May 15, 2000

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED ENTITY CLASSIFICATION REGULATIONS

This Report comments on the proposed amendments to Treas. Regs. § 301.7701-2 and -3 (herein, the "Check-the-Box Regulations") that were issued on November 29, 1999 (herein, the "Proposed Regulations").[1] The Report was prepared jointly by the Committee on Foreign Activities of U.S. Taxpayers and the Committee on Partnerships.[2]

Summary

In summary of what is set out in more detail below,

1. With regard to paragraph (h) of the Proposed Regulations (herein, the "Extraordinary Transaction Rules"):

a. We recommend that the Treasury Department and the Internal Revenue Service discuss publicly, in more detail, the particular concerns underlying the Extraordinary Transaction Rules (and any similar guidance that may be issued in the future). A more complete understanding of the government's views on the issues raised by particular uses of the Check-the-Box Regulations, and the relative merits of possible mechanisms for addressing abuse, would help taxpayers and practitioners to comment more constructively on proposed guidance in this area.

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[1] REG-110385-99, 64 F.R. 66591-66595.

[2] The principal drafter of the Report was Emily S. McMahon. Significant contributions were received from William B. Brannan, Deborah J. Jacobs, Gary Rozenshteyn, Isaac Sonsino, and Willard B. Taylor. Helpful comments were received from Andrew N. Berg, Kimberly S.

b. We recommend that any anti-abuse rules adopted in connection with the Check-the-Box Regulations be drawn narrowly so as not to undermine the simplification goals of those Regulations; and

c. We believe that the Extraordinary Transaction Rules are overly broad and, if they are adopted, the 10% threshold should be raised significantly.

Although we agree on the foregoing points, we are not in agreement on whether the Extraordinary Transaction Rules should be adopted. Although a number of us believe that the Extraordinary Transaction Rules should be adopted (with the modifications suggested herein), others believe that carving out exceptions to the Check-the-Box Regulations will have significant costs in terms of complexity and would recommend that any abuses associated with the transactions targeted by the Extraordinary Transaction Rules be addressed through other mechanisms.

2. In the event that Treasury and the Service decide to adopt the Extraordinary Transaction Rules, we have included a number of technical points that we believe should be addressed in final regulations.

3. Finally, we have also included some technical comments with respect to the proposed amendments to paragraph (d) of Treas. Regs. § 301.7701-3 (the "Relevance Rules").

I. GENERAL COMMENTS ON PROPOSED REGULATION § 301.7701-3(H).

A. Summary of the Extraordinary Transaction Rules.

Under the Extraordinary Transaction Rules of paragraph (h) of the Proposed Regulations, a foreign eligible entity that would otherwise be classified as

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a disregarded entity 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 a disregarded entity, 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. If this general rule applies, the foreign eligible entity will be taxable as a corporation (and no intervening Federal tax classification will be valid) from and including the date that the foreign eligible entity otherwise ceased to be classified as an association taxable as a corporation.

Under an additional special rule for "shelf entities", a foreign eligible entity that would otherwise be classified as a disregarded entity 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 commencement 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, (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 a disregarded entity, 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. For purposes of calculating the asset ratio, cash and marketable securities of an entity are not to be included to the extent that the cash and marketable securities exceed the reasonable needs of that entity's business. If this special shelf entity rule applies, the foreign eligible entity will be taxable as a corporation from and including the date of the acquisition transaction (or the last of such transactions).

An exception is provided under which neither the general rule nor the special shelf entity rule will 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 Extraordinary Transaction Rules are proposed to be effective on or after the date final regulations are published in the Federal Register.

B. Preamble Explanation of the Extraordinary Transaction Rules.

The Preamble to the Proposed Regulations notes that the Check-the-Box Regulations were intended to ease administrative burdens for taxpayers and the government, but were not intended to change the application of substantive Internal Revenue Code provisions. The Preamble then explains that

> . . . 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 the 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)).

Finally, the Preamble states that the Extraordinary Transaction Rules were viewed as "the most equitable and administrable approach" to these transactions and as providing the "greatest certainty to all parties involved". There is no discussion, however, of any alternatives that may have been considered.

C. General Comments.

1. Objectives of the Extraordinary Transaction Rules.

As a preliminary matter, we believe that it would have been helpful for the Preamble to explain in more detail the particular concerns underlying the Extraordinary Transaction Rules and their objectives. Although the Preamble notes that the transactions targeted by the Extraordinary Transaction Rules have inappropriate consequences under the cited Code sections, a more detailed discussion of these consequences—as well as an explanation of why the targeted transactions are covered when other structurally similar transactions are not[3]—would have been useful in helping taxpayers and practitioners to comment constructively on the Rules. Many of us are concerned that the adoption of a series of transactionally-based exceptions to the Check-the-Box Regulations will undermine the simplification goals of the Regulations. At the same time, we recognize that the Regulations are susceptible of abuse, and that the government must address this possibility. Striking a balance between the two concerns is obviously difficult. We suggest, however, that taxpayers and practitioners could be more helpful in this effort with a more complete understanding of the government's thinking on the appropriate scope of the Regulations, the issues raised by particular uses of the Regulations, and the relative merits of possible mechanisms for addressing abuse.

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[3] For example, it is not entirely clear why the switch from corporate to disregarded entity classification has been singled out for attention when other classification conversions apparently are viewed as acceptable first steps in the disposition of a foreign eligible entity, such as (i) a conversion from corporate to partnership classification or (ii) a conversion from either disregarded entity or partnership classification to corporate classification. Although the switch into disregarded entity classification tends to produce more favorable treatment of the disposition for the taxpayer than would a switch into either of the other two classifications, this fact alone does not seem a sufficient explanation.

2. Consequences of the Targeted Transactions.

The effect of a change in the classification of a foreign eligible entity from corporation to disregarded entity, when combined with a subsequent disposition of the entity, is to convert what would otherwise be treated as a sale of foreign subsidiary stock into a sale of the assets of a foreign branch. This conversion has the effect of invoking different treatment for the disposition under the Code provisions cited in the Preamble than would have been the case if no change in classification had occurred. More specifically:

a. Sections 861 through 865. Under section 865(a), gain from the sale of shares in a foreign corporation by a U.S. resident is treated as U.S. source income, unless the sale qualifies for the limited "active trade or business" exception in Section 865(f) or the exception of Section 865(h) for gains that are treated as foreign source under a tax treaty. The gain from a sale of assets, however, may qualify as foreign source income (generally viewed as more desirable because it increases the taxpayer's ability to use foreign tax credits) under the rules of Section 865(c) for depreciable personal property or Section 865(d) for amortizable intangible property used (or in the case of goodwill, generated) outside the United States.

b. Section 904. To the extent that gain realized on a sale of stock in a foreign subsidiary is treated as foreign source income under Section 865(f), it generally will fall within the passive income basket of Section 904(d)(1)(A)—a basket that typically includes income subject to low foreign taxes, so that there is little opportunity to offset U.S. taxes on the gain with foreign taxes paid on other items of income. In contrast, gain realized on a sale of assets used in a foreign trade or business may fall in the general limitation basket of Section 904(d)(1)(I)—a basket that typically includes income subject to high foreign taxes, so that cross-crediting opportunities may exist.

c. Subpart F (Sections 951 through 964). When an upper-tier controlled foreign corporation sells stock in a lower-tier controlled foreign corporation, any gain recognized is usually treated as foreign personal holding company income (*i.e.*, subpart F income subject to a current inclusion requirement) under Section 954(c)(1)(B).[4] On the other hand, gain realized by a controlled foreign corporation on a sale of assets that are used in an active trade or business may qualify for an exclusion from foreign personal holding company income under Treas. Regs. § 1.954-2(e)(3).[5]

d. Section 367(a). Under the Treasury Regulations issued under section 367(a), a gain recognition agreement generally is required for a U.S. taxpayer to avoid immediate recognition of gain on an exchange of shares in one foreign corporation for shares of another foreign corporation in a transaction that would otherwise be tax-free under Section 351 or 354 (for example, a "B" reorganization).[6] These regulations do not require a gain recognition agreement, however, to avoid recognition on a transfer of assets that are used in an active trade or business.[7]

In view of the above, the treatment of a disposition of foreign assets (the result of the disregarded entity election) is typically more favorable to a taxpayer than the treatment of a disposition of foreign stock (the result if no election had been made).[8]

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[4] This is because the stock would be treated as property that gives rise to dividends, which are treated as foreign personal holding company income under Section 954(c)(1)(A).

[5] This difference is addressed in Technical Assistance Memorandum 199937038, discussed in more detail below.

[6] *See* Treas. Regs. § 1.367(a)-3(b).

[7] *See* Section 367(a)(3); Treas. Regs. § 1.367(a)-2T.

[8] Also, though not mentioned in the Preamble, the existence of a difference between the "inside" basis of a foreign entity in its assets and the "outside" basis of the equity interests in that entity in

3. The Government's Concerns.

As noted above, the Preamble to the Proposed Regulations indicates that the foregoing consequences of a switch from corporate to disregarded entity classification are believed to be inappropriate. We think that the government's particular concerns are most likely one or both of the following: (i) an "arbitrage" concern that taxpayers should not be entitled to benefit from asset sale treatment for U.S. tax purposes without bearing the associated foreign tax and non-tax costs of an actual asset sale; and (ii) a "timing" or "step transaction" concern that the Check-the-Box Regulations were not intended to provide taxpayers with the more advantageous treatment accorded an asset sale under the cited Code provisions when the assets being sold were held in corporate solution until very shortly prior to the sale. We discuss each of these concerns below.

a. Absence of Foreign Tax Consequences. First, the deemed liquidation resulting from an election to treat a foreign corporate entity as a disregarded entity has none of the foreign tax (and non-tax) consequences that an actual liquidation would have. Similarly, a deemed asset sale has none of the foreign tax and other consequences that an actual asset sale may have. Thus, the making of a disregarded entity election shortly prior to the sale of a foreign entity permits a taxpayer to achieve the more favorable U.S. tax treatment of a sale of foreign assets without bearing the foreign tax and other burdens of an actual liquidation and asset sale. We note, however, that inconsistency with foreign law is inherent in the application of the Check-the-Box Regulations to foreign eligible entities, and particularly the rules that permit the existence of disregarded entities. To a large degree, we believe that the Treasury and the Service has accepted this situation in extending the Check-the-Box Regulations to foreign entities and

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the hands of its owners can mean that a sale of assets will produce a different tax liability than a sale of shares. This situation is addressed by the Extraordinary Transaction Rules in the context of a disregarded entity election but not in the context of an actual liquidation.

permitting the existence of "hybrids".[9] Therefore, we assume that Treasury and the Service would not seek to "turn off" the Check-the-Box Regulations for the sole reason that they create an inconsistency (in the taxpayer's favor) with foreign law in a particular context.[10] At the same time, we can appreciate that inconsistent treatment of a transaction under U.S. and foreign law may raise the government's level of concern when the transaction takes advantage of discontinuities in the law. We suspect that this is the case for the transactions targeted by the Extraordinary Transaction Rules.

b. Timing of the Conversion. In particular, the targeted transactions permit a taxpayer to obtain the benefits of asset sale treatment for a disposition under the international provisions of the Code, without having borne the less favorable consequences of disregarded entity classification (*e.g.*, current inclusion of branch income) for a meaningful period of time. In other words, the concern underlying the Extraordinary Transaction Rules may arise from the fact that the switch to disregarded entity classification occurs only in connection with a planned disposition. We can appreciate that the government may consider the ability of a taxpayer to elect asset sale treatment for a disposition by making a disregarded entity election immediately prior to the disposition to be inconsistent with the original intent of the Check-the-Box Regulations – which was to provide elective classification for the ongoing business operations of a taxpayer, and not necessarily

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[9] We continue to believe that the decision to extend the Check-the-Box Regulations to foreign entities was the correct one. It may be that, with hindsight, Treasury and the Service wish to revisit this decision. If so, we would remind Treasury and the Service that the alternatives are not very attractive. Reinstating prior law in the foreign context would only revive the needless complexity that prevailed before the Check-the-Box Regulations were adopted, and following foreign tax classification rules is clearly unacceptable from a sovereignty perspective. We also believe that applying different classification rules to similar entities in the domestic and foreign contexts would have adverse effects on simplification.

[10] In this regard, we note also that the Service recently accepted the reduction of foreign tax as an appropriate business purpose for the use of hybrid entities in the context of a foreign corporation's transfer of stock of one indirect U.S. subsidiary to another U.S. subsidiary. Priv. Ltr. Rul. 200005023 (Nov. 9, 1999).

to facilitate inconsistent treatment of the ongoing business and its ultimate disposition.

We see at least three possible ways to deal with this concern. The first is for the Service to seek application of the step transaction doctrine to ignore a disregarded entity election made immediately prior to, and in contemplation of, a disposition of a foreign eligible entity. In this regard, we note that the same concerns are presented where a taxpayer actually liquidates a foreign subsidiary immediately prior to a disposition, in order to receive actual asset sale treatment – notwithstanding that the assets in question may have been held in corporate solution at all times prior to the liquidation. To the extent that an actual liquidation were of concern, it could be addressed through application of the "step transaction" doctrine, and we see no reason in theory that the step transaction doctrine could not also apply in connection with a deemed liquidation that occurs by virtue of a disregarded entity election.

Further, Treasury and the Service seemed, at least until recently, to agree with this view. The preamble to the final regulations under Section 367(a), issued in June 1998, clearly contemplates the step transaction doctrine can apply with respect to a disregarded entity election made before a transfer of shares that would, if treated as a share transfer, be subject to a gain recognition agreement requirement.[11] In fact, the Preamble to the Proposed Regulations alludes to this earlier statement, and also refers to the statement in Treas. Regs. §301.7701-3(g)(2) (the "conversion" regulations) that the tax treatment of a change in the

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[11] T.D. 8770, issued on June 19, 1998 ("If the step transaction doctrine and the active trade or business anti-avoidance rule do not apply, however, the use of the 'check-the-box' regulations in this context will not be viewed as inconsistent with the purposes of section 367(a), and, therefore, the transaction will be respected as an asset transfer."). Similarly, the Service recently stated in the preamble to the final regulations with respect to qualified subchapter S corporation subsidiaries that the "general principles of tax law, including step transaction, apply to determine the tax consequences of the transactions that include a QSub election." T.D. 8869, issued on January 20, 2000.

classification of an entity for federal income tax purposes is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.[12] As a practical matter, of course, the likelihood that the government would succeed in making a step transaction argument would depend on the particular circumstances (*e.g.*, the timing of the seller's election in relation to its negotiation and agreement on a transaction with the buyer).

The second possible approach is illustrated in Technical Assistance Memorandum 199937038 (June 28, 1999), which addressed the consequences of a sale of the shares of a wholly-owned lower-tier controlled foreign corporation ("FC2") by an upper-tier controlled foreign corporation ("FC1"). That sale was immediately preceded by an actual liquidation of FC2 or, in the alternative, a deemed liquidation resulting from the making of a disregarded entity election for FC2. In both cases, the Service concluded the sale would be treated as a sale by FC1 of the assets of FC2, but the gain from the sale would not qualify for exclusion from subpart F income under the exception of Code section 954(c)(1)(B)(iii) and Treas. Regs. § 1.954-2(e)(3) for gain realized on the sale of property used in a trade or business because FC1 did not hold the FC2 assets for use in a trade or business of its own and for the requisite holding period under the regulations. In other words, the Service respected both the actual and the deemed liquidation as giving rise to an asset sale, and did not attempt to apply the step transaction doctrine to treat the combined transactions as a sale of the stock of FC2. Rather, the Service dealt with the potential for abuse by interpreting the specific Code and regulatory provisions involved as providing favorable treatment only where the relevant assets were held

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[12] In an analogous context, the Service recently reaffirmed the application of the step transaction doctrine in determining the consequences of a qualified subchapter S subsidiary election. Treas. Regs. § 1.1361-4(a)(2)(i), T.D. 8869, issued on January 25, 2000.

for use in the seller's business and not where the seller held the assets (actually or constructively) solely for purposes of the sale.[13]

The third possible approach is a transactionally-based exception to the Check-the-Box Regulations, such as the Extraordinary Transaction Rules. As noted above, we have been unable to reach a consensus on whether the Extraordinary Transaction Rules should be adopted. A significant number of members are of the view that the potential for abuse arising from the targeted transactions is better addressed through application of the step transaction doctrine, interpretation of specific Code and regulatory provisions,[14] or a combination of the two. These approaches have the advantage of applying equally to both actual and deemed liquidations that precede a disposition. In addition, they would not disturb the mechanics of the Check-the-Box Regulations and thus may better preserve the simplification achievements of those Regulations than the adoption of one or more detailed transactional exceptions.

On the other hand, many members believe that an explicit anti-abuse rule, such as the Extraordinary Transaction Rules, is warranted and in fact necessary to provide greater certainty for the government. One of the obvious disadvantages to the government of relying on the step transaction doctrine is that there is no guarantee of success. Similarly, drafting appropriate guidance under the substantive international Code sections may be difficult to do in some cases without significantly reworking the relevant regulations. These factors argue in favor of adopting the Extraordinary Transaction Rules.

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[13] The TAM reached the same conclusion where the actual or deemed liquidation occurred at a time when FC1 had entered into a contract to sell the shares in FC2 but the actual sale was not consummated for a period of time, *e.g.*, 3 months or less.

[14] We had understood that a principal reason for the extension of the Check-the-Box Regulations to the foreign context was to enhance the government's ability to address cross-border tax issues without regard to classification issues. It would be consistent with that objective to review the substantive provisions involved and address particular concerns in those contexts.

Both groups are in agreement, however, that the Extraordinary Transaction Rules are overly broad as drafted. The rules apply when a taxpayer disposes of as little as 10% of a foreign eligible entity within one year of the disregarded entity election. In that situation, the taxpayer could have retained as much as 90% of the foreign business and could be intending to continue the foreign business in essentially the same manner as before the disposition. Invalidating the taxpayer's disregarded entity election with respect to the ongoing business interest represents a very harsh penalty in relation to any benefits the taxpayer may derive from disregarded entity treatment on its sale of a 10% interest. Moreover, a 10% threshold may have the undesirable (from the government's perspective) effect of permitting taxpayers to revoke a disregarded entity election, in circumstances where revocation would not otherwise be allowed, by selling a 10% interest in the entity and affirmatively invoking the Extraordinary Transaction Rules. Therefore, we recommend that the 10% threshold be raised to a much higher level so that the Extraordinary Transaction Rules would apply only where a taxpayer was disposing of a substantial interest in a foreign eligible entity – for example, more than 50%, or an 80% interest (*i.e.*, substantially all).

In addition, we are concerned that a series of transactional exceptions could effectively negate the simplification benefits that were the original goal of the Check-the-Box Regulations. Therefore, if the government chooses to adopt this approach for dealing with abuse, we recommend that any additional anti-abuse rules that the government may be considering be drawn as narrowly as possible.

II. TECHNICAL COMMENTS ON PROPOSED REGULATIONS § 301.7701-3(h).

We have also set forth below a number of technical comments on the Extraordinary Transaction Rules.

1. 10-Percent Interest. The Extraordinary Transaction Rules apply when a 10-percent or greater interest in a foreign eligible entity is sold, exchanged,

transferred or otherwise disposed of in one or more extraordinary transactions. The Proposed Regulations do not provide a definition of the term "10-percent or greater interest". We recommend the meaning of this term be clarified and, in particular, that the regulations indicate whether the 10 percent test is intended to refer to a percentage of the voting power or the value of the interests in the eligible entity, or both. In addition, any attribution rules that are intended to apply should be specified, and the treatment of options to acquire interests in a foreign eligible entity should be addressed.[15]

2. Applicable Testing Period. Under paragraph (h)(1)(i)(A) of the Extraordinary Transaction Rules, the general rule is applicable when an extraordinary transaction occurs during the period beginning one day before the effective date of the change in classification and ending twelve months after such date. This period is referred to herein as the "Testing Period".

The retroactive aspect of the Testing Period has the potential to cause unintended results and create traps for the unwary. This problem could arise in any situation where a buyer seeks to acquire a foreign entity classified as an association but which the buyer would prefer be a disregarded entity. In those cases, it is possible the seller can not or will not elect for the foreign entity to change to disregarded entity status, so that the buyer ends up acquiring the entity as an association but then immediately electing for the entity to be disregarded. If the buyer's election is made effective on the closing date, or even on the next day, the purchase will occur during the Testing Period.[16] This problem can be avoided

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[15] The same recommendation would apply if the government adopts our recommendation that the 10% threshold be raised.

[16] Note that, without the seller's consent, the buyer may not make the election effective any earlier than the closing date. *See* Treas. Reg. § 301.7701-3(c)(2)(ii), which provides that an election that is to be effective prior to the date on which it is filed must be signed by each person that was an owner at any time during the period beginning on the effective date and ending on the filing date. It appears that a purported retroactive election that lacks the requisite

easily by the well-advised buyer by making the effective date of the "check the box" election at least two days after the closing date.

The Committees see no reason why the Testing Period rule should pick up any election that has no tax consequences to the seller or (as to the buyer) with respect to the extraordinary transaction itself. We suspect that the reason the Testing Period was phrased this way was to deal with the technical point that, under proposed regulations, the deemed liquidation resulting from an election to convert from association to disregarded entity status occurs the day before the effective date of the election.[17] As a result, an election that is effective on the closing date technically will cause the foreign entity to be deemed to have liquidated as of the end of the day before the closing date and, therefore, apparently cause the extraordinary transaction to be treated as an asset sale. This is true even if the seller has not consented to the election.[18]

The Committees accept the point that the Testing Period should encompass elections filed after the extraordinary transaction that affect the tax consequences of the entity in the seller's hands and/or the tax consequences of the extraordinary transaction to the buyer or the seller. However, the Committees recommend that the Testing Period rule be rephrased to exclude elections that do not affect the seller or the consequences of the extraordinary transaction to the buyer. That change would make the purpose of the rule clearer and would protect taxpayers in

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prior owner signatures would be invalid, as opposed to effective beginning on the filing date. *But cf.* Treas. Reg. § 301.7701-3(c)(1)(iii).

[17] *See* Prop. Treas. Reg. § 301.7701-3(g)(3).

[18] The Committees suggest that this anomaly be studied further in connection with the finalization of Prop. Treas. Reg. § 301.7701-3(g)(3). It may make sense to provide in the final regulations that the deemed liquidation occurs as of the close of business on the effective date of the election, at least in cases where an extraordinary transaction has occurred on that date.

cases where the effective date of the election is the day after the closing date for the extraordinary transaction.[19]

3. Binding Contracts. As noted above, the general rule of the Extraordinary Transaction Rules governs when an extraordinary transaction occurs during the Testing Period. We suggest that, to prevent avoidance opportunities, Treasury and the Service may want to consider extending the Testing Period to cover extraordinary transactions that occur more than one year after the effective date of the classification election, but pursuant to binding contracts entered into within that one-year period.[20]

4. Treatment of Classification Election. It would be useful to clarify in the text of the regulations that the making of a disregarded entity election is not itself an extraordinary transaction within the meaning of the Proposed Regulations. This point is made in the Preamble to the Proposed Regulations, which states that "[t]he 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." The text of the Proposed Regulations does not, however, make this clear.

5. No Material Alteration Exception. Paragraph (h)(3) of the Extraordinary Transaction Rules provides that the general and shelf entity rules 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. We recommend additional

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[19] If the suggestion made in the prior note is taken, this change also would protect taxpayers in cases where the election is effective on the date of the extraordinary transaction.

[20] *See, e.g.*, Technical Assistance Memorandum 199937038.

guidance be provided on the manner in which a taxpayer can establish this point. In particular:

> (a) How does this exception apply where the election does not materially alter the tax consequences to the seller of a foreign eligible entity but does provide a significant tax benefit to the purchaser, such as a basis step-up?
>
> (b) What is meant by "material"?
>
> (c) Will any exceptions be granted for situations in which a taxpayer makes a disregarded entity election for reasons unrelated to the possibility of an extraordinary transaction, and an extraordinary transaction then occurs unexpectedly within the Testing Period?

In addition, we believe it should be possible for a taxpayer to make this showing in advance of an extraordinary transaction, *e.g.*, by obtaining a private letter ruling on an expedited basis.

6. Intra-Group Transactions. As currently drafted, the Extraordinary Transaction Rules effectively prohibit internal restructurings (*e.g.*, in a foreign-to-foreign Section 368(a)(1)(D) reorganization), even where there is no disposition of foreign business assets outside the group. For example, assume U.S. parent directly owns 100 percent of each of F1 and F2, both foreign corporations. U.S. parent drops F1 under F2 and then checks the box on the following day to treat F1 as a disregarded entity. As a result of the election, F1 is deemed to liquidate into F2. Historically, Rev. Rul. 67-274 and other related guidance have provided that the transfer of a foreign target's stock to a foreign acquiring corporation followed by the liquidation of the foreign target will be stepped together and treated as a foreign-to-foreign Section 368(a)(1)(D) reorganization for which no gain recognition agreement ("GRA") is required.[21] Absent the

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[21] In Revenue Ruling 67-274, 1967-2 C.B. 141, the Service recharacterized a purported B reorganization as a C reorganization because the transferred corporation was liquidated as part of the transaction. Private Letter Rulings relying on Rev. Rul. 67-274 to treat a transfer of stock

application of the step transaction doctrine, the transfer would be considered a Section 351 contribution (and a reorganization under Section 368(a)(1)(B)) for which a GRA would be required under Section 367(a) and the regulations thereunder.

Under the Extraordinary Transaction Rules, however, because F1's stock is "disposed of" in a transfer to F2 during the period "commencing one day before" the effective date of the disregarded entity election, the election would be invalid.[22] Thus, there would be no deemed Section 332 liquidation of F1 and, as a result, the transaction would fail to qualify as a foreign-to-foreign Section 368(a)(1)(D) reorganization. Instead, the transaction would be viewed merely as a transfer of F1 stock in a Section 351 transaction (or a Section 386(a)(1)(B) reorganization) for which a 5-year GRA is required. The Extraordinary Transaction Rules thus effectively preclude disregarded entity elections to accomplish foreign-to-foreign D reorganizations, even where there is no intention to dispose of the foreign target. Although the Preamble to the Proposed Regulations suggests that a subsequent disregarded entity election would not be prohibited, it is unclear how an election would be treated under the Extraordinary Transaction Rules if considered part of the original plan of reorganization. The subsequent election and the deemed liquidation triggered as a result of that election could result in application of the

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followed by a liquidation as a D reorganization include PLR 9804038 (Oct. 27, 1997) (acquisition of target stock was made solely with acquiring corporation stock, other than cash paid for fractional shares, followed by dissolution of target); PLR 9743001 (June 4, 1997) (acquisition of target stock was made with acquiring corporation stock, other than cash paid for fractional shares, followed by dissolution of target); PLR 9721010 (Feb. 13, 1997) (acquisition of target stock was made solely with acquiring corporation stock followed by dissolution of target); PLR 9109055 (Dec. 5, 1990) (acquisition of target stock was made solely with acquiring corporation stock followed by dissolution of target).

[22] If the disregarded entity election is made so as to be effective two days after the transfer of F1 stock, as currently drafted, the Extraordinary Transaction Rules apparently would not apply, in which case the transaction could qualify as a Section 368(a)(1)(D) reorganization. The Service, however, has suggested that as long as the transaction is deemed to be a D reorganization, the transfer will be treated as occurring within the prohibited period and the Extraordinary Transaction Rules will apply.

step transaction doctrine again. Query whether application of the step transaction doctrine under these circumstances could trigger the rules all over again.

The Service and the Treasury have indicated that application of the Extraordinary Transaction Rules to the transaction described above is intentional, because taxpayers presently are able to convert what would otherwise be a nontaxable foreign stock acquisition with a 5-year GRA requirement into a nontaxable foreign-to-foreign D reorganization for which there is no GRA requirement. The Treasury and the Service are concerned that, without the limitation of a GRA, taxpayers could dispose of the foreign target after the reorganization without recognizing gain for U.S. tax purposes. A similar concern was expressed in the preamble to the final Section 367(a) regulations (T.D. 8770), published in 1998, which provides an example wherein US parent owns F1 and F2, foreign corporations. To come under the active business exception of Section 367(a)(3), US elects to treat F1 as a disregarded entity and contributes F1's assets to F2. The preamble warns that the transaction will be treated as a transfer of F1 stock (and therefore subject to a GRA) if, as part of the same transaction, F2 disposes of F1's assets. However, the preamble also suggests that if there is no intention to sell F1's assets, the transaction will be respected as an asset transfer. (In contrast, under the Extraordinary Transaction Rules, the disregarded entity election for F1 would not be valid, and US would be treated as contributing F1 stock to F2, even if F2 had no intention to subsequently sell F1).

If the Treasury and the Service are in fact concerned about the subsequent transfer of assets following an internal restructuring, we suggest the Extraordinary Transaction Rules are overbroad. In particular, we do not believe there are compelling reasons to extend the application of the Extraordinary Transaction Rules to intra-group restructurings where the assets are retained by the overall group. These restructurings typically are part of a plan to reduce foreign taxes by employing a centralized holding vehicle that facilitates the free flow of funds

between subsidiaries, and they do not warrant the harsh treatment of the Extraordinary Transaction Rules. Rather, we recommend the Service and Treasury consider a more targeted remedy. Indeed, the Service and Treasury have already considered alternative remedies. For example, the preamble to the Section 367(a) regulations hints that the use of GRAs could be expanded, noting that "[a]lthough GRAs are currently used solely with respect to outbound transfers of stock or securities, the IRS and the Treasury Department may, at a later date, permit taxpayers to secure nonrecognition treatment under Section 367(a) with respect to other types of assets by entering into GRAs." Such an expansion would certainly cure the perceived abuse described in the preamble to the final Section 367(a) regulations. The government might consider this more limited remedy with respect to foreign-to-foreign reorganizations as well. We recognize that these reorganizations would not be within the ambit of Section 367(a). However, the government could adopt the principles of those rules under the Proposed Regulations, and require entering into an appropriate gain recognition agreement as a condition of securing a disregarded entity election.

7. Effective Date. The Proposed Regulations state, in paragraph (h)(5), that the Extraordinary Transaction Rules will apply on or after the date final regulations are published in the Federal Register. It is not clear under this language whether the regulation will apply in a case where a taxpayer has made a disregarded entity election for a foreign eligible entity that takes effect before final regulations are published and an extraordinary transaction occurs in respect of that foreign eligible entity after the publication date and within one year and one day of the election.

We recommend this point be clarified, preferably before the publication of final regulations so that taxpayers that are presently considering whether to make disregarded entity elections may understand the potential consequences under the Proposed Regulation. Further, in the event the regulations generally are intended

to apply in the circumstance described above,[23] we recommend that an exception be made under which the regulations would **not** apply where an extraordinary transaction occurs after the publication date of final regulations but pursuant to a binding contract entered into before that date.

III. Proposed Regulations § 301.7701-3(d) (the Relevance Rules).

A. The Existing Regulations.

Under the Check-the-Box Regulations, a foreign eligible entity that was ***in existence*** prior to January 1, 1997 is treated by default as having the same classification as it had previously claimed, provided that: (1) it is not an entity treated as a "per se corporation" under the new rules (and thus, not an eligible entity);[24] (2) it was not an eligible entity with a single owner that had claimed to be a partnership (and thus, a disregarded entity under the new rules);[25] or (3) it did not elect a new entity status by filing Form 8832 (Entity Classification Election) with the appropriate IRS Service Center.[26] For purposes of these rules, a foreign eligible entity is considered to have been ***in existence*** prior to January 1, 1997 only if at any time during the sixty months prior to that date the entity's classification was ***relevant*** as defined in Treas. Reg. § 301.7701-3(d).

Treas. Reg. § 301.7701-3(d)(1) provides that a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. Thus, for example, a foreign eligible entity's classification becomes relevant if U.S. source income is paid to the entity and the

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[23] Will Morris, of the Treasury's Office of International Tax Counsel, reportedly has indicated that the Proposed Regulations are intended to apply to election-extraordinary transaction combinations that straddle its proposed effective date. *See* Sheppard, "Putting Checks on the Check-the-Box Rules", 1999 Tax Notes Today 238-2 (December 10, 1999).

[24] Treas. Reg. § 301.7701-3(a).

[25] Treas. Reg. § 301.7701-3(b)(3).

[26] *Id.*

amount of U.S. withholding tax would vary depending on the entity's classification. As a result, the classification might affect the following: (1) the documentation that the withholding agent must receive; (2) the type of tax to be paid; (3) the information return to be filed; or (4) how the return must be prepared. The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined.[27]

Existing Treas. Reg. § 301.7701-3(d)(2) provides a special rule for when the classification of a foreign eligible entity, which was previously relevant for federal tax purposes, ceases to be relevant. Under this rule (the "Sixty-Month Rule"), if the classification of the foreign eligible entity ceases to be relevant for sixty consecutive months, then the entity's classification will initially be determined under the default classification rules (see below) when the classification of the foreign eligible entity again becomes relevant. The date that the classification of the foreign eligible entity ceases to be relevant is the date an event occurs that causes the classification to no longer be relevant, or, if no event occurs in a taxable year that causes the classification to be relevant, then the date is the first day of that taxable year.

B. The Default Classification Rules.

In circumstances in which a foreign entity was not ***in existence (and thus, not relevant)*** prior to January 1, 1997, and in which it had not made an affirmative election by filing Form 8832, the Check-the-Box Regulations provide that the entity is classified under the default classification rules. The default classification rules are also applicable when the foreign eligible entity ceases to be relevant under

[27] One example of a date on which the classification of an entity becomes relevant is the date on which a U.S. person acquires an interest in the entity for which it will be required to file an information return on Form 5471.

the Sixty-Month Rule. The default classification rules provide that a foreign eligible entity is treated as (1) a partnership if it has at least two members and any one member has unlimited liability; (2) an association (corporation) if no member has unlimited liability; and (3) as a disregarded entity if it has a single owner with unlimited liability.[28] Thus, a foreign eligible entity that was not ***in existence*** prior to January 1, 1997, and a foreign eligible entity that ceased to be relevant under the Sixty-Month Rule, would be classified according to their default classifications absent an affirmative election.[29] However, it was not entirely clear under the Check-the-Box Regulations that a foreign eligible entity whose classification was not relevant for federal tax purposes or had ceased to be relevant for federal tax purposes could make such an election.

C. The Proposed Conversion Regulations.

The preamble to the proposed conversion regulations[30] clarified that a foreign eligible entity whose classification was not relevant or had ceased to be relevant for federal tax purposes could make such an affirmative election:

> Any eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification. The IRS and Treasury request comments on the appropriateness of allowing such a foreign eligible entity to make a classification election, and comments on what the federal tax consequences of such an election should be (*e.g.*, with respect to the basis of property held by the entity).

Although there was no textual language in the proposed conversion regulations saying that a foreign eligible entity whose classification is not relevant for federal tax purposes could change its classification, we believe that this was the original intent set forth in the Check-the-Box Regulations and we found this language helpful.

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[28] Treas. Reg. § 301.7701-3(b)(2).

[29] Treas. Reg. § 301.7701-3(a).

D. Comments on the Proposed Relevance Rules.

In the preamble to the Proposed Regulations[31], Treasury and the Service noted that the Check-the-Box Regulations provide a special rule when the Federal tax classification of a foreign eligible entity is no longer relevant. Under this rule, the Sixty-Month Rule, the classification of a foreign eligible entity is determined under the Default Classification Rules when the entity again becomes relevant. However, Treasury and the Service noted that practitioners have requested guidance on whether the act of filing an entity classification election (Form 8832, Entity Classification Election) will cause an entity to be relevant for purposes of the Sixty-Month Rule. Treasury and the Service also noted that practitioners have requested clarification regarding whether a newly formed foreign eligible entity that has never been relevant is subject to the Sixty-Month Rule.

1. One-Day Relevance. The proposed amendments to Treas. Reg. § 301.7701-3(d) provide special rules for foreign eligible entities. Prop. Reg. § 301.7701-3(d)(1)(ii)(A) provides that a foreign eligible entity that files a Form 8832 (Entity Classification Election) is deemed relevant on the date that the entity classification election is effective. However, if the foreign eligible entity is otherwise not relevant within the meaning of Treas. Reg. § 301.7701-3(d)(1)(i), then it is deemed relevant only on the date that the entity classification election is effective.[32] Thus, for purposes of applying the Sixty- Month Rule, the entity will be considered to be not relevant the day after the effective date of the entity classification election.

While we appreciate the clarification that the filing of a Form 8832 is deemed to make an entity relevant for purposes of the Sixty-Month Rule, we fail

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[30] *See* REG-105162-97 (October 28, 1997).

[31] *See* REG-110385-99 (November 29, 1999).

[32] Prop. Reg. § 301.7701-3(d)(1)(ii)(A).

to understand the reason for limiting the deemed relevance to one day. We also believe that further guidance on when, and under what circumstances, a foreign eligible entity that was previously relevant ceases to be relevant under the Sixty-Month Rule would be helpful.

2. Entities that Were Never Relevant. Prop. Reg. § 301.7701-3(d)(2) provides an exception for a foreign eligible entity whose Federal tax classification has never been relevant.[33] Under this rule, such an entity initially will have its classification determined under the Default Classification Rules of Treas. Reg. § 301.7701-3(b)(2) when the entity first becomes relevant. The preamble states that a foreign eligible entity that was never relevant is excepted from the Sixty-Month Rule. It should be clarified whether this exception applies from the time the entity becomes relevant until the first time subsequently that an election (or new election) changes the entity's classification.

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[33] Prop. Reg. § 301.7701-3(d)(2).