

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

[REG-101739-00]

RIN 1545-AX75

Clarification of Entity Classification Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document proposes regulations under section 7701 that address the Federal tax classification of a business entity wholly owned by a foreign government and provide that a nonbank entity that is wholly owned by a foreign bank cannot be disregarded as an entity separate from its owner (disregarded entity) for purposes of applying the special rules of the Internal Revenue Code applicable to banks. This document also proposes regulations under section 892 that provide that a partnership can be a controlled commercial entity for purposes of section 892(a)(2)(B). In addition, this document provides notice of a public hearing on the proposed regulations.

DATES: Written comments and outline of topics to be discussed at the public hearing scheduled for May 16, 2001, must be received by April 25, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-101739-00), room 5226, 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:M&SP:RU (REG-101739-00), 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.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html). The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Camille B. Evans, (202) 622-3860 (not a toll-free number); concerning submissions and the hearing, Sonya M. Cruse, (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background and Purpose**

On December 18, 1996, the IRS and the Treasury Department published the elective regime under section 7701 known as the check-the-box regulations. 61 FR 66584. Generally, the check-the-box regulations allow any business entity to elect to be treated for Federal tax purposes as a corporation, a partnership (if it has two or more members), or a disregarded entity (if it has a single owner). This document proposes to amend the current Procedure and Administration Regulations (26 CFR Part 301) to address the treatment of an entity wholly owned by a foreign government (as defined in §1.892-2T) and a nonbank entity wholly owned by a foreign bank.

This document also proposes to provide that a partnership can be a controlled commercial entity under section 892.

**Explanation of Provisions**

A. §301.7701-2

Section 301.7701-2(b) of the check-the-box regulations specifies that certain business entities are classified as per se corporations for Federal tax purposes (i.e., those business entities that are not permitted to elect a noncorporate Federal tax classification). Section 301.7701-2(b)(6) classifies a business entity wholly owned by a State or any of its political subdivisions as a per se corporation. However, the regulations do not specify that the phrase State or any political subdivision thereof includes a foreign government.

The IRS and Treasury believe that it is appropriate to treat a foreign government similarly to a State in this context. Thus, to achieve parallel tax treatment under the check-the-box regulations of a business entity wholly owned by a State or any of its political subdivisions and a business entity wholly owned by a foreign government, these proposed regulations provide that a business entity wholly owned by a foreign government cannot elect to be treated as a disregarded entity.

The check-the-box regulations also provide a special rule for the treatment of nonbank entities that are wholly owned by banks. In particular, §301.7701-2(c)(2)(ii) provides that a bank cannot treat a wholly owned nonbank entity as a disregarded entity for purposes of applying the special rules of the Internal

Revenue Code (Code) applicable to banks. The term bank for this purpose is defined in section 581 to include only domestic entities. Section 301.7701-2(c)(2)(ii) does not explicitly restrict foreign banks from treating their wholly owned nonbank entities as disregarded entities for all tax purposes (because foreign banks are not defined as banks under section 581).

As with the rule described for foreign governments, the IRS and Treasury believe that nonbank entities wholly owned by domestic banks and foreign banks should be treated similarly in this context. These regulations incorporate a reference to section 585(a)(2)(B) (which includes certain foreign banks that are engaged in a U.S. trade or business in the definition of the term bank) in §301.7701-2(c)(2)(ii). As a result, neither domestic banks nor foreign banks engaged in a U.S. trade or business can treat wholly owned nonbank entities as disregarded entities for purposes of applying the special rules of the Code applicable to banks.

B. §1.892-5(a)

Section 1.892-5T(a) currently provides that for purposes of defining the term controlled commercial entity, the term entity encompasses corporations and trusts (including pension trusts described in §1.892-2T(c)) and estates. To ensure that investments in the United States by a foreign government through separate juridical entities are treated similarly, these proposed regulations under §1.892-5(a) provide that, for purposes of section 892(a)(2)(B), the term entity also includes a

partnership.

**Proposed Effective Dates**

The regulations that address the Federal tax classification of business entities wholly owned by a foreign government under §301.7701-2 are proposed to apply on or after the earlier of [INSERT DATE 365 DAYS AFTER THE DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER] or the date these regulations are published as final regulations in the **FEDERAL REGISTER** to such business entities regardless of any prior entity classification, and the regulations that address the definition of the term entity for purposes of section 892(a)(2)(B) are proposed to apply on or after the earlier of [INSERT DATE 365 DAYS AFTER THE DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER] or the date these regulations are published as final regulations in the **FEDERAL REGISTER**. The regulations relating to a nonbank entity that is wholly owned by a foreign bank are proposed to apply to taxable years beginning after [INSERT DATE THIS DOCUMENT IS 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, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their 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 Department request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 16, 2001, beginning at 10 a.m., in room 6718, 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 fifteen (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 (preferably a signed original and eight (8) copies) by April 25, 2001.

A period of ten (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 Camille B. Evans of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

**List of Subjects**

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift Taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for "Sections 1.892-1T through 1.892-7T" and adding the following entries in numerical order:

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

Section 1.892-1T also issued under 26 U.S.C. 892(c).  
Section 1.892-2T also issued under 26 U.S.C. 892(c).

Section 1.892-3T also issued under 26 U.S.C. 892(c).  
Section 1.892-4T also issued under 26 U.S.C. 892(c).  
Section 1.892-5 also issued under 26 U.S.C. 892(c).  
Section 1.892-5T also issued under 26 U.S.C. 892(c).  
Section 1.892-6T also issued under 26 U.S.C. 892(c).  
Section 1.892-7T also issued under 26 U.S.C. 892(c). \* \* \*

Par. 2. Section 1.892-5 is added to read as follows:

§1.892-5 Controlled commercial entity.

(a) through (a)(2) [Reserved]. For further information, see §1.892-5T(a) through (a)(2).

(3) For purposes of section 892(a)(2)(B), the term entity means and includes a corporation, a partnership, a trust (including a pension trust described in §1.892-2T(c)) and an estate.

(4) Effective date. This section applies on or after the earlier of [**INSERT DATE 365 DAYS AFTER THE DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER**] or the date these regulations are published as final regulations in the **FEDERAL REGISTER**.

(b) through (d) [Reserved]. For further information, see §§1.892-5T(b) through (d).

Par. 3. Section 1.892-5T is amended by:

1. Removing the flush language immediately following paragraph (a)(2).

2. Adding paragraph (a)(3).

The addition reads as follows:

§1.892-5T Controlled commercial entity (temporary regulations).

(a) \* \* \*

(3) [Reserved]. For further information, see



§1.892-5(a)(3).

\* \* \* \* \*

PART 301--PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

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

Par. 5. Section 301.7701-2 is amended by:

- 1. Revising paragraphs (b)(6) and (c)(2)(ii).
- 2. Revising the first sentence of paragraph (e).

The revisions read as follows:

§301.7701-2 Business entities; definitions.

\* \* \* \* \*

(b) \* \* \*

(6) A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government (as defined in §1.892-2T);

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(ii) Special rule for certain business entities. If the single owner of a business entity is a bank (as defined in section 581, or, in the case of a foreign bank, as defined in section 585(a)(2)(B) without regard to the second sentence thereof), then the special rules of the Internal Revenue Code applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity.

\* \* \* \* \*

(e) Effective date. Except as otherwise provided in this paragraph (e), the rules of this section apply as of January 1, 1997, except that paragraph (b)(6) applies on or after the earlier of [INSERT DATE 365 DAYS AFTER THE DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER] or the date these regulations are published as final regulations in the **FEDERAL REGISTER** to a business entity wholly owned by a foreign government regardless of any prior entity classification, and paragraph (c)(2)(ii) of this section applies to taxable years beginning after [INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]. \* \* \*

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Robert E. Wenzel

Deputy Commissioner of Internal Revenue.