers use the regulations in a manner inconsistent with the application of any Code provisions, and, if so, what, if any, action is appropriate. The preamble to the check-the-box regulations cited the use of partnerships as a primary concern. However, it has become apparent to the IRS and Treasury that taxpayers may attempt to use entities that are disregarded as entities separate from their owners (disregarded entities), in addition to partnerships, to achieve results, in relation to certain transactions, that are inconsistent with the policies and rules of particular Code sections or tax treaties. These regulations are intended to address inappropriate Federal tax consequences that would otherwise result from certain of these transactions under a number of international provisions of the Code. These provisions include the rules governing source of income under sections 861 through 865, foreign tax credit limitation categories under section 904, the disposition of ownership interests under Subpart F (sections 951 through 964), and outbound transfers under section 367 (in this last case, leading to a different result than that outlined in the example in the preamble to the section 367(a) regulations (63 FR 33550)).

The IRS and Treasury considered several responses to these transactions and determined that a special rule completely revoking the entity's classification as a disregarded entity was the most equitable and administrable approach. Of the responses considered, the IRS and Treasury believe that this approach also gives the greatest certainty to all parties involved in the transactions covered by this rule.

Explanation of Provisions

This special rule is limited in scope. It only applies to "extraordinary transac-

tions” (such as sales of a part or whole interest) that occur within a period commencing one day before and ending 12 months after the date that a foreign eligible entity changed its classification to disregarded entity status, provided that the entity had been classified as an association taxable as a corporation within the 12-month period prior to the extraordinary transaction. The rule also applies to certain “shelf” entities that might be used in an attempt to circumvent the 12-month rule. In these cases, the entity would not be treated as a disregarded entity, and instead would be classified as an association taxable as a corporation for all purposes. The regulations provide rules specifying from what date this classification as an association taxable as a corporation will be applicable. Examples of these provisions are included in the regulations.

This special rule will not apply to an extraordinary transaction if a taxpayer establishes to the satisfaction of the Commissioner that the classification as a disregarded entity does not materially alter the Federal tax consequences of the extraordinary transaction.

The IRS and Treasury do not intend that this regulation will invalidate an entity classification election in the absence of a separate extraordinary transaction, even though the deemed consequences of such election under the conversion regulations may constitute an extraordinary transaction. In the preamble to the conversion regulations, however, the IRS and Treasury requested comments on the appropriate tax consequences of an entity classification election made by a foreign eligible entity that is not relevant for Federal tax purposes (e.g., with respect to the basis of property or earnings and profits of the entity). No comments have been received. The IRS and Treasury continue to study and solicit comments on this important issue and are considering whether, in certain circumstances, the election, combined with another event whereby the entity becomes relevant, should be considered to be inappropriate and, therefore, invalid under these regulations.

If an entity made a classification election pursuant to §301.7701-3(c) to be disregarded, and that election was considered a change in classification, that entity would normally be subject to the 60-

month limitation on elections under §301.7701-3(c)(1)(iv). However, if that classification election under §301.7701-3(c) is invalid under this regulation, then the election to be a disregarded entity shall not constitute an election for all Federal tax purposes, including the limitation on elections under §301.7701-3(c)(1)(iv).

These regulations do not prevent the Commissioner from applying all applicable common law doctrines to any extraordinary transaction to which this rule applies, in any administrative or judicial proceeding (and create no inference as to the treatment of such transactions occurring prior to the effective date of these regulations). Conversely, the Commissioner may also provide administrative relief from these regulations by published guidance.

The IRS and Treasury will continue to monitor potentially improper uses of the check-the-box regulations involving partnerships and disregarded entities, and will take appropriate action when such uses achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.

This special rule does not apply to the transactions described in the proposed regulations on hybrid branch transactions published in the Federal Register on July 13, 1999 (64 FR 37727), issued pursuant to Notice 98-35 (1998-27 IRB 35). These proposed regulations apply only to dispositions of interests in disregarded entities in extraordinary transactions.

The IRS and Treasury request comments with respect to the special rule contained herein. In particular, the IRS and Treasury request comments on the specific types of transactions which should be excluded from the application of the special rule. When this proposed regulation is finalized, the IRS and Treasury intend to issue guidance that will identify specific transactions that will be excluded from the application of this special rule.

Grandfathered Foreign Per Se Entities

The check-the-box regulations allowed for certain corporations under §301.7701-2(b)(8)(i) to be treated as partnerships if certain conditions enumerated in §301.7701-2(d)(1) were satisfied. However, upon the occurrence of certain events, such an entity’s “grandfathered

status” could be terminated. See §301.7701-2(d)(3)(i). The IRS and Treasury are concerned that taxpayers have been trafficking in these types of entities. Accordingly, these proposed regulations would add a new provision to §301.7701-2(d)(3)(i) which terminates an entity’s “grandfather status” when one or more persons, who were not owners of the entity as of November 29, 1999, become owners of 50 percent or more of the interests in the entity.

Relevance

The check-the-box regulations provide a special rule when the Federal tax classification of a foreign eligible entity is no longer relevant. The rule states that if the classification of a foreign eligible entity which was previously relevant for Federal tax purposes ceases to be relevant for sixty consecutive months, the entity’s classification will initially be determined under the default classification when the classification of the foreign eligible entity again becomes relevant (hereinafter 60-month rule). Several practitioners have requested guidance on whether the act of filing an entity classification election (Form 8832, Entity Classification Election) causes an entity to be relevant for purposes of the 60-month rule. Practitioners also have requested clarification regarding whether a newly formed foreign eligible entity, that has never been relevant, is subject to the 60-month rule.

These proposed regulations provide that if a foreign eligible entity files an entity classification election, it is considered relevant on the effective date of the election for purposes of the 60-month rule. However, if the foreign eligible entity is otherwise not relevant within the meaning of §301.7701-3(d)(1)(i), then for purposes of applying the 60-month rule the entity will be considered to be not relevant on the day after the date the entity classification election was effective.

The preamble to the conversion regulations stated that a foreign eligible entity that is not relevant has a Federal tax classification. The proposed regulations clarify that such an entity is subject to the 60-month rule. However, the proposed regulations provide an exception for a foreign eligible entity that was never relevant (within the meaning of §301.7701-3(d)(1)) during its existence.

Such entity's classification will initially be determined pursuant to the provisions of §301.7701-3(b)(2) when the entity first becomes relevant.

Proposed Effective Date

Except as otherwise specified, these regulations are proposed to apply as of the date final regulations are published in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulation and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 31, 2000, beginning at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit timely

written comments and an outline of the topics to be discussed and the time to be devoted to each topic by (preferably a signed original and eight (8) copies) January 10, 2000. However, comments not to be presented at the hearing must be submitted by February 28, 2000.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Mark D. Harris, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301--PROCEDURE AND ADMINISTRATION

Par. 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 301.7701-2 is amended by:

- 1. Removing the language "or" at the end of paragraph (d)(3)(i)(B).
- 2. Removing the period at the end of paragraph (d)(3)(i)(C) and adding "; or" in its place.
- 3. Adding paragraph (d)(3)(i)(D).
- 4. Adding a sentence at the end of paragraph (e).

The additions read as follows:

§301.7701-2 *Business entities; definitions.*

* * * * *

(d) * * *

(3) * * *

(i) * * *

(D) The date any person or persons, who were not owners of the entity as of November 29, 1999, own in the aggregate a 50 percent or greater interest in the entity.

* * * * *

(e) *Effective date.* * * * However, paragraph (d)(3)(i)(D) of this section applies

on or after the date final regulations are published in the Federal Register.

Par. 3. Section 301.7701-3 is amended as follows:

1. The text of paragraph (d)(1) following the paragraph heading is redesignated as paragraph (d)(1)(i), and a paragraph heading is added for paragraph (d)(1)(i).

2. Paragraph (d)(1)(ii) is added.

3. Paragraph (d)(2) is revised.

4. Paragraphs (d)(3) and (d)(4) are added.

5. Paragraph (h) is redesignated as paragraph (i).

6. A new paragraph (h) is added.

The revision and addition reads as follows:

§301.7701-3 *Classification of certain business entities.*

* * * * *

(d) *Special rules for foreign eligible entities—(1) Definition of relevance—(i) General rule.* * * *

(ii) *Deemed relevance—(A) General rule.* For purposes of this section, except as provided in paragraph (d)(1)(ii)(B) of this section, a foreign eligible entity that files Form 8832 (Entity Classification Election) shall be deemed to be relevant only on the date the entity classification election is effective.

(B) *Exception.* If a foreign eligible entity is relevant within the meaning of paragraph (d)(1)(i) of this section, then the rule in paragraph (d)(1)(ii)(A) of this section shall not apply.

(2) *Entities that were never relevant.* If a foreign eligible entity's Federal tax classification has never been relevant (as defined in paragraph (d)(1) of this section), then the entity's classification will initially be determined pursuant to the provisions of paragraph (b)(2) of this section when the entity first becomes relevant (as defined in paragraph (d)(1)(i) of this section).

(3) *Special rule when classification is no longer relevant.* If the classification of a foreign eligible entity is not relevant for sixty consecutive months, the entity's classification will initially be determined under the default classification when the classification of the foreign eligible entity becomes relevant. The date that the classification of a foreign entity is not relevant is the date an event occurs that causes the classification to no longer be relevant, or, if no event occurs in a tax-

able year that causes the classification to be relevant, then the date is the first day of that taxable year.

(4) *Effective date.* Paragraphs (d)(1)(ii), (d)(2), and (d)(3) of this section apply on or after the date final regulations are published in the Federal Register.

* * * * *

(h) *Special rule when foreign entities that are disregarded as entities separate from their owner are used in an extraordinary transaction—*(1) *General rule—*(i)

When an eligible entity becomes disregarded as an entity separate from its owner. Notwithstanding any other provision of this section, a foreign eligible entity classified as an entity that is disregarded as an entity separate from its owner, will instead be classified as an association taxable as a corporation, if—

(A) A 10-percent or greater interest in the foreign eligible entity is sold, exchanged, transferred or otherwise disposed of in one or more transactions (collectively, extraordinary transactions) that occur (or are treated as occurring) in the period commencing one day before and ending 12 months after the effective date of that foreign eligible entity's change in classification to an entity that is disregarded as an entity separate from its owner; and

(B) The foreign eligible entity was previously classified as an association taxable as a corporation at any time within the 12-month period prior to the date of the commencement of the extraordinary transaction.

(ii) *Period of reclassification.* If paragraph (h)(1)(i) of this section applies, the foreign eligible entity shall be treated as an association taxable as a corporation (and no intervening Federal tax classification will be valid) from and including the date that the foreign eligible entity ceased to be classified as an association taxable as a corporation.

(2) *Shelf entities—*(i) *Acquisition of assets from another entity.* A foreign eligible entity, classified as an entity that is disregarded as an entity separate from its owner, will instead be classified as an association taxable as a corporation, if—

(A) It acquires the assets of one or more foreign business entities (which were classified as associations taxable as corporations at any time within the 12-month period prior to the date of the com-

mencement of the extraordinary transaction) in a transaction or series of related transactions in which gain or loss is not recognized (for Federal tax purposes), in whole or in part (acquisition transaction);

(B) After the acquisition transaction (or transactions), the acquired assets comprise more than 80 percent of the value of the assets of the entity that is disregarded as an entity separate from its owner; and

(C) Such entity is subsequently involved in an extraordinary transaction within 12 months of the date on which the acquisition transaction (or the last of such transactions) is completed.

(ii) *Calculation of value of entities.* For purposes of calculating the ratio of assets under paragraph (h)(2)(i)(B) of this section, cash and marketable securities of an entity shall not be included to the extent that the cash and marketable securities exceed the reasonable needs of that entity's business.

(iii) *Period of reclassification.* If paragraph (h)(2)(i) of this section applies, the foreign eligible entity shall be treated as an association taxable as a corporation from and including the date of the acquisition transaction, or, if the acquisition transaction involves a series of related transactions, the date of the last of such transactions.

(3) *Exception.* The rules in paragraphs (h)(1) and (2) of this section will not apply to an extraordinary transaction if a taxpayer establishes to the satisfaction of the Commissioner that the classification as an entity that is disregarded as an entity separate from its owner does not materially alter the Federal tax consequences of the extraordinary transaction. The Commissioner may also provide exceptions to paragraphs (h)(1) and (2) of this section by published guidance (see §601.601(d)(2) of this chapter).

(4) *Examples.* The following examples illustrate the rules of this paragraph (h). These examples assume that all foreign entities (FC) are eligible entities that are classified as associations taxable as corporations, and all U.S. entities (P) are corporations, unless otherwise specified. The examples are as follows:

Example 1. (i) *Facts.* P owns 100 percent of FC1. P plans to sell FC1. An entity classification election under paragraph (c) of this section is made for FC1 such that FC1 is now classified as an entity disregarded as an entity separate from its owner (P). P sells FC1 to an unrelated third party within 12

months of the effective date of the entity classification election.

(ii) *Result.* The sale of FC1, an entity that is disregarded as an entity separate from its owner which was previously classified as an association taxable as a corporation, is an extraordinary transaction, and because it occurred within 12 months of the effective date of the entity classification election, it is subject to the rule of paragraph (h)(1) of this section. Under paragraph (h)(1) of this section, the entity classification election to treat FC1 as an entity that is disregarded as an entity separate from its owner is invalid, and FC1 remains classified as an association taxable as a corporation as if there had been no election to be disregarded as an entity separate from its owner. Therefore, P is taxed as if it sold the stock of FC1, and not the assets of FC1.

Example 2. (i) *Facts.* The facts are the same as *Example 1*, except that an entity classification election is not made for FC1. P wishes to avoid the result in *Example 1*, and not be subject to paragraph (h)(1) of this section. P had formed FC2 two years before the date of the extraordinary transaction. At that time, P had elected for FC2 to be treated as an entity that is disregarded as an entity separate from P. Since that time, FC2 has conducted no business activities and has held no assets. P causes FC1 to merge into FC2 (under foreign law), with FC2 surviving, in a transaction in which gain or loss is not recognized for Federal tax purposes. On the same day, P sells FC2 to an unrelated third party.

(ii) *Result.* The sale of FC2 is an extraordinary transaction. Furthermore, despite the fact that FC2 was formed two years before the date of the extraordinary transaction, paragraph (h)(2) of this section treats FC2 as an association taxable as a corporation. This is because more than 80 percent of FC2's post-merger assets were acquired from FC1. Thus, the extraordinary transaction is subject to the rule of paragraph (h)(2) of this section, and has the same result as *Example 1*.

(5) *Effective date.* This paragraph (h) applies on or after the date final regulations are published in the Federal Register.

* * * * *

Charles O. Rossotti,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on November 26, 1999, 8:45 a.m., and published in the issue of the Federal Register for November 29, 1999, 64 F.R. 66591)