

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations providing rules regarding the application of the general entity classification rules to certain foreign business entities, in particular providing a rule that terminates the grandfathered status of certain foreign business entities upon a 50 percent change of ownership and a special rule that clarifies and further modifies the rules relating to whether the classification of certain foreign eligible entities is relevant for Federal tax purposes.

**EFFECTIVE DATES:** These regulations are effective as of October 22, 2003.

**FOR FURTHER INFORMATION CONTACT:** Ronald M. Gootzeit, (202) 622-3860 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:****Background**

On December 18, 1996, Treasury and IRS published in the **Federal Register** (61 FR 66584) final regulations relating to the classification of business entities under section 7701 (check-the-box regulations). On November 29, 1999, Treasury and the IRS published in the **Federal Register** (64 FR 66591) a notice of proposed rulemaking (REG-110385-99) proposing to amend §§ 301.7701-2 and 301.7701-3 of the current check-the-box regulations (proposed regulations). A public hearing on the proposed regulations was held on January 31, 2000. In addition, written comments were received. Most of the written and oral comments related to proposed § 301.7701-3(h), which provided a rule that would have operated to change the classification of a foreign disregarded entity if a so-called "extraordinary transaction" occurred one day before or within one year after the election to treat the entity as disregarded. On June 26, 2003, Treasury and the IRS issued Notice 2003-46 (2003-28 IRB 53) announcing the intention to withdraw this extraordinary transaction rule of proposed § 301.7701-3(h) and to finalize the remaining provisions of the proposed regulations.

With the publication of a notice of withdrawal elsewhere in this issue of the **Federal Register**, proposed § 301.7701-3(h) is withdrawn. This Treasury decision adopts without substantive change the remaining provisions of the proposed regulations. The final regulations thus adopt the following provisions from the proposed regulations: (1) The rule that terminates the grandfathered status of certain foreign business entities when there has been a 50 percent change of ownership

of such entity; (2) the provision clarifying that a foreign eligible entity with respect to which an entity classification election is made and which is not otherwise relevant for Federal tax purposes is deemed so relevant only on the effective date specified on a Form 8832, "Entity Classification Election"; and (3) the modifications to the classification rules for certain foreign eligible entities that have never been relevant or are no longer relevant for Federal tax purposes.

**Explanation of Provisions***A. Grandfathered Foreign Per Se Entities*

The check-the-box regulations allow certain foreign business entities that were in existence and treated as partnerships prior to the date the check-the-box regulations were proposed (PS-43-95, 61 FR 21989) and that would otherwise be classified as per se corporations under § 301.7701-2(b)(8)(i) to remain classified as partnerships if the conditions enumerated in § 301.7701-2(d)(1) are satisfied. These rules also provide that the occurrence of certain events results in a termination of this grandfathered status. See § 301.7701-2(d)(3)(i). The final regulations adopt the rule in the proposed regulations at § 301.7701-2(d)(3)(i) that provides an additional event resulting in the termination of an entity's grandfathered status. Under this rule, an entity's grandfathered status is terminated on the date when one or more 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. Consistent with the proposed regulations, the final regulations provide that this rule will apply as of the date the final regulations are published in the **Federal Register**; therefore, if persons that were not owners of a grandfathered entity on November 29, 1999, obtain a greater than 50 percent ownership interest between November 29, 1999, and October 22, 2003, the grandfathered entity will cease to have that status on October 22, 2003.

Several commentators requested clarification as to whether this rule takes into account changes in direct ownership only or also changes in indirect ownership, and they suggested that the rule should take into account only changes in direct ownership. Treasury and the IRS believe that for purposes of grandfathered foreign per se entities a rule that took only direct changes of ownership into account could be easily circumvented in inappropriate cases. Therefore, this rule has not been modified in these final

regulations. Some commentators requested that the rule be limited to significant changes in ownership within a specified period of time. For example, one commentator suggested that the rule be limited to situations where persons obtained a 50 percent or greater ownership interest within a 12-month period. The final regulations do not adopt this suggestion because Treasury and the IRS believe that an entity should retain grandfathered status only if there have been no significant changes in the ownership of that entity.

*B. Relevance of Classification*

The check-the-box regulations provide that if the classification of a foreign eligible entity that was previously relevant for Federal tax purposes ceases to be relevant for 60 consecutive months and then subsequently becomes relevant again, the entity's classification at the start of the subsequent period of relevance will be determined under the default classification rules (60-month rule).

These final regulations adopt the two rules in the proposed regulations that relate to the application of the 60-month rule. First, these final regulations adopt the rule providing that the classification of a foreign eligible entity that files an entity classification election is deemed to be relevant for Federal tax purposes on the effective date of the election for purposes of the 60-month rule. Second, these final regulations adopt the rule providing that the classification of a foreign eligible entity whose classification has never been relevant for Federal tax purposes will initially be determined pursuant to the default classification provisions of § 301.7701-3(b)(2) at the time the classification of the entity first becomes relevant.

Commentators generally agreed with and supported the approach taken in the proposed regulations with respect to the relevance issues, and several commentators requested that these provisions be retroactive when finalized. These final regulations do not adopt the suggestion that these provisions be applied retroactively because Treasury and the IRS believe that it is not in the interest of sound tax administration.

One commentator requested that the provisions be revised to clarify that it is the Federal tax classification of the foreign eligible entity, and not the entity itself, that is deemed to be relevant. Treasury and the IRS have adopted this clarifying change in these final regulations.

One commentator requested that the regulations clarify why the classification of a foreign eligible entity, not otherwise