## Entity Classification for Certain Foreign Eligible Entities

## Notice 2003–46

On November 29, 1999, the IRS and Treasury issued proposed regulations (REG–110385–99, 1999–2 C.B. 670 [64 FR 66591]) addressing certain transactions that occur within a specified period of time before or after a change in entity classification. The proposed regulations generally would provide that if an "extraordinary transaction," as defined in the proposed regulations, occurred either one day before or within 12 months after the date a foreign entity changed its classification to disregarded-entity status, then the entity would not be treated as a disregarded entity but instead would be classified as an association taxable as a corporation for all purposes. In addition to this extraordinary transaction rule, the proposed regulations also address "grandfathered" pass-through entities and the determination of relevance of the classification of a foreign entity for U.S. federal income tax purposes.

A public hearing on the proposed regulations was held on January 31, 2000. In addition, written comments were received. Most commentators criticized the approach adopted in the proposed regulations as overly broad and expressed concern that it would mitigate the increased certainty promoted by the entity classification regulations issued in 1996.

After considering the comments received, the IRS and Treasury have decided to withdraw the extraordinary transaction rule of the proposed regulations. Therefore, the IRS and Treasury will withdraw proposed section 301.7701–3(h). The IRS and Treasury received minimal comments on the portions of the proposed regulations addressing grandfathered entities and the relevancy of classification status, and intend to finalize those portions of the proposed regulations.

The IRS and Treasury remain concerned about cases in which a taxpayer, seeking to dispose of an entity, makes an election to disregard it merely to alter the tax consequences of the disposition. The IRS will continue to pursue the application of other principles of existing law (such as the substance over form doctrine) to determine the proper tax consequences in such cases. As the Supreme Court has noted: "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945).

In addition, the IRS and Treasury are continuing to examine the potential use of the entity classification regulations to achieve results inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties. In contrast to the approach of the extraordinary transaction rule, which would operate to change the classification of an entity if certain conditions are met, this examination will focus on ensuring that the substantive rules of particular Code provisions and U.S. tax treaties reach appropriate results notwithstanding changes in entity classification.

One category of transactions that the IRS and Treasury are considering is the acquisition of the assets of one controlled foreign corporation (the acquired CFC) by a second controlled foreign corporation (the acquiring CFC) that involves the acquisition of the stock in the acquired CFC followed by its liquidation into the acquiring CFC (through an actual liquidation or by electing to treat the acquired CFC as a disregarded entity). Such a transaction typically would be treated as an asset reorganization under section 368(a)(1)(C) or (D), provided that the transaction meets the other requirements generally applicable to reorganizations, including the requirements that the transaction have a valid business purpose and continuity of business enterprise. See §1.368–1. Although the regulations under section 367(a) would require certain U.S. shareholders of the acquired corporation to enter into a gain recognition agreement if the acquiring CFC had acquired the stock of the acquired CFC, the regulations do not require a gain recognition agreement in an asset reorganization. §1.367(a)–3(a) and (b)(1)(ii). A gain recognition agreement generally requires former U.S. shareholders of the acquired corporation to recognize gain on their original transfers if the acquiring corporation disposes of the stock or substantially all of the assets of the acquired corporation (including a disposition of substantially all of the assets following a liquidation of the acquired corporation) during the five-year period following the initial transaction. The IRS and Treasury are considering whether to extend the gain recognition agreement requirement for nonrecognition treatment under the section 367 regulations to asset reorganizations.

Another category of transactions that the IRS and Treasury are considering is the disposition of a controlled foreign corporation by liquidating the corporation (through an actual liquidation or by electing to treat the corporation as a disregarded entity) and selling its assets rather than by selling the stock of the controlled foreign corporation. For purposes of subpart F, section 954(c)(1) generally characterizes gain on the sale of assets based on the type of income produced by such assets. Thus, section 954(c)(1) distinguishes between gain from the sale of stock, which generally is characterized as subpart F income because stock gives rise to dividend income, and gain from the sale of the underlying assets of the corporation, which is characterized as subpart F income or other income based on the types of income produced by such assets. The IRS and Treasury are continuing to consider the proper treatment of these transactions under the substantive rules of subpart F.

Written comments concerning this notice may be submitted to CC:PA:RU (Notice 2003–46), room 5226, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 4 pm to: CC:PA:RU (Notice 2003–46), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044. Alternatively, taxpayers may submit comments electronically to: *notice.comments@irscounsel.treas.gov.*

FOR FURTHER INFORMATION CONTACT: Concerning the notice, Aaron A. Farmer or Ronald M. Gootzeit at (202) 622–3860; concerning submissions of comments, Lanita Van Dyke, (202) 622–7180 (not toll-free numbers).