
26 CFR 301.7701-3: Classification of certain business entities.

T.D. 8697

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301, and 602**

**Simplification of Entity
Classification Rules**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that classify certain business organizations under an elective regime. These regulations replace the existing classification rules.

DATES: These regulations are effective as of January 1, 1997. For dates of applicability of these regulations, see Effective Dates under Supplementary Information.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Mark D. Harris, (202) 622-3050; concerning foreign organizations, William H. Morris or Ronald M. Gootzeit, (202) 622-3880 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1486. Responses to these collections of information are required to obtain a benefit (to choose an entity's classification by election).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimates of the reporting burden in these final regulations are reflected in the burden estimates in Form 8832 (Entity Classification Election).

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On April 3, 1995, Notice 95-14 (1995-1 C.B. 297), relating to classification of business organizations under section 7701 of the Code, was published in the Internal Revenue Bulletin. A notice of public hearing was published in the Federal Register on May 10, 1995 (60 FR 24813). Written comments were received and a public hearing was held on July 20, 1995.

On May 13, 1996, the IRS and Treasury issued a notice of proposed rulemaking (61 FR 21989 [PS-43-95, 1996-24 I.R.B. 20]) under section 7701. The regulations proposed to replace the existing regulations for classifying certain business organizations with an elective regime. Comments responding to the notice were received, and a public

hearing was held on August 21, 1996. After considering the comments that were received in response to the notice of proposed rulemaking and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

Section 7701(a)(2) of the Code 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.

The existing regulations for classifying business organizations as associations (which are taxable as corporations under section 7701(a)(3)) or as partnerships under section 7701(a)(2) are based on the historical differences under local law between partnerships and corporations. Treasury and the IRS believe that those rules have become increasingly formalistic. This document replaces those rules with a much simpler approach that generally is elective.

As stated in the preamble to the proposed regulations, in light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.

A. Summary of the Regulations

Section 301.7701-1 provides an overview of the rules applicable in determining an organization's classification for federal tax purposes. The first step in the classification process is to determine whether there is a separate entity for federal tax purposes. The regulations explain that certain joint undertakings that are not entities under local law may nonetheless constitute separate entities for federal tax purposes; however, not all entities formed under local law are recognized as separate entities for federal tax purposes. Whether an organization is treated as an entity for federal

tax purposes is a matter of federal tax law, and does not affect the rights and obligations of its owners under local law. For example, if a domestic limited liability company with a single individual owner is disregarded as an entity separate from its owner under § 301.7701-3, its individual owner is subject to federal income tax as if the company's business was operated as a sole proprietorship.

An organization that is recognized as a separate entity for federal tax purposes is either a trust or a business entity (unless a provision of the Code expressly provides for special treatment, such as the Qualified Settlement Fund rules (§ 1.468B) or the Real Estate Mortgage Investment Conduit (REMIC) rules, see section 860A(a)). The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

Section 301.7701-2 clarifies that business entities that are classified as corporations for federal tax purposes include corporations denominated as such under applicable law, as well as associations, joint-stock companies, insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, organizations that are taxable as corporations under a provision of the Code other than section 7701(a)(3), and certain organizations formed under the laws of a foreign jurisdiction (including a U.S. possession, territory, or commonwealth).

The regulations in § 301.7701-2 include a special grandfather rule, under which an entity described in the list of foreign entities treated as per se corporations will nevertheless be classified as other than a corporation. The regulations also list certain situations where a grandfathered entity would lose its grandfathered status.

Any business entity that is not required to be treated as a corporation for federal tax purposes (referred to in the regulation as an *eligible entity*) may choose its classification under the rules of § 301.7701-3. Those rules provide that an eligible entity with at least two members can be classified as either a partnership or an association, and that an eligible entity with a single member can be classified as an association or can be disregarded as an entity separate from its owner. However, if the single owner of a business entity is a bank (as

defined in section 581), then the special rules applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity.

In order to provide most eligible entities with the classification they would choose without requiring them to file an election, the regulations provide default classification rules that aim to match taxpayers' expectations (and thus reduce the number of elections that will be needed). The regulations adopt a passthrough default for domestic entities, under which a newly formed eligible entity will be classified as a partnership if it has at least two members, or will be disregarded as an entity separate from its owner if it has a single owner. The default for foreign entities is based on whether the members have limited liability. Thus a foreign eligible entity will be classified as an association if all members have limited liability. A foreign eligible entity will be classified as a partnership if it has two or more members and at least one member does not have limited liability; the entity will be disregarded as an entity separate from its owner if it has a single owner and that owner does not have limited liability. Finally, the default classification for an existing entity is the classification that the entity claimed immediately prior to the effective date of these regulations. An entity's default classification continues until the entity elects to change its classification by means of an affirmative election.

An eligible entity may affirmatively elect its classification on Form 8832, Entity Classification Election. The regulations require that the election be signed by each member of the entity or any officer, manager, or member of the entity who is authorized to make the election and who represents to having such authorization under penalties of perjury. An election will not be accepted unless it includes all of the required information, including the entity's taxpayer identifying number (TIN).

Taxpayers are reminded that a change in classification, no matter how achieved, will have certain tax consequences that must be reported. For example, if an organization classified as an association elects to be classified as a partnership, the organization and its owners must recognize gain, if any, under the rules applicable to liquidations of corporations.^a

B. Discussion of Comments on the General Approach and Scope of the Regulations

Several comments requested clarification with regard to the rules for determining when an owner of an interest in an organization will be respected as a bona fide owner for federal tax purposes. Some commentators were concerned, for example, that certain owners would be required to maintain certain net worth requirements. Other commentators, relying on Rev. Rul. 93-4, 1993-1 C.B. 225, suggested that if two wholly-owned subsidiaries of a common parent were the owners of an organization, those owners would not be respected as bona fide owners and the organization would be treated as having only one owner (the common parent). Although the determination of whether an organization has more than one owner is based on all the facts and circumstances, the fact that some or all of the owners of an organization are under common control does not require the common parent to be treated as the sole owner. Consistent with this approach, Rev. Rul. 93-4 treated two wholly owned subsidiaries as associates and then classified the foreign entity based on the four corporate characteristics under section 7701. While these four factors will no longer apply with the adoption of the regulations, determining whether the subsidiaries are associates continues to be an issue.

The IRS has received a number of comments asking for clarification of the tax treatment of entities that are wholly owned by an Indian tribe and incorporated under tribal law. Treasury and the IRS are currently studying this issue and will, if necessary, issue separate guidance regarding this issue.

Most commentators agreed that inclusion of the list of foreign business entities treated as corporations per se was appropriate. However, several commentators requested clarification about certain foreign business entities on the per se list. Other commentators requested clarification whether and how the list of such corporations might be updated in the future. The regulations are clarified with respect to entities formed in the following jurisdictions: Aruba, Canada, People's Republic of China, Republic of China (Taiwan), India, Indonesia, Netherlands Antilles, and Sweden. Any further modifications will be announced in a notice of proposed rulemaking and will be prospective only.

Commentators also raised the issue of how to determine if a joint venture or other contractual arrangement that is considered a separate entity under these regulations is considered a foreign or domestic entity. This issue is outside the scope of these regulations and thus is not addressed in the final regulations.

Some commentators raised issues relating to the application of the grandfather rule for certain existing entities organized under foreign statutes included on the list of per se corporations. In particular, commentators requested clarification regarding existing entities that would be listed on the per se list. Commentators have asked whether an existing entity on the per se list which had claimed non-corporate status could retain that status, and, if so, whether it could subsequently elect to be treated as a corporation. Commentators also asked for clarification as to the effect of a deemed termination under section 708(b)(1)(B) or a division under section 708(b)(2)(B) on a grandfathered per se entity.

In response to these comments, the grandfather rules clarify that an entity on the list which was previously disregarded as a separate entity (i.e., treated as a branch) or was treated as a partnership may continue to be treated as such when the regulations become effective. Moreover, entities on the list which continue to treat themselves as branches or partnerships after the effective date of the regulations may subsequently elect to be treated as corporations. However, after such election they may not subsequently elect to be treated as a partnership or a branch. Finally, any termination under section 708(b)(1)(B) (except in the case of a sale or exchange of interests in an entity described in § 301.7701-2(d)(2) where the sale or exchange is to a related person within the meaning of sections 267(b) and 707(b) and occurs no later than 12 months after the date the entity is formed) or division under section 708(b)(2)(B) will end the grandfathered status of any entity on the per se list, and therefore the successor entity (or entities) will thereafter be permanently treated as a corporation.

Other commentators suggested that the requirement that an existing entity included on the per se list must have claimed passthrough treatment for all prior periods is burdensome and precludes grandfather treatment for entities that restructured in the past and recognized the resulting tax consequences. In

response to these comments, the regulations are modified to indicate that an existing entity can continue to be treated as a non-corporate entity if it was in existence on May 8, 1996, and was reasonably treated as a non-corporate entity on that date (or formed thereafter pursuant to a written binding contract in effect on May 8, 1996, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, and which would otherwise meet the grandfather rules if the date the entity is formed is substituted for May 8, 1996). If the entity changed its claimed tax status within the sixty months prior to May 8, 1996, the entity and its members must have recognized the tax consequences that resulted from that change in tax status. Moreover, the regulations clarify that the grandfather treatment applies if no person for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the period including May 8, 1996.

One commentator suggested that it was unclear when the classification of a foreign entity is "relevant" for federal tax purposes. This determination is important, as it affects whether the grandfather rule, the default rule for existing entities, or the default rule for a newly formed foreign entity applies. In general, an entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. The date that the classification of a foreign entity is relevant is the date an event occurs that causes an obligation to file a return or statement for which the classification of the entity must be determined.

C. Discussion of Comments Relating to the Elective Regime

Most of the commentators agreed that the default rules included in the proposed regulations generally would match taxpayers' expectations. However, some commentators expressed concern over the application of the default rule for newly formed foreign eligible entities which would treat such entities as associations if no member had unlimited liability. Specifically, certain commentators noted that under the definition of unlimited liability in the proposed regulations, certain contractual joint ventures

which, under current law, would generally be classified as partnerships, would be treated as associations under the default rule. The members of these contractual joint ventures are not jointly and severally liable for all debts of the entity; rather, each member has unlimited liability for a certain proportion of the debts of the entity. To simplify the default rules, the regulations are modified to provide that a newly formed foreign eligible entity will— (1) be treated as a partnership if it has at least two members and at least one member does not have limited liability; (2) be treated as an association if all members of the entity have limited liability; and (3) be disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

The regulations are modified to provide that a member does not have limited liability if the member, by virtue of being a member, has personal liability for all or any portion of the debts of the entity.

Certain commentators asked for clarification of the default rule in the case where the relevant statute or law of a particular country provides for limited or unlimited liability. Generally, the regulations specify that only the statute or law is relevant. Where, however, the underlying statute allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may be relevant.

Some commentators requested that taxpayers be allowed to make classification elections with their first tax returns. The regulations retain the requirement that elections be made at the beginning of the taxable year. Treasury and the IRS continue to believe that it is appropriate to determine an entity's classification at the time that it begins its operations. Taxpayers can specify the date on which an election will be effective, provided that date is not more than 75 days prior to the date on which the election is filed (irrespective of when the interest was acquired) and not more than 12 months after the date the election was filed. If a taxpayer specifies an effective date more than 75 days prior to the date on which the election is filed, the election will be effective 75 days prior to the date on which the election was filed. If a taxpayer specifies an effective date more than 12 months from the filing date, the election will be effective 12 months after the

date the election was filed. No election, whenever filed, will be effective before January 1, 1997.

One commentator expressed concern about the ability to make protective elections where there is uncertainty, for example, about an entity's status as a business entity. Such protective elections are not prohibited under the regulations.

The regulations limit the ability of an entity to make multiple classification elections by prohibiting more than one election to change an entity's classification during any sixty month period. One commentator suggested that the regulations be amended to waive application of this rule in certain circumstances, particularly when there has been a substantial change in ownership of the entity. In response to this comment, the regulations permit the Commissioner to waive the application of the sixty month limitation by letter ruling. However, waivers will not be granted unless there has been more than a fifty percent ownership change. The sixty month limitation only applies to a change in classification by election; the limitation does not apply if the organization's business is actually transferred to another entity.

Several commentators requested clarification concerning the classification of a foreign entity when the classification of the entity becomes relevant for federal tax purposes after a period during which the classification of the entity was not relevant. Generally, such an entity will retain its prior classification. However, if the classification of a foreign eligible entity which was previously relevant for federal tax purposes ceases to be relevant for sixty consecutive months, the entity's classification will be determined initially under the default classification when the classification of the foreign eligible entity again becomes relevant.

Some commentators requested clarification regarding the rule permitting elections to be signed by any authorized officer, manager, or member of the electing entity. The regulations retain this rule, as it provides taxpayers with flexibility in complying with the election requirements. The determination of whether a person is authorized to make an election is based on local law. Thus, the election can be made by anyone authorized to act on behalf of the entity.

Several commentators asked for guidance regarding the necessary signatures on the classification election. The regulations are modified to provide that if

the election is made by all of the members, each person who is an owner at the time the election is made must consent to the election. However, if an election is to be effective for any period prior to the date it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed (even if by an authorized person), and who is not an owner at the time the election is filed, must also consent to the election.

Several commentators requested that the classification election be coordinated with the election under section 856(c)(1) to be a real estate investment trust (REIT). Because the latter election is required to be made with the REIT's first tax return, the regulations are modified to provide that an election by an eligible entity to be a REIT will be treated as a deemed election to be classified as an association, effective for the entire period during which REIT status is claimed.

Some commentators suggested that the regulations should not require an entity or its direct or indirect owners to attach a copy of the entity's election to their federal tax returns. Specifically, some commentators were concerned that the failure of one owner to attach a copy of the election to the owner's return would void an otherwise valid election. The regulations retain the requirement that taxpayers must attach a copy of the election to their returns, but clarify that failure to do so will not invalidate an otherwise valid election. Although the failure to attach a copy will not adversely affect an otherwise valid election, taxpayers are reminded that each member of the entity is required to file returns that are consistent with the entity's election. Failure to attach the election form to a federal tax or information return as directed in the regulations may give rise to penalties against the non-filing party. Other applicable penalties may also apply to parties who file federal tax or information returns inconsistent with the entity's election.

One commentator asked for guidance on the treatment of conversions by election from partnership to corporation and from corporation to partnership. This issue is outside the scope of these classification rules and thus is not addressed in these regulations. Treasury and the IRS, however, are actively considering issuing guidance on the treatment of such conversions.

D. Effective Dates

The regulations are effective as of January 1, 1997.

The regulations provide a special transition rule for existing entities. The IRS will not challenge the prior classification of an existing eligible entity, or an existing entity described on the per se list, for periods prior to January 1, 1997, if— (1) the entity had a reasonable basis (within the meaning of section 6662) for its claimed classification; (2) the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and (3) neither the entity nor any member had been notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

Some commentators were concerned that an entity organized after May 8, 1996, would be excluded from this transition rule for existing entities. Because § 301.7701-3(f)(2) applies to entities that were in existence prior to January 1, 1997, no change is necessary to provide relief for entities organized after May 8, 1996.

Some commentators were concerned about entities that claimed to be trusts for the period prior to January 1, 1997, but are subsequently determined to be business entities. In that case, the entity's claimed classification for purposes of applying the provisions of the special transition rule will be the business entity classification claimed by the entity after it has been determined to be a business entity.

Effect on other documents

The Service has published a number of revenue rulings and revenue procedures interpreting the section 7701 regulations. The Service is currently reviewing these revenue rulings and revenue procedures to determine which are affected by the publication of these regulations. See accompanying Notice 97-1. Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 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. It is hereby certified that these regulations do

not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the automatic classification rules of § 301.7701-2(b) and the default classification rules of § 301.7701-3(b) will operate in such a manner that only a limited number of entities will need to make an election under § 301.7701-3(c) to determine their classification. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these final regulations has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Armando Gomez and Mark D. Harris of the Office of Assistant Chief Counsel (Passthroughs and Special Industries) and William H. Morris and Ronald M. Gootzeit of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.581-1 is revised to read as follows:

§ 1.581-1 Banks.

(a) In order to be a bank as defined in section 581, an institution must be a corporation for federal tax purposes. See § 301.7701-2(b) of this chapter for the definition of a corporation.

(b) This section is effective as of January 1, 1997.

Par. 3. Section 1.581-2 is amended as follows:

1. Paragraph (a) is removed.

2. Paragraphs (b) and (c) are redesignated as paragraphs (a) and (b), respectively.

3. Newly designated paragraph (a) is amended by revising the second and last sentences.

The revisions read as follows:

§ 1.581-2 *Mutual savings banks, building and loan associations, and cooperative banks.*

(a) * * * See section 593 for special rules concerning reserves for bad debts. * * * See also section 594 and § 1.594-1 for special rules governing the taxation of a mutual savings bank conducting a life insurance business.

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Par. 4. In § 1.761-1, paragraph (a) is revised to read as follows:

§ 1.761-1 *Terms defined.*

(a) *Partnership.* The term *partnership* means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3 of this chapter.

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PART 301—PROCEDURE AND ADMINISTRATION

Par. 5. The authority citation for part 301 continues to read in part as follows:

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

Par. 6. Section 301.6109-1 is amended as follows:

1. Paragraph (b)(2)(iii) is amended by removing the language “and” at the end of the paragraph.

2. Paragraph (b)(2)(iv) is amended by removing the period at the end of the paragraph, and replacing it with the language “; and”.

3. Paragraph (b)(2)(v) is added.

4. The text of paragraph (d)(2) is redesignated as paragraph (d)(2)(i).

5. A paragraph heading is added for newly designated paragraph (d)(2)(i).

6. Paragraph (d)(2)(ii) is added.

The revisions and additions read as follows:

§ 301.6109-1 *Identifying numbers.*

* * * * *

(b) * * *

(2) * * *

(v) A foreign person that makes an election under § 301.7701-3(c).

* * * * *

(d) * * *

(2) *Employer identification number—*
(i) *In general.* * * *

(ii) *Special rule for entities electing to change their federal tax classification under § 301.7701-3(c).* Any entity that has an employer identification number and then elects under § 301.7701-3(c)

to change its federal tax classification will retain that employer identification number.

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Par. 7. Sections 301.7701-1, 301.7701-2, and 301.7701-3 are revised to read as follows:

§ 301.7701-1 *Classification of organizations for federal tax purposes.*

(a) *Organizations for federal tax purposes—*(1) *In general.* The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

(2) *Certain joint undertakings give rise to entities for federal tax purposes.* A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

(3) *Certain local law entities not recognized.* An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State. Similarly, tribes incorporated under section 17 of the Indian Reorganization Act of 1934, as amended, 25 U.S.C. 477, or under section 3 of the Oklahoma Indian Welfare Act, as amended, 25 U.S.C.

503, are not recognized as separate entities for federal tax purposes.

(4) *Single owner organizations.* Under §§ 301.7701-2 and 301.7701-3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.

(b) *Classification of organizations.* The classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Internal Revenue Code (such as section 860A addressing Real Estate Mortgage Investment Conduits (REMICs)) provides for special treatment of that organization. For the classification of organizations as trusts, see § 301.7701-4. That section provides that trusts generally do not have associates or an objective to carry on business for profit. Sections 301.7701-2 and 301.7701-3 provide rules for classifying organizations that are not classified as trusts.

(c) *Qualified cost sharing arrangements.* A qualified cost sharing arrangement that is described in § 1.482-7 of this chapter and any arrangement that is treated by the Commissioner as a qualified cost sharing arrangement under § 1.482-7 of this chapter is not recognized as a separate entity for purposes of the Internal Revenue Code. See § 1.482-7 of this chapter for the proper treatment of qualified cost sharing arrangements.

(d) *Domestic and foreign entities.* For purposes of this section and §§ 301.7701-2 and 301.7701-3, an entity is a domestic entity if it is created or organized in the United States or under the law of the United States or of any State; an entity is foreign if it is not domestic. See sections 7701(a)(4) and (a)(5).

(e) *State.* For purposes of this section and § 301.7701-2, the term *State* includes the District of Columbia.

(f) *Effective date.* The rules of this section are effective as of January 1, 1997.

§ 301.7701-2 *Business entities; definitions.*

(a) *Business entities.* For purposes of this section and § 301.7701-3, a *business entity* is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not

properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

(b) *Corporations*. For federal tax purposes, the term *corporation* means—

(1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association (as determined under § 301.7701-3);

(3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) An insurance company;

(5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute;

(6) A business entity wholly owned by a State or any political subdivision thereof;

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and

(8) *Certain foreign entities*—(i) *In general*. Except as provided in paragraphs (b)(8)(ii) and (d) of this section, the following business entities formed in the following jurisdictions:

American Samoa, Corporation
Argentina, Sociedad Anonima
Australia, Public Limited Company
Austria, Aktiengesellschaft
Barbados, Limited Company
Belgium, Societe Anonyme
Belize, Public Limited Company
Bolivia, Sociedad Anonima
Brazil, Sociedade Anonima
Canada, Corporation and Company
Chile, Sociedad Anonima
People's Republic of China, Gufen Youxian Gongsi
Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu
Colombia, Sociedad Anonima
Costa Rica, Sociedad Anonima
Cyprus, Public Limited Company
Czech Republic, Akciova Spolecnost

Denmark, Aktieselskab
Ecuador, Sociedad Anonima or Compania Anonima

Egypt, Sharikat Al-Mossahamah

El Salvador, Sociedad Anonima

Finland, Osakeyhtio/Aktiebolag

France, Societe Anonyme

Germany, Aktiengesellschaft

Greece, Anonymos Etaireia

Guam, Corporation

Guatemala, Sociedad Anonima

Guyana, Public Limited Company

Honduras, Sociedad Anonima

Hong Kong, Public Limited Company

Hungary, Reszvenytarsasag

Iceland, Hlutfelag

India, Public Limited Company

Indonesia, Perseroan Terbuka

Ireland, Public Limited Company

Israel, Public Limited Company

Italy, Societa per Azioni

Jamaica, Public Limited Company

Japan, Kabushiki Kaisha

Kazakhstan, Ashyk Aktsionerlik

Kogham

Republic of Korea, Chusik Hoesa

Liberia, Corporation

Luxembourg, Societe Anonyme

Malaysia, Berhad

Malta, Partnership Anonyme

Mexico, Sociedad Anonima

Morocco, Societe Anonyme

Netherlands, Naamloze Vennootschap

New Zealand, Limited Company

Nicaragua, Compania Anonima

Nigeria, Public Limited Company

Northern Mariana Islands, Corpora-

tion

Norway, Aksjeselskap

Pakistan, Public Limited Company

Panama, Sociedad Anonima

Paraguay, Sociedad Anonima

Peru, Sociedad Anonima

Philippines, Stock Corporation

Poland, Spolka Akcyjna

Portugal, Sociedade Anonima

Puerto Rico, Corporation

Romania, Societe pe Actiuni

Russia, Otkrytoye Aktsionerloy

Obshchestvo

Saudi Arabia, Sharikat Al-Mossahamah

Singapore, Public Limited Company

Slovak Republic, Akciova Spolecnost

South Africa, Public Limited Com-

pany

Spain, Sociedad Anonima

Surinam, Naamloze Vennootschap

Sweden, Publika Aktiebolag

Switzerland, Aktiengesellschaft

Thailand, Borisat Chamkad (Mahachon)

Trinidad and Tobago, Public Limited Company

Tunisia, Societe Anonyme

Turkey, Anonim Sirket

Ukraine, Aktsionerne Tovaristvo

Vidkritogo Tipu

United Kingdom, Public Limited Company

United States Virgin Islands, Corpora-

tion

Uruguay, Sociedad Anonima

Venezuela, Sociedad Anonima or

Compania Anonima

(ii) *Exceptions in certain cases*. The following entities will not be treated as corporations under paragraph (b)(8)(i) of this section:

(A) With regard to Canada, any corporation or company formed under any federal or provincial law which provides that the liability of all of the members of such corporation or company will be unlimited; and

(B) With regard to India, a company deemed to be a public limited company solely by operation of Section 43A(1) (relating to corporate ownership of the company), section 43A(1A) (relating to annual average turnover), or section 43A(1B) (relating to ownership interests in other companies) of the Companies Act, 1956 (or any combination of these), provided that the organizational documents of such deemed public limited company continue to meet the requirements of section 3(1)(iii) of the Companies Act, 1956.

(iii) *Public companies*. With regard to Cyprus, Hong Kong, Jamaica, and Trinidad and Tobago, the term public limited company includes any limited company which is not a private limited company under the laws of those jurisdictions.

(iv) *Limited companies*. Any reference to a limited company (whether public or private) in paragraph (b)(8)(i) of this section includes, as the case may be, companies limited by shares and companies limited by guarantee.

(v) *Multilingual countries*. Different linguistic renderings of the name of an entity listed in paragraph (b)(8)(i) of this section shall be disregarded. For example, an entity formed under the laws of Switzerland as a Societe Anonyme will be a corporation and treated in the same manner as an Aktiengesellschaft.

(c) *Other business entities*. For federal tax purposes—

(1) The term *partnership*

single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

(i) *Special rule for certain business entities.* If the single owner of a business entity is a bank (as defined in section 581), then the special rules applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity.

(d) *Special rule for certain foreign business entities—(1) In general.* Except as provided in paragraph (d)(3) of this section, a foreign business entity described in paragraph (b)(8)(i) of this section will not be treated as a corporation under paragraph (b)(8)(i) of this section if—

(i) The entity was in existence on May 8, 1996;

(ii) The entity's classification was relevant (as defined in § 301.7701-3(d)) on May 8, 1996;

(iii) No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the taxable year including May 8, 1996;

(iv) Any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to May 8, 1996;

(v) A reasonable basis (within the meaning of section 6662) existed on May 8, 1996, for treating the entity as other than a corporation; and

(vi) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

(2) *Binding contract rule.* If a foreign business entity described in paragraph (b)(8)(i) of this section is formed after May 8, 1996, pursuant to a written binding contract (including an accepted bid to develop a project) in effect on May 8, 1996, and all times thereafter, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, paragraph (d)(1) of this section will be

applied to that entity by substituting the date of the entity's formation for May 8, 1996.

(3) *Termination of grandfather status—(i) In general.* An entity that is not treated as a corporation under paragraph (b)(8)(i) of this section by reason of paragraph (d)(1) or (d)(2) of this section will be treated permanently as a corporation under paragraph (b)(8)(i) of this section from the earliest of:

(A) The effective date of an election to be treated as an association under § 301.7701-3;

(B) A termination of the partnership under section 708(b)(1)(B) (regarding sale or exchange of 50 percent or more of the total interest in an entity's capital or profits within a twelve month period); or

(C) A division of the partnership under section 708(b)(2)(B).

(ii) *Special rule for certain entities.* For purposes of paragraph (d)(2) of this section, paragraph (d)(3)(i)(B) of this section shall not apply if the sale or exchange of interests in the entity is to a related person (within the meaning of sections 267(b) and 707(b)) and occurs no later than twelve months after the date of the formation of the entity.

(e) *Effective date.* The rules of this section are effective as of January 1, 1997.

§ 301.7701-3 Classification of certain business entities.

(a) *In general.* A business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an *eligible entity*) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that

occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections. Paragraph (d) of this section provides special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods.

(b) *Classification of eligible entities that do not file an election—(1) Domestic eligible entities.* Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is—

(i) A partnership if it has two or more members; or

(ii) Disregarded as an entity separate from its owner if it has a single owner.

(2) *Foreign eligible entities—(i) In general.* Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a foreign eligible entity is—

(A) A partnership if it has two or more members and at least one member does not have limited liability;

(B) An association if all members have limited liability; or

(C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

(ii) *Definition of limited liability.* For purposes of paragraph (b)(2)(i) of this section, a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes

such liability or agrees to indemnify that member for any such liability.

(3) *Existing eligible entities*—(i) *In general.* Unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under §§ 301.7701–1 through 301.7701–3 as in effect on the date prior to the effective date of this section; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this paragraph (b)(3)(i). For special rules regarding the classification of such entities for periods prior to the effective date of this section, see paragraph (f)(2) of this section.

(ii) *Special rules.* For purposes of paragraph (b)(3)(i) of this section, a foreign eligible entity is treated as being in existence prior to the effective date of this section only if the entity's classification was relevant (as defined in paragraph (d) of this section) at any time during the sixty months prior to the effective date of this section. If an entity claimed different classifications prior to the effective date of this section, the entity's classification for purposes of paragraph (b)(3)(i) of this section is the last classification claimed by the entity. If a foreign eligible entity's classification is relevant prior to the effective date of this section, but no federal tax or information return is filed or the federal tax or information return does not indicate the classification of the entity, the entity's classification for the period prior to the effective date of this section is determined under the regulations in effect on the date prior to the effective date of this section.

(c) *Elections*—(1) *Time and place for filing*—(i) *In general.* Except as provided in paragraphs (c)(1)(iv) and (v) of this section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See § 301.6109–1 for rules on applying for and displaying Employer Identification Numbers.

(ii) *Further notification of elections.* An eligible entity required to file a

federal tax or information return for the taxable year for which an election is made under paragraph (c)(1)(i) of this section must attach a copy of its Form 8832 to its federal tax or information return for that year. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the federal income tax or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the Form 8832 to its return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a Form 8832 to its return as directed in this section, an otherwise valid election under paragraph (c)(1)(i) of this section will not be invalidated, but the non-filing party may be subject to penalties, including any applicable penalties if the federal tax or information returns are inconsistent with the entity's election under paragraph (c)(1)(i) of this section.

(iii) *Effective date of election.* An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997.

(iv) *Limitation.* If an eligible entity

election under this paragraph (c), it will continue to be classified as an association under paragraph (b)(3) of this section.

(ii) Z files a Form 8832 pursuant to this paragraph (c) to be classified as a partnership, effective as of the effective date of this section. Z can file an election to be classified as an association at any time thereafter, but then would not be permitted to change its classification by election during the sixty months succeeding the effective date of that subsequent election.

(2) *Authorized signatures*—(i) *In general.* An election made under paragraph (c)(1)(i) of this section must be signed by—

(A) Each member of the electing entity who is an owner at the time the election is filed; or

(B) Any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

(ii) *Retroactive elections.* For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is to be effective for any period prior to the time that it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election.

(d) *Special rules for foreign eligible entities*—(1) For purposes of this section, a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. For example, a foreign entity's classification would be relevant if U.S. income was paid to the entity and the determination by the withholding agent of the amount to be withheld under chapter 3 of the Internal Revenue Code (if any) would vary depending upon whether the entity is classified as a partnership or as an association. Thus, the classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or 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. Thus, the classification of a foreign entity is relevant, for example, on the date that an interest in

the entity is acquired which will require a U.S. person to file an information return on Form 5471.

(2) *Special rule classification is no longer relevant.* If the classification of a foreign eligible entity which was previously relevant for federal tax purposes ceases to be relevant for sixty consecutive months, the entity's classification will initially be determined under the default classification when the classification of the foreign eligible entity again becomes relevant. The date that the classification of a foreign 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.

(e) *Coordination with section 708(b).* Except as provided in § 301.7701-2(d)(3) (regarding termination of grandfather status for certain foreign business entities), an entity resulting from a transaction described in section 708(b)(1)(B) (partnership termination due to sales or exchanges) or section 708(b)(2)(B) (partnership division) is a partnership.

(f) *Effective date*—(1) *In general.* The rules of this section are effective as of January 1, 1997.

(2) *Prior treatment of existing entities.* In the case of a business entity that is not described in § 301.7701-2(b)(1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification(s) will be respected for all periods prior to January 1, 1997, if—

(i) The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;

(ii) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and

(iii) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

Par. 8. Section 301.7701-4 is amended as follows:

1. The last sentence of paragraphs (b), (c)(1), (c)(2) *Example 1*, and (c)(2) *Example 3* are revised.

2. Paragraph (f) is added.

The revisions and addition read as follows:

§ 301.7701-4 *Trusts.*

* * * * *

(b) *Business trusts.* * * * The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under § 301.7701-2.

(c) * * * (1) * * * An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under § 301.7701-2; however, an investment trust with multiple classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

(2) * * *

Example 1. * * * As a consequence, the existence of multiple classes of trust ownership is not incidental to any purpose of the trust to facilitate direct investment, and, accordingly, the trust is classified as a business entity under § 301.7701-2.

* * * * *

Example 3. * * * Accordingly, the trust is classified as a business entity under § 301.7701-2.

* * * * *

(f) *Effective date.* The rules of this section generally apply to taxable years beginning after December 31, 1960. Paragraph (e)(5) of this section contains rules of applicability for paragraph (e) of this section. In addition, the last sentences of paragraphs (b), (c)(1), and (c)(2) *Example 1* and *Example 3* of this section are effective as of January 1, 1997.

Par. 9. Section 301.7701-6 is revised to read as follows:

§ 301.7701-6 *Definitions; person, fiduciary.*

(a) *Person.* The term *person* includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group. The term also includes a guardian, commit-

tee, trustee, executor, administrator, trustee in bankruptcy, receiver, assignee for the benefit of creditors, conservator, or any person acting in a fiduciary capacity.

(b) *Fiduciary*—(1) *In general*. Fiduciary is a term that applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another, as in the case of receivers. A committee or guardian of the property of an incompetent person is a fiduciary.

(2) *Fiduciary distinguished from agent*. There may be a fiduciary relationship between an agent and a principal, but the word agent does not denote a fiduciary. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the Internal

Revenue Code. In cases when no legal trust has been created in the estate controlled by the agent and attorney, the liability to make a return rests with the principal. (c) *Effective date*. The rules of this section are effective as of January 1, 1997.

§ 301.7701-7 [Removed]

Par. 10. Section 301.7701-7 is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 12. In § 602.101, paragraph (c) is amended by adding a new entry in numerical order to the table to read as follows:

§ 602.101 *OMB Control numbers*.

* * * * *

(c) * * *

CFR part or section where identified or described	Current OMB control No.
* * * * *	
301.7701-3	1545-1486
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 10, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 17, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 18, 1996, 61 F.R. 66584)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97-1, page 10.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 1997. See Rev. Rul. 97-1, page 10.