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Memorandum

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subject: Federal Tax Classification of Certain Foreign Entities

This memorandum should not be used or cited as precedent.

Issues

Issue 1. Does a foreign eligible entity the classification of which has never been relevant as defined in Treas. Reg. § 301.7701-3(d)(1) have a federal tax classification pursuant to Treas. Reg. § 301.7701-3 during the period in which its classification is not relevant?[1]

Issue 2. Does Treas. Reg. § 301.7701-3(c)(1)(iv), which prohibits an entity that makes an election to change its classification from making another election to change its classification during the 60 months following the effective date of the first election (the "60-month limitation rule"), apply if a foreign eligible entity the classification of which has not previously been relevant elects to change its classification?

Conclusions

Issue 1. Yes, a foreign eligible entity is classified pursuant to Treas. Reg. § 301.7701-3(b)(2) ("the default classification provision") during the period in which its classification is not relevant. This determination is made when the classification of the entity first becomes relevant, but the classification applies during the non-relevant period.

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[1] For purposes of this memorandum, unless otherwise indicated the use of the terms "relevant" and "relevancy" should be read as "relevant for purposes of Treas. Reg. § 301.7701-3(d)(1)."

Issue 2. No, the 60-month limitation rule does not apply if the election to change the classification is effective on the first date the classification is relevant.

Facts

Situation 1. On Date 1, S1 and S2, each a nonresident alien individual, form X, a foreign business entity that is eligible to make a classification election described in Treas. Reg. § 301.7701-3(c). On Date 2, S1 acquires all of S2's interests in X and becomes the sole owner of X. On Date 3, S1 becomes a U.S. citizen. On Date 4, X makes a valid election, effective on Date 3, to be classified as an association. Before Date 3, the classification of X is not relevant. Neither S1 nor S2 has limited liability within the meaning of Treas. Reg. § 301.7701-3(b)(2)(ii) with respect to X at any time during their ownership.

Situation 2. The facts are the same as in Situation 1, except that S1 does not become a U.S. citizen and the classification of X is never relevant as defined in Treas. Reg. § 301.7701-3(d)(1)(i).

Law and Analysis

Section 7701(a)(2) defines a partnership to include a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and that is not a trust or estate or a corporation. Section 7701(a)(3) defines a corporation to include associations, joint-stock companies, and insurance companies.

Section 7701(a)(4) defines the term "domestic" when applied to a corporation or partnership to mean created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations. Section 7701(a)(5) defines the term "foreign" when applied to a corporation or partnership to mean a corporation or partnership which is not domestic.

Before the 1997 promulgation of the current entity classification rules in Treas. Reg. § 301.7701-3, an entity's tax classification as either an association or a partnership was determined by a multi-factor test provided by regulations.[2] The current regulations replaced the multi-factor test with a classification regime that, among other things, provides certain entities the ability to choose their federal tax classification and, in the absence of an election, provides the default classification of those entities. Such entities

[2] *See* Prior Treas. Reg. §§ 301.7701-2 and 301.7701-3 as in effect before January 1, 1997 (often referred to as the "*Kintner* regulations"). The *Kintner* regulations classified an entity as an association if it had a preponderance of four specified corporate characteristics: (1) continuity of life, (2) centralization of management, (3) liability for organization debts limited to the organization's assets, and (4) free transferability of interests.

are referred to as “eligible entities” and generally include all business entities that are not classified as associations under Treas. Reg. § 301.7701-2(b).[3]

In the absence of an election, a foreign eligible entity is classified for federal tax purposes pursuant to the default classification provision. The default classification provision provides that a foreign eligible entity is classified as (i) a partnership if the entity has two or more members and at least one member does not have limited liability; (ii) an association[4] if all of the entity’s members have limited liability; and (iii) a disregarded entity if the entity has a single owner that does not have limited liability.[5] As an alternative to the default classification, a foreign eligible entity may elect pursuant to Treas. Reg. § 301.7701-3(c) to be classified as (i) an association; (ii) a partnership if the entity has at least two members; or (iii) a disregarded entity if the entity has only one owner.

Treasury Regulation § 301.7701-3(g) provides the tax treatment resulting from an election to change a classification. For example, if an eligible entity classified as a disregarded entity elects pursuant to Treas. Reg. § 301.7701-3(c) to be treated as an association, the owner of the disregarded entity is treated as contributing all of the assets and liabilities of the entity to the association in exchange for stock of the association.[6] The deemed contribution is treated as occurring immediately before the close of the day before the election is effective.[7]

Treasury Regulation § 301.7701-3(d)(2) provides that the classification of a foreign eligible entity the classification of which has never been relevant will initially be determined pursuant to the default classification provision when the classification of the entity first becomes relevant. This initial determination requires the classification of the entity not only when it becomes relevant, but also the pre-relevancy classification of the entity and any changes in classification.[8]

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[3] Treas. Reg. § 301.7701-3(a).

[4] An association (as determined under §301.7701-3) is a corporation for federal tax purposes. Treas. Reg. § 301.7701-2(b)(2).

[5] Treas. Reg. § 301.7701-3(b)(2).

[6] Treas. Reg. § 301.7701-3(g)(1)(iv).

[7] Treas. Reg. § 301.7701-3(g)(3)(i).

[8] Further, an initial determination would be made with respect to any other foreign eligible entity the classification of which first became relevant. For example, if a foreign eligible entity (“target”) merged with and into another foreign eligible entity (“acquiring”) and the classification of target and acquiring was never relevant during their existence, the classification of target would become relevant on the date that acquiring’s classification becomes relevant because target’s classification (and the corresponding federal tax characterization of the merger) would affect federal tax and reporting obligations once acquiring’s classification becomes relevant.

The classification of a foreign eligible entity is relevant when its classification affects the liability of any person for federal tax or information reporting purposes.[9] Additionally, a classification may be deemed to be relevant on the date its entity classification election is effective.[10]

An entity has a classification for federal tax purposes at all times, including during periods when its classification is not relevant and regardless of whether the classification has ever been relevant. Section 7701(a)(2) and (3) do not suggest that the classification of an entity as a partnership or a corporation, respectively, depends on relevancy. In addition, neither the current nor prior entity classification regulations indicate that an entity does not have a classification during periods when the classification is not relevant. Such pre-relevancy classification is necessary, for example, to determine the entity's tax attributes, such as earnings and profits (if classified as an association) or tax basis in assets, if the classification becomes relevant. If a classification election has not been made for an entity, then its classification is determined under the default classification provision. This conclusion obtains from a plain reading of the default classification provision and is also consistent with statements in the preambles to the regulations. For example, the preamble to the entity classification regulations issued in 1997 provides that "[a]ny eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification."[11] The preamble to the entity classification regulations issued in 1999 reiterates that "a foreign eligible entity that is not relevant has a Federal tax classification."[12] The requirement in Treas. Reg. § 301.7701-3(d)(2) that an entity's classification must initially *be determined* when the entity becomes relevant is consistent with this conclusion; the fact that the determination is first made when the classification becomes relevant addresses the time of determination but does not indicate that the entity has no classification prior to such time.

Under the 60-month limitation rule, if an entity elects pursuant to Treas. Reg. § 301.7701-3(c) to change its classification, the entity is generally precluded from changing its classification by election again for 60 months.[13] This rule does not, however, apply to an election by a newly formed eligible entity that is effective on the

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[9] Treas. Reg. § 301.7701-3(d)(1)(i).

[10] *See* Treas. Reg. § 301.7701-3(d)(1)(ii)(A). However, Treas. Reg. § 301.7701-3(d)(1)(ii)(B) provides that Treas. Reg. § 301.7701-3(d)(1)(ii)(A) does not apply if the classification of the entity is relevant under Treas. Reg. § 301.7701-3(d)(1)(i).

[11] *See* 1997-2 C.B. 649 (62 Fed. Reg. 55768).

[12] *See* 1999-2 C.B. 670 (64 Fed. Reg. 66591).

[13] Treas. Reg. § 301.7701-3(c)(1)(iv). However, the entity may request a private letter ruling to change its classification if there is a change in ownership of more than fifty percent during the 60-month period. *See id.*

date of formation.[14] Further, Treas. Reg. § 301.7701-3(d)(2) should be interpreted such that an elective classification that is effective on the date the classification first becomes relevant is treated solely for purposes of the 60-month limitation rule as if it were effective on the date of formation and the election does not preclude a subsequent election within 60 months to change the classification. This interpretation is consistent with the preamble to the 2003 entity classification regulations:

> [T]he entity's classification initially will be determined under the default classification rules of § 301.7701-3(b)(2) when the classification of the entity becomes relevant. Under the general rules of § 301.7701-3(c), an eligible entity may elect at such time to be classified other than as provided under the default classification rules, and may elect at some later time to change its classification.[15]

In Situation 1, the classification of X is relevant, as defined in Treas. Reg. § 301.7701-3(d)(1)(i), on Date 3 because the classification affects the federal tax or information reporting liability of a person, S1, as of Date 3. Further, because the classification of X has never been relevant before Date 3, Treas. Reg. § 301.7701-3(d)(2) applies to initially determine X's default classification on Date 3. Because neither S1 nor S2 has limited liability, the default classification of X is a partnership on Date 1 and through the end of the day before Date 2 (a period in which X had two members) and a disregarded entity on Date 2 and through the end of the day before Date 3 (a period in which X had a single owner).[16] Pursuant to its classification election, X is treated as an association as of Date 3.[17]

Solely for purposes of Treas. Reg. § 301.7701-3(c)(1)(iv), X's classification election is treated as if it were effective on the date that X was formed and, therefore, does not preclude X from making an election to change its classification within 60 months after Date 3.

In Situation 2, the classification of X is never relevant as defined in Treas. Reg. § 301.7701-3(d)(1)(i). However, as a result of the entity classification election and pursuant to Treas. Reg. § 301.7701-3(d)(1)(ii), the classification of X is deemed to be relevant as defined in Treas. Reg. § 301.7701-3(d)(1)(i) on Date 3. As a result, Treas.

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[14] *See id.*

[15] *See* 2003-2 C.B. 1156, T.D. 9093 (68 Fed. Reg. 60296).

[16] The X partnership terminates on Date 2. For purposes of determining the tax treatment of S1, X is deemed to make a liquidating distribution of all its assets to S1 and S2, and following this distribution, S1 is treated as acquiring the assets deemed to have been distributed to S2 in liquidation of S2's X partnership interest. *See* Rev. Rul. 99-6, Situation 1.

[17] Pursuant to Treas. Reg. § 301.7701-3(g)(1)(iv), S1 is treated as contributing all of the assets and liabilities of X to X in exchange for X stock. Pursuant to Treas. Reg. § 301.7701-3(g)(3), the deemed contribution occurs immediately before the close of the day before Date 3.

Reg. § 301.7701-3(d)(2) requires that X's entity classification initially be determined on Date 3. As such, the result in Situation 2 is the same as in Situation 1: X is classified as a partnership on Date 1 and through the end of the day before Date 2; X is classified as a disregarded entity on Date 2 and through the end of the day before Date 3; X is classified as an association as of Date 3; and the 60-month limitation rule does not apply as a result of the election effective on Date 3.

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