HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 96–14, page 20.

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for February 1996.

T.D. 8641, page 4.

Final regulations under sections 597 and 7507 of the Code relating to the treatment of acquisition of certain financial institutions and certain tax consequences of Federal financial assistance to financial institutions.

INTL–3–95, page 29.

Proposed regulations under section 863 of the Code relating to the source of income from sales of inventory and natural resources produced in one jurisdiction and sold in another jurisdiction. A public hearing will be held on April 16, 1996.

EMPLOYEE PLANS

Notice 96–8, page 23.

Determining amount of single sum distributions from cash balance plans. This notice provides guidance concerning the requirements of section 411(a) and 417(e) with respect to the determination of the amount of a single sum distribution from a cash balance plan. The notice also describes proposed guidance to be issued later in regulations that would provide a list of standard indices and associated margins for use by cash balance plans in determining the amount of interest credits.

Notice 96–9, page 26.

Guidelines are set forth for determining for January 1996, the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code as amended by the Omnibus Budget Reconciliation Act of 1987 and by the Uruguay Round Agreements Act (GATT).

ADMINISTRATIVE

Notice 96–5, page 22.

Estimated tax payments for individuals. The Service will waive penalties for individuals who are residents of the District of Columbia, Connecticut, Delaware, Kentucky, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, Vermont, Virginia, and West Virginia for the 4th installment payment of estimated tax if that payment was made on or before 1/22/96.

Notice 96–7, page 22.

Capital expenditures. Public comment is invited on approaches the Service should consider to address issues raised under sections 162 and 263 of the Code particularly in light of *INDOPCO vs Commissioner,* 503 U.S. 79 (1992).

DL–1–95, page 28.

Proposed regulations under section 6103 of the Code relate to the disclosure of returns and return information in connection with the procurement of property and services for tax administration purposes.

Finding Lists begin on page 45.
Announcement of Disbarments and Suspensions begin on page 42.
Monthly Index for January begins on page 47.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is ‘‘protecting the revenue.’’ The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellanous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes an index for the matters published during the preceding month. These monthly indexes are cumulated on a quarterly and semiannual basis, and are published in the first Bulletin of the succeeding quarterly and semi-annual period, respectively.

The Bulletin Index-Digest System, a research and reference service supplementing the Bulletin, may be obtained from the Superintendent of Documents on a subscription basis. It consists of four Services: Service No. 1, Income Tax; Service No. 2, Estate and Gift Taxes; Service No. 3, Employment Taxes; Service No. 4, Excise Taxes. Each Service consists of a basic volume and a cumulative supplement that provides (1) finding lists of items published in the Bulletin, (2) digests of revenue rulings, revenue procedures, and other published items, and (3) indexes of Public Laws, Treasury Decisions, and Tax Conventions.

For sale by the Superintendent of Documents U.S. Government Printing Office, Washington, D.C. 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted federal long-term rate is set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 597.—Treatment of Transactions in Which Federal Financial Assistance Provided

26 CFR 1.597–1: Definitions

T.D. 8641

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

Treatment of Acquisition of Certain Financial Institutions; Certain Tax Consequences of Federal Financial Assistance to Financial Institutions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to Federal financial assistance, as defined in section 597(c) of the Internal Revenue Code, that is received by a financially troubled bank or thrift institution, and to acquisitions of financially troubled bank or thrift institutions in which Federal financial assistance is provided. This document also contains final regulations under section 7507. These regulations provide guidance concerning the proper tax treatment of various transactions involving the receipt of Federal financial assistance.

DATES: These regulations are effective December 21, 1995.

For dates of applicability, see the ''§1.597-7 Effective date'' section under the ''SUPPLEMENTARY INFORMATION'' portion of the preamble and the effective date provisions (§1.597–7) of this document.

FOR FURTHER INFORMATION CONTACT: Steven M. Flanagan at 202-622-7790, Vicki J. Hyche at 202-622-7530, William D. Alexander at 202-622-7710, or Steven R. Glickstein at 202-622-4439 (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 1545–1300. Responses to these collections of information are required to track deferred income and its subsequent recapture, elect to disaffiliate earlier than would otherwise be permitted, elect to apply the provisions of the regulation retroactively, and report uncollected income tax.

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 estimated annual burden per respondent/recordkeeper varies from 1 hour to 11 hours, depending on individual circumstances, with an estimated average of 4.4 hours.

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

This document contains final regulations under section 597, as amended by section 1401 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Public Law 101–73) (FIRREA). The regulations provide guidance for banks and domestic building and loan associations (Institutions) and their affiliates in connection with receipt of Federal financial assistance (FFA), as defined in section 597(c).

Section 597(a) delegates to the Secretary of the Treasury authority to prescribe regulations concerning ''any transaction in which Federal financial assistance is provided.'' These regulations are issued under the authority of section 597(a).

This document also amends the regulations under section 7507 to reflect the treatment of FFA under FIRREA.

The IRS published proposed regulations under sections 597 and 7507 on April 22, 1992 (57 FR 14794, FI–46–89, 1992–1 C.B. 1037).

Public Comments and the Final Regulations

The IRS received comments on the proposed regulations, and a public hearing was held on July 17, 1992. After consideration of the comments and the statements made at the hearing, the proposed regulations are adopted as revised by this Treasury decision. The principal comments and revisions are discussed below.

§1.597–2 Taxation of FFA

Section 1.597–2 contains rules concerning accounting for FFA as income. The final regulations retain the proposed rule that, generally, FFA is income to the failed Institution when it is received or accrued in accordance with the Institution's method of accounting. Section 1.597–2(c) contains rules permitting certain Institutions to defer the inclusion of FFA.

Deferral formula without Continuing Equity. Under the proposed regulations, unresolved Institutions without Continuing Equity were permitted to defer inclusion of FFA in excess of amounts determined under a formula. The proposed formula required current inclusion equal to the sum of liabilities less aggregate adjusted basis at the beginning of the assistance year (representing losses already recognized), plus loss in the current year (disregarding FFA). The proposed formula generally allowed the Institution the benefit of any prior losses of its owners' equity, but offset any losses of creditors' capital by the inclusion of FFA. However, with respect to losses during the year FFA is received, the proposed formula did not distinguish between losses of owners' equity and losses of creditors' capital and, therefore, offset losses of owners' equity by inclusion of FFA. The formula (together with related recapture rules) in the final regulations has been changed to reflect that the owners' equity is the first capital lost and, in a transaction without Continuing Equity, is not offset by inclusion of FFA.

Deferral formula with Continuing Equity. The proposed regulations allowed deferral under different conditions where Continuing Equity is present. In that case, the Institution must include currently, in addition to the normal formula amount, income equal to all net operating loss carryovers available to it. Also, an Institution with Continuing Equity must recapture deferred FFA at least as quickly as pro rata over a maximum of six years, regardless of whether it recognizes all of its built-in losses during that time.

Commentators suggested that the proposed regulations unfairly limited deferral for Institutions with Continuing Equity and recommended the same deferral formula apply in all cases. They criticized the Continuing Equity concept because it focused on the identity of the Institution's shareholders after the assistance transaction.

Under the definition of Continuing Equity in the proposed regulations, an Institution generally would have Continuing Equity if five percent or more of its stock at the end of a taxable year was owned by shareholders who owned stock before the Institution was placed in receivership by a supervisory agency (Agency) or first received FFA. The five percent reference was misleading because, under §1.597–5, a 50 percent change in ownership generally results in a deemed Taxable Transfer (now defined in §1.597–5(a)(1)) in which the failed Institution is treated as a New Entity. The deferral rules do not apply after a deemed Taxable Transfer. The final regulations thus clarify that Continuing Equity exists only if the Institution is not (i) a Bridge Bank, (ii) in Agency receivership, or (iii) treated as a New Entity. The modification to the definition of Continuing Equity is not intended as a substantive change. The Continuing Equity deferral provisions apply only to the limited number of ''open bank'' resolutions not subject to the deemed Taxable Transfer rules. (As discussed below, the Taxable Transfer definitions have also been modified to clarify that most ''open bank'' assisted transactions are treated as Taxable Transfers.)

The final regulations do not eliminate the special treatment of Institutions with Continuing Equity. The regulations provide deferral rules to ameliorate a timing mismatch between FFA income and related losses. Deferral is not designed to allow built-in losses to offset operating income instead of FFA or to permit the permanent elimination of any subsidy provided by Agency. The requirement that Institutions with Continuing Equity recapture their deferred FFA within six years is a reasonable safeguard against indefinite deferral of FFA income. The results under these rules are comparable in effect to those applicable to acquirors in Taxable Transfers.

The final regulations do, however, modify the Continuing Equity formula, which, in the proposed regulations, counted some losses twice. Recognized losses represented in the first prong of the formula (liabilities minus asset bases) may comprise part of the third prong (net operating losses available to the Institution or its consolidated group). The final regulations correct this double counting of losses.

Transfers of money and property to Agency. The proposed regulations contained rules for taxing FFA if money or property is also transferred to Agency. These rules, together with rules for the treatment of FFA received pursuant to a Loss Guarantee, have been clarified, reorganized, and restated in §1.597–2(d).

The proposed regulations provided an offset or deduction for payments by an Institution to Agency to the extent of previously received FFA. The rule as proposed provided limited relief for payments made to Agency by a New Entity or Acquiring, because they receive little or no FFA. However, an assisted acquisition can result in income to a New Entity or Acquiring in the form of built-in gain. Under section 597(c) and §1.597–3(b), an instrument issued to Agency by a New Entity or Acquiring is, in effect, disregarded. If a New Entity or Acquiring issues its instrument to Agency in connection with the acquisition of an Institution, the value of the instrument is not included in the purchase price. Consequently, a New Entity or Acquiring may have a basis shortfall in the assets acquired (or deemed acquired) from the failed Institution. The final regulations provide a New Entity or Acquiring a purchase price adjustment upon any transfer to Agency (*e.g.,* in satisfaction of the disregarded instrument).

In response to comments, the final regulations also specifically provide for repayments to Agency by Institution affiliates. Moreover, the final regulations provide that if Agency sells an Institution's instrument to a third party, the sales price is treated as a repayment to Agency by the issuer. Furthermore, the instrument is treated as having been newly issued by the issuer to the holder at that time. The IRS and Treasury believe that this is an appropriate time for the issuer to offset FFA or increase its basis, because the sales price reasonably fixes the value of the instrument, and any subsequent cost associated with the instrument should be accounted for in accordance with the nature of the instrument.

§1.597–4(g) Elective disaffiliation

The proposed regulations would allow a consolidated group to elect (after the regulations became final) to exclude an Institution in receivership from its group. The election potentially requires the inclusion of a ''toll charge'' in the income of those members owning the common stock of the Institution (the member shareholders). The amount of the toll charge is the excess of the disaffiliated Institution's liabilities over the adjusted basis of its assets. The toll charge is intended to reflect the amount that would be included in income if Agency were to provide the entire amount of FFA necessary to restore the Institution's solvency at the time of the event permitting disaffiliation. Commentators suggested that the final regulations should include the toll charge in the income of the disaffiliated Institution (rather than its member shareholders), provide the group with a ''toll charge deduction,'' and clarify the ability of the member shareholders to take a worthless stock deduction.

Toll charge. Commentators suggested that the final regulations include the toll charge in the income of the failed Institution rather than its member shareholders. According to the commentators, including the toll charge in the income of the member shareholders may result in disadvantageous state tax consequences in those states where banking corporations are not permitted to file consolidated returns with non-banking corporations. Under the proposed regulations, a bank holding corporation (the disaffiliated Institution's shareholder) would have to include in income the toll charge without the benefit of the Institution's offsetting losses.

The IRS and Treasury agree that the toll charge is more appropriately included in the income of the Institution (*i.e.*, the entity that is reimbursed by Agency for its loss), because the toll charge represents accelerated FFA income. Thus, the final regulations provide that the Institution, rather than its member shareholders, takes the toll charge into income.

Toll charge deduction. Under the proposed regulations, the Institution does not recognize built-in losses on disaffiliation. One commentator suggested the final regulations provide for a ''toll charge deduction'' for the excess of the Institution's adjusted basis over its liabilities. According to the commentator, such a deduction is appropriate because the Institution incurred economic loss while it was a member of the consolidated group, before the Institution was placed in receivership by Agency.

The commentator's recommendation is not adopted in the final regulations because a toll charge deduction would accelerate recognition of losses in advance of realization. Such a deduction is particularly inappropriate because federal banking laws now permit placing solvent institutions in receivership. In such cases, it is uncertain whether the loss represented by such a deduction will ever be realized.

Worthless stock deduction. Under the proposed regulations, if an election to disaffiliate is made, the members of the consolidated group are treated as having disposed of their stock in the Institution. One commentator suggested that the final regulations clarify that, upon disaffiliation, the Institution's stock is worthless.

The final regulations address the commentator's concerns by providing that, as a consequence of the election, the members of the consolidated group treat their stock in the Institution as worthless if the Institution is factually insolvent on the date the Institution is placed in receivership (or on the date the consolidated group is deemed to make the election to disaffiliate). This rule preempts otherwise applicable tests for worthlessness under section 165 and §1.1502–19. Any worthless stock deduction is subject to the limitations of the loss disallowance regulations (§§1.337(d)–1 and 1.1502–20).

Consistency rule. Under the proposed regulations, a consolidated group could elect to disaffiliate a subsidiary Institution only if the Institution was its first subsidiary placed in Agency receivership after the enactment of FIRREA. The election made for the first subsidiary bound all future subsidiaries placed in Agency receivership. To address the concern that the scope of the proposed consistency rule was too broad, the final regulations modify the consistency rule to require, generally, that a consolidated group must elect consistently only for subsidiary Institutions placed in Agency receivership within five years of each other.

§1.597–5 Taxable Transfers

Section 597 applies to FFA and transactions in connection with which FFA is provided. The proposed regulations generally define a Taxable Transfer as a transfer of deposit liabilities or stock while an Institution is under Agency Control. However, IRS and Treasury now understand that it is possible for Agency to resolve an Institution under its control without providing assistance, or to provide assistance without placing an Institution under its control. In light of this information, the final regulations refine the definition of a Taxable Transfer.

Under the final regulations, Taxable Transfers include the transfer of any deposit liability in connection with which FFA is provided or the transfer of any asset for which Agency has an obligation (*e.g.*, assets covered by Loss Guarantees). Certain transfers of stock cause a Taxable Transfer if FFA is provided in connection with the transfer, if the Institution is a Bridge Bank or if the Institution has a balance in its deferred FFA account. The phrase ''in connection with'' should be interpreted broadly. If any party to a transaction receives FFA, all parties and all related transactions are within the scope of these regulations. To provide certainty regarding tax treatment for purchasers of stock of subsidiaries of Institutions under Agency Control, the final regulations treat all transactions in which such a subsidiary leaves its group as Taxable Transfers.

§1.597–6 Limitation on collection of income tax

Limitation where tax is borne by Agency. The proposed regulations provided that income tax attributable to the receipt of FFA or gain on a

Taxable Transfer would not be collected from an Institution without Continuing Equity if Agency would bear the burden of the tax. Commentators suggested that the limitation on noncollection in cases of Continuing Equity is inappropriate because it requires Agency to gross-up any assistance paid to cover the tax thereon.

The final regulations retain the limitation on noncollection in cases of Continuing Equity. The IRS and Treasury believe that the limitation is appropriate for transactions in which Agency assists an Institution while allowing old shareholders to retain their ownership. Noncollection should not inure to the benefit of the Institution's old shareholders, who would have use of the Institution's losses while escaping responsibility for the tax on related FFA income. The congressional purpose in FIRREA to eliminate any tax subsidy for assisted transactions requires that the IRS not waive its rights as a creditor in cases where all other creditors and equity holders retain their rights.

Transferee liability. The proposed regulations limited the collection of a failed Institution's income taxes from a transferee in a Taxable Transfer (*i.e.*, a New Entity or Acquiring). This rule would not apply if (similar to the Continuing Equity rule discussed above under the heading ''Deferral formula with Continuing Equity'') there is a five percent overlap in the ownership of the transferor Institution and the New Entity or Acquiring.

Commentators suggested that the final regulations should not include the five percent overlap exception because the exception appears to punish former owners of Institutions, Institutions have difficulty tracking ownership, and the exception contains no limits on aggregation.

Because good faith purchasers of assets for value generally do not have transferee liability, the final regulations clarify that Acquiring (the purchaser of Institution's assets in an actual Taxable Transfer) is not subject to such liability in any case. This rule applies even if shareholders of Acquiring were shareholders of the selling Institution.

The final regulations do not, however, except a New Entity (the resulting corporation in a deemed Taxable Transfer) from collection if the Institution's previous equity interests remain outstanding in the New Entity, or are reacquired or exchanged for consideration. As in those cases in which a Taxable Transfer does not occur, the IRS should remain a creditor if all other creditors retain their interests and the Institution's previous equity interests had retained value. However, by focusing on whether previous equity interests retain value, the final regulations eliminate the need to track or aggregate ownership and do not penalize any particular potential acquirors.

§1.597–7 Effective Date

As proposed, these final regulations generally apply to taxable years ending on or after April 22, 1992. However, the provisions of these regulations do not apply to FFA received or accrued for taxable years ending after April 22, 1992, in connection with an Agency assisted acquisition that occurs before April 22, 1992. Taxpayers not subject to these regulations must comply with an interpretation of the statute that is reasonable in light of the legislative history and applicable administrative pronouncements. For this purpose, the rules contained in Notice 89–102 (1989–2 C.B. 436) apply to the extent provided in the Notice.

An irrevocable election is available to apply the regulations to taxable years prior to the general effective date. However, the election cannot be made if the Institution's statute of limitations has expired or a section 338 election was available but not made for the Institution. In addition, consistent treatment is required in ''open bank'' resolutions that would result under the regulations in deemed Taxable Transfers before April 22, 1992.

The proposed regulations required an electing taxpayer to extend the statute of limitations for all items for three years from the date of filing the election. The final regulations adopt a commentator's suggestion that the taxpayer extend the statute of limitations only for items affected by application of the regulations.

An Institution or consolidated group makes the election on its first annual income tax return filed on or after March 15, 1996. However, to make the affirmative election to disaffiliate under §1.597–4(g)(5) for an Institution placed in Agency receivership in a taxable year ending before April 22, 1992, a consolidated group must send the affected Institution the required statement advising it of the elective disaffiliation on or before May 31, 1996. In that case, the consolidated group is deemed to have elected retroactive application of these regulations but must nevertheless attach the required statement to its first annual income tax return filed on or after March 15, 1996.

The final regulations provide that taxpayers may rely on the provisions of the proposed regulations to the extent they acted in reliance on the proposed regulations prior to December 21, 1995. Such reliance must be reasonable and transactions with respect to which such taxpayers rely must be consistent with the overriding policies of section 597, as expressed in the legislative history, as well as the overriding policies of the proposed regulations.

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 is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will generally only apply to certain financially troubled financial institutions and the consolidated groups, if any, to which they belong. 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 regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Steven M. Flanagan, Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * * *

Adoption of Amendments to the Regulations

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

Paragraph 1. The authority for part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * *
Sections 1.597–1 through 1.597–7 also issued under 26 U.S.C. 597 and 1502.

Par. 2. Sections 1.597–1 through 1.597–7 are added to read as follows:

§1.597–1 Definitions.

For purposes of the regulations under section 597—

(a) Unless the context otherwise requires, the terms *consolidated group*, *member* and *subsidiary* have the meanings provided in §1.1502–1; and

(b) The following terms have the meanings provided below—

Acquiring. The term *Acquiring* means a corporation that is a transferee in a Taxable Transfer, other than a deemed transferee in a Taxable Transfer described in §1.597–5(b).

Agency. The term *Agency* means the Resolution Trust Corporation, the Federal Deposit Insurance Corporation, any similar instrumentality of the United States government, and any predecessor or successor of the foregoing (including the Federal Savings and Loan Insurance Corporation).

Agency Control. An Institution or entity is under *Agency Control* if Agency is conservator or receiver of the Institution or entity, or if Agency has the right to appoint any of the Institution's or entity's directors.

Agency Obligation. The term *Agency Obligation* means a debt instrument that Agency issues to an Institution or to a direct or indirect owner of an Institution.

Bridge Bank. The term *Bridge Bank* means an Institution that is organized by Agency to hold assets and liabilities of another Institution and that continues the operation of the other Institution's business pending its acquisition or liquidation, and that is any of the following—

(1) A national bank chartered by the Comptroller of the Currency under section 11(n) of the Federal Deposit Insurance Act (12 U.S.C. 1821(n)) or section 21A(b)(10)(A) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)-(10)(A)) or any successor sections;

(2) A Federal savings association chartered by the Director of the Office of Thrift Supervision under section 21A(b)(10)(A) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)-(10)(A)) or any successor section; or

(3) A similar Institution chartered under any other statutory provisions.

Consolidated Subsidiary. The term *Consolidated Subsidiary* means a member of the consolidated group of which an Institution is a member that bears the same relationship to the Institution that the members of a consolidated group bear to their common parent under section 1504(a)(1).

Continuing Equity. An Institution has *Continuing Equity* for any taxable year if, on the last day of the taxable year, the Institution is not (1) a Bridge Bank, (2) in Agency receivership, or (3) treated as a New Entity.

Controlled Entity. The term *Controlled Entity* means an entity under Agency Control.

Federal Financial Assistance (FFA). The term *Federal Financial Assistance* (FFA), as defined by section 597(c), means any money or property provided by Agency to an Institution or to a direct or indirect owner of stock in an Institution under section 406(f) of the National Housing Act (12 U.S.C. 1729(f)), section 21A(b)(4) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)(4)), section 11(f) or 13(c) of the Federal Deposit Insurance Act (12 U.S.C. 1821(f), 1823(c)), or under any similar provision of law. Any such money or property is FFA, regardless of whether the Institution or any of its affiliates issues Agency a note or other obligation, stock, warrants, or other rights to acquire stock in connection with Agency's provision of the money or property. FFA includes Net Worth Assistance, Loss Guarantee payments, yield maintenance payments, cost to carry or cost of funds reimbursement payments, expense reimbursement or indemnity payments, and interest (including original issue discount) on an Agency Obligation.

Institution. The term *Institution* means an entity that is, or immediately before being placed under Agency Control was, a bank or domestic building and loan association within the meaning of section 597 (including a Bridge Bank). Except as otherwise provided in the regulations under section 597, the term *Institution* includes a New Entity or Acquiring that is a bank or domestic building and loan association within the meaning of section 597.

Loss Guarantee. The term *Loss Guarantee* means an agreement pursuant to which Agency or a Controlled Entity guarantees or agrees to pay an Institution a specified amount upon the disposition or charge-off (in whole or in part) of specific assets, an agreement pursuant to which an Institution has a right to put assets to Agency or a Controlled Entity at a specified price, or a similar arrangement.

Net Worth Assistance. The term *Net Worth Assistance* means money or property (including an Agency Obligation to the extent it has a fixed principal amount) that Agency provides as an integral part of a Taxable Transfer, other than FFA that accrues after the date of the Taxable Transfer. For example, Net Worth Assistance does not include Loss Guarantee payments, yield maintenance payments, cost to carry or cost of funds reimbursement payments, or expense reimbursement or indemnity payments. An Agency Obligation is considered to have a fixed principal amount notwithstanding an agreement providing for its adjustment after issuance to reflect a more accurate determination of the condition of the Institution at the time of the acquisition.

New Entity. The term *New Entity* means the new corporation that is treated as purchasing all of the assets of an Old Entity in a Taxable Transfer described in §1.597–5(b).

Old Entity. The term *Old Entity* means the Institution or Consolidated Subsidiary that is treated as selling all of its assets in a Taxable Transfer described in §1.597–5(b).

Residual Entity. The term *Residual Entity* means the entity that remains after an Institution transfers deposit liabilities to a Bridge Bank.

Taxable Transfer. The term *Taxable Transfer* has the meaning provided in §1.597–5(a)(1).

§1.597–2 Taxation of Federal Financial Assistance.

(a) *Inclusion in income*—(1) *In general*. Except as otherwise provided in the regulations under section 597, all FFA is includible as ordinary income to the recipient at the time the FFA is received or accrued in accordance with the recipient's method of accounting. The amount of FFA received or accrued is the amount of any money, the fair market value of any property (other than an Agency Obligation), and the issue price of any Agency Obligation (determined under §1.597–3(c)(2)). An Institution (and not the nominal recipient) is treated as receiving directly any FFA that Agency provides in a taxable year to a direct or indirect shareholder of the Institution, to the extent money or property is transferred to the Institution pursuant to an agreement with Agency.

(2) *Cross references*. See paragraph (c) of this section for rules regarding the timing of inclusion of certain FFA. See paragraph (d) of this section for additional rules regarding the treatment of FFA received in connection with transfers of money or property to Agency or a Controlled Entity, or paid pursuant to a Loss Guarantee. See §1.597–5(c)(1) for additional rules regarding the inclusion of Net Worth Assistance in the income of an Institution.

(b) *Basis of property that is FFA*. If FFA consists of property, the Institution's basis in the property equals the fair market value of the property (other than an Agency Obligation) or the issue price of the Agency Obligation, as determined under §1.597–3(c)(2).

(c) *Timing of inclusion of certain FFA*—(1) *Scope*. This paragraph (c) limits the amount of FFA an Institution must include in income currently under certain circumstances and provides rules for the deferred inclusion in income of amounts in excess of those limits. This paragraph (c) does not apply to a New Entity or Acquiring.

(2) *Amount currently included in income by an Institution without Continuing Equity*. The amount of FFA an Institution without Continuing Equity must include in income in a taxable year under paragraph (a)(1) of this section is limited to the sum of—

(i) The excess at the beginning of the taxable year of the Institution's liabilities over the adjusted bases of the Institution's assets; and

(ii) The amount by which the excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (determined without regard to FFA) is greater than the excess at the beginning of the taxable year of the adjusted bases of the Institution's assets over the Institution's liabilities.

(3) *Amount currently included in income by an Institution with Continuing Equity*. The amount of FFA an Institution with Continuing Equity must include in income in a taxable year under paragraph (a)(1) of this section is limited to the sum of—

(i) The excess at the beginning of the taxable year of the Institution's liabilities over the adjusted bases of the Institution's assets;

(ii) The greater of—

(A) The excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (determined without regard to FFA); or

(B) The excess for the taxable year of the deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) of the consolidated group of which the Institution is a member on the last day of the Institution's taxable year over the group's gross income (determined without regard to FFA); and

(iii) The excess of the amount of any net operating loss carryover of the Institution (or in the case of a carryover from a consolidated return year of the Institution's current consolidated group, the net operating loss carryover of the group) to the taxable year over the amount described in paragraph (c)(3)(i) of this section.

(4) *Deferred FFA*—(i) *Maintenance of account*. An Institution must establish a deferred FFA account commencing in the first taxable year in which it receives FFA that is not currently included in income under paragraph (c)(2) or (c)(3) of this section, and must maintain that account in accordance with the requirements of this paragraph (c)(4). The Institution must add the amount of any FFA that is not currently included in income under paragraph (c)(2) or (c)(3) of this section to its deferred FFA account. The Institution must decrease the balance of its deferred FFA account by the amount of deferred FFA included in income under paragraphs (c)(4)(ii), (iv) and (v) of this section. (See also paragraph (d)(5)(i)(B) of this section for other adjustments that decrease the deferred FFA account.) If, under paragraph (c)(3) of this section, FFA is not currently included in income in a taxable year, the Institution thereafter must maintain its deferred FFA account on a FIFO (first in, first out) basis (*e.g.*, for purposes of the first sentence of paragraph (c)(4)(iv) of this section).

(ii) *Deferred FFA recapture*. In any taxable year in which an Institution has a balance in its deferred FFA account, it must include in income an amount equal to the lesser of the amount described in paragraph (c)(4)(iii) of this section or the balance in its deferred FFA account.

(iii) *Annual recapture amount*—(A) *Institutions without Continuing Equity*—(*1*) *In general*. In the case of an Institution without Continuing Equity, the amount described in this paragraph (c)(4)(iii) is the amount by which—

(*i*) The excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (taking into account FFA included in income under paragraph (c)(2) of this section); is greater than

(*ii*) The Institution's remaining equity as of the beginning of the taxable year.

(*2*) *Remaining equity*. The Institution's remaining equity is—

(*i*) The amount at the beginning of the taxable year in which the deferred FFA account was established equal to the adjusted bases of the Institution's assets minus the Institution's liabilities (which amount may be positive or negative); plus

(*ii*) The Institution's taxable income (computed without regard to any carryover from any other year) in any subsequent taxable year or years; minus

(*iii*) The excess in any subsequent taxable year or years of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income.

(B) *Institutions with Continuing Equity*. In the case of an Institution with Continuing Equity, the amount described in this paragraph (c)(4)(iii) is the amount by which the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) exceed its gross income (taking into account FFA included in income under paragraph (c)(3) of this section).

(iv) *Additional deferred FFA recapture by an Institution with Continuing Equity*. To the extent that, as of the end of a taxable year, the cumulative amount of FFA deferred under paragraph (c)(3) of this section that an Institution with Continuing Equity has recaptured under this paragraph (c)(4) is less than the cumulative amount of FFA deferred under paragraph (c)(3) of this section that the Institution would have recaptured if that FFA had been included in income ratably over the six taxable years immediately following the taxable year of deferral, the Institution must include that difference in income for the taxable year. An Institution with Continuing Equity must include in income the balance of its deferred FFA account in the taxable year in which it liquidates, ceases to do business, transfers (other than to a Bridge Bank) substantially all of its assets and liabilities, or is deemed to transfer all of its assets under §1.597–5(b).

(v) *Optional accelerated recapture of deferred FFA*. An Institution that has a deferred FFA account may include in income the balance of its deferred FFA account on its timely filed (including extensions) original income tax return for any taxable year that it is not under Agency Control. The balance of its deferred FFA account is income on the last day of that year.

(5) *Exceptions to limitations on use of losses*. In computing an Institution's taxable income or alternative minimum taxable income for a taxable year, sections 56(d)(1), 382 and 383 and §§1.1502–15, 1.1502–21 and 1.1502–22 do not limit the use of the attributes of the Institution to the extent, if any, that the inclusion of FFA (including recaptured FFA) in income results in taxable income or alternative minimum taxable income (determined without regard to this paragraph (c)(5)) for the taxable year. This paragraph (c)(5) does not apply to any limitation under section 382 or 383 or §1.1502–15, 1.1502–21 or 1.1502–22 that arose in connection with or prior to a corporation becoming a Consolidated Subsidiary of the Institution.

(6) *Operating rules*—(i) *Bad debt reserves*. For purposes of paragraphs (c)(2), (c)(3) and (c)(4) of this section, the adjusted bases of an Institution's assets are reduced by the amount of the Institution's reserves for bad debts under section 585 or 593, other than supplemental reserves under section 593.

(ii) *Aggregation of Consolidated Subsidiaries*. For purposes of this paragraph (c), an Institution is treated as a single entity that includes the income, expenses, assets, liabilities, and attributes of its Consolidated Subsidiaries, with appropriate adjustments to prevent duplication.

(iii) *Alternative minimum tax*. To compute the alternative minimum taxable income attributable to FFA of an Institution for any taxable year under section 55, the rules of this section, and related rules, are applied by using alternative minimum tax basis, deductions, and all other items required to be taken into account. All other alternative minimum tax provisions continue to apply.

(7) *Earnings and profits*. FFA that is not currently included in income under this paragraph (c) is included in earnings and profits for all purposes of the Internal Revenue Code to the extent and at the time it is included in income under this paragraph (c).

(d) *Transfers of money or property to Agency, and property subject to a Loss Guarantee*—(1) *Transfers of property to Agency*. The transfer of property to Agency or a Controlled Entity is a taxable sale or exchange in which the Institution is treated as realizing an amount equal to—

(i) The property's fair market value; or

(ii) For property subject to a Loss Guarantee, the greater of the property's fair market value or the guaranteed value or price at which the property can be put at the time of transfer.

(2) *FFA with respect to property covered by a Loss Guarantee other than on transfer to Agency*. (i) FFA provided pursuant to a Loss Guarantee with respect to covered property is included in the amount realized with respect to the property to the extent the total amount realized does not exceed the greater of—

(A) The property's fair market value; or

(B) The guaranteed value or price at which the property can be put at the time of transfer.

(ii) For the purposes of this paragraph (d)(2), references to an amount realized include amounts obtained in whole or partial satisfaction of loans, amounts obtained by virtue of charging off or marking to market covered property, and other amounts similarly related to property, whether or not disposed of.

(3) *Treatment of FFA received in exchange for property*. FFA included in the amount realized for property under this paragraph (d) is not includible in income under paragraph (a)(1) of this section. The amount realized is treated in the same manner as if realized from a person other than Agency or a Controlled Entity. For example, gain attributable to FFA received with respect to a capital asset retains its character as capital gain. Similarly, FFA received with respect to property that has been charged off for income tax purposes is treated as a recovery to the extent of the amount previously charged off. Any FFA provided in excess of the amount realized under this paragraph (d) is includible in income under paragraph (a)(1) of this section.

(4) *Adjustment to FFA*—(i) *In general*. If an Institution pays or transfers money or property to Agency or a Controlled Entity, the amount of money and fair market value of the property is an adjustment to its FFA to the extent the amount paid and transferred exceeds the amount of money and fair market value of property Agency or a Controlled Entity provides in exchange.

(ii) *Deposit insurance*. This paragraph (d)(4) does not apply to amounts paid to Agency with respect to deposit insurance.

(iii) *Treatment of an interest held by Agency or a Controlled Entity*—(A) *In general*. For purposes of this paragraph (d), an interest described in §1.597–3(b) is not treated as property when transferred by the issuer to Agency or a Controlled Entity nor when acquired from Agency or a Controlled Entity by the issuer.

(B) *Dispositions to persons other than issuer*. On the date Agency or a Controlled Entity transfers an interest described in §1.597–3(b) to a holder other than the issuer, Agency or a Controlled Entity, the issuer is treated for purposes of this paragraph (d)(4) as having transferred to Agency an amount of money equal to the sum of the amount of money and the fair market value of property that was paid by the new holder as consideration for the interest.

(iv) *Consolidated groups*. For purposes of this paragraph (d), an Institution will be treated as having made any transfer to Agency or a Controlled Entity that was made by any other member of its consolidated group. The consolidated group must make appropriate investment basis adjustments to the extent the member transferring money or other property is not the member that received FFA.

(5) *Manner of making adjustments to FFA*—(i) *Reduction of FFA and deferred FFA*. An Institution adjusts its FFA under paragraph (d)(4) of this section by reducing in the following order and in an aggregate amount not greater than the adjustment—

(A) The amount of any FFA that is otherwise includible in income for the taxable year (before application of paragraph (c) of this section); and

(B) The balance (but not below zero) in the deferred FFA account, if any, maintained under paragraph (c)(4) of this section.

(ii) *Deduction of excess amounts*. If the amount of the adjustment exceeds the sum of the amounts described in paragraph (d)(5)(i) of this section, the Institution may deduct the excess to the extent the deduction does not exceed the amount of FFA included in income for prior taxable years reduced by the amount of deductions allowable under this paragraph (d)(5)(ii) in prior taxable years.

(iii) *Additional adjustments*. Any adjustment to FFA in excess of the sum of the amounts described in paragraphs (d)(5)(i) and (ii) of this section is treated—

(A) By an Institution other than a New Entity or Acquiring, as a deduction of the amount in excess of FFA received that is required to be transferred to Agency under section 11(g) of the Federal Deposit Insurance Act (12 U.S.C. 1821(g)); or

(B) By a New Entity or Acquiring, as an adjustment to the purchase price paid in the Taxable Transfer (see §1.338(b)–3T).

(e) *Examples*. The following examples illustrate the provisions of this section:

Example 1. Timing of inclusion of FFA in income. (i) Institution M, a calendar year taxpayer without Continuing Equity because it is in Agency receivership, is not a member of a consolidated group and has not been acquired in a Taxable Transfer. On January 1, 1997, M has assets with a total adjusted basis of $100 million and total liabilities of $120 million. M's deductions do not exceed its gross income (determined without regard to FFA) for 1997. Agency provides $30 million of FFA to M in 1997. The amount of this FFA that M must include in income in 1997 is limited by §1.597–2(c)(2) to $20 million, the amount by which M's liabilities ($120 million) exceed the total adjusted basis of its assets ($100 million) at the beginning of the taxable year. Pursuant to §1.597–2(c)(4)(i), M must establish a deferred FFA account for the remaining $10 million.

(ii) If Agency instead lends M the $30 million, M's indebtedness to Agency is disregarded and the results are the same as in paragraph (i) of this *Example 1*. Section 597(c); §§1.597–1(b) (defining FFA) and 1.597–3(b).

Example 2. Transfer of property to Agency. (i) Institution M, a calendar year taxpayer without Continuing Equity because it is in Agency receivership, is not a member of a consolidated group and has not been acquired in a Taxable Transfer. At the beginning of 1998, M's remaining equity is $0 and M has a deferred FFA account of $10 million. Agency does not provide any FFA to M in 1998. During the year, M transfers property not covered by a Loss Guarantee to Agency and does not receive any consideration. The property has an adjusted basis of $5 million and a fair market value of $1 million at the time of the transfer. M has no other taxable income or loss in 1998.

(ii) Under §1.597–2(d)(1), M is treated as selling the property for $1 million, its fair market value, thus recognizing a $4 million loss ($5 million – $1 million). In addition, because M did not receive any consideration from Agency, under §1.597–2(d)(4) M has an adjustment to FFA of $1 million, the amount by which the fair market value of the transferred property ($1 million) exceeds the consideration M received from Agency ($0). Because no FFA is provided to M in 1998, this adjustment reduces the balance of M's deferred FFA account to $9 million ($10 million – $1 million). Section 1.597–2(d)(5)(i)(B). Because M's $4 million loss causes M's deductions to exceed its gross income by $4 million in 1998 and M has no remaining equity, under §1.597–2(c)(4)(iii)(A) M must include $4 million of deferred FFA in income, and must decrease the remaining $9 million balance of its deferred FFA account by the same amount, leaving a balance of $5 million.

Example 3. Loss Guarantee. Institution Q, a calendar year taxpayer, sells an asset covered by a Loss Guarantee to an unrelated third party for $4,000. Q's adjusted basis in the asset at the time of sale and the asset's guaranteed value are both $10,000. Pursuant to the Loss Guarantee, Agency pays Q $6,000 ($10,000 – $4,000). Q's amount realized from the sale of the asset is $10,000 ($4,000 from the third party and $6,000 from Agency). Section 1.597–2(d)(2). Q realizes no gain or loss on the sale ($10,000 – $10,000 = $0), and therefore includes none of the $6,000 of FFA it receives pursuant to the Loss Guarantee in income. Section 1.597–2(d)(3).

§1.597–3 Other rules.

(a) *Ownership of assets*. For all income tax purposes, an Institution is treated as the owner of all assets covered by a Loss Guarantee, yield maintenance agreement, or cost to carry or cost of funds reimbursement agreement, regardless of whether Agency (or a Controlled Entity) otherwise would be treated as the owner under general principles of income taxation.

(b) *Debt and equity interests received by Agency*. Debt instruments, stock, warrants, or other rights to acquire stock of an Institution (or any of its affiliates) that Agency or a Controlled Entity receives in connection with a transaction in which FFA is provided are not treated as debt, stock or other equity interests of or in the issuer for any purpose of the Internal Revenue Code while held by Agency or a Controlled Entity. On the date Agency or a Controlled Entity transfers an interest described in this paragraph (b) to a holder other than Agency or a Controlled Entity, the interest is treated as having been newly issued by the issuer to the holder with an issue price equal to the sum of the amount of money and the fair market value of property paid by the new holder in exchange for the interest.

(c) *Agency Obligations*—(1) *In general*. Except as otherwise provided in this paragraph (c), the original issue discount rules of sections 1271 et seq. apply to Agency Obligations.

(2) *Issue price of Agency Obligations provided as Net Worth Assistance*. The issue price of an Agency Obligation that is provided as Net Worth Assistance and that bears interest at either a single fixed rate or a qualified floating rate (and provides for no contingent payments) is the lesser of the sum of the present values of all payments due under the obligation, discounted at a rate equal to the applicable federal rate (within the meaning of section 1274(d)(1) and (3)) in effect for the date of issuance, or the stated principal amount of the obligation. The issue price of an Agency Obligation that bears a qualified floating rate of interest (within the meaning of §1.1275–5(b)) is determined by treating the obligation as bearing a fixed rate of interest equal to the rate in effect on the date of issuance under the obligation.

(3) *Adjustments to principal amount*. Except as provided in §1.597–5(d)(2)(iv), this paragraph (c)(3) applies if Agency modifies or exchanges an Agency Obligation provided as Net Worth Assistance (or a successor obligation). The issue price of the modified or new Agency Obligation is determined under paragraphs (c)(1) and (2) of this section. If the issue price is greater than the adjusted issue price of the existing Agency Obligation, the difference is treated as FFA. If the issue price is less than the adjusted issue price of the existing Agency Obligation, the difference is treated as

an adjustment to FFA under §1.597–2(d)(4).

(d) *Successors*. To the extent necessary to effectuate the purposes of the regulations under section 597, an entity's treatment under the regulations applies to its successor. A successor includes a transferee in a transaction to which section 381(a) applies or a Bridge Bank to which another Bridge Bank transfers deposit liabilities.

(e) *Loss disallowance*. For purposes of §1.1502–20, FFA and the amount described in §1.597–4(g)(3) are treated as an extraordinary gain disposition within the meaning of §1.1502–20(c)(2)(i) and a Taxable Transfer is treated as an applicable asset acquisition under section 1060(c) within the meaning of §1.1502–20(c)(2)(i)(A)(*4*).

(f) *Losses and deductions with respect to covered assets*. Prior to the disposition of an asset covered by a Loss Guarantee, the asset cannot be charged off, marked to a market value, depreciated, amortized, or otherwise treated in a manner that supposes an actual or possible diminution of value below the greater of the asset's highest guaranteed value or the highest price at which the asset can be put.

(g) *Anti-abuse rule*. The regulations under section 597 must be applied in a manner consistent with the purposes of section 597. Accordingly, if, in structuring or engaging in any transaction, a principal purpose is to achieve a tax result that is inconsistent with the purposes of section 597 and the regulations thereunder, the Commissioner can make appropriate adjustments to income, deductions and other items that would be consistent with those purposes.

§1.597–4 Bridge Banks and Agency Control.

(a) *Scope*. This section provides rules that apply to a Bridge Bank or other Institution under Agency Control and to transactions in which an Institution transfers deposit liabilities (whether or not the Institution also transfers assets) to a Bridge Bank.

(b) *Status as taxpayer*. A Bridge Bank or other Institution under Agency Control is a corporation within the meaning of section 7701(a)(3) for all purposes of the Internal Revenue Code and is subject to all Internal Revenue Code provisions that generally apply to corporations, including those relating to methods of accounting and to requirements for filing returns, even if Agency owns stock of the Institution.

(c) *No section 382 ownership change*. The imposition of Agency Control, the cancellation of Institution stock by Agency, a transaction in which an Institution transfers deposit liabilities to a Bridge Bank, and an election under paragraph (g) of this section are disregarded in determining whether an ownership change has occurred within the meaning of section 382(g).

(d) *Transfers to Bridge Banks*—(1) *In general*. Except as otherwise provided in paragraph (g) of this section, the rules of this paragraph (d) apply to transfers to Bridge Banks. In general, a Bridge Bank and its associated Residual Entity are together treated as the successor entity to the transferring Institution. If an Institution transfers deposit liabilities to a Bridge Bank (whether or not it also transfers assets), the Institution recognizes no gain or loss on the transfer and the Bridge Bank succeeds to the transferring Institution's basis in any transferred assets. The associated Residual Entity retains its basis in any assets it continues to hold. Immediately after the transfer, the Bridge Bank succeeds to and takes into account the transferring Institution's items described in section 381(c) (subject to the conditions and limitations specified in section 381(c)), taxpayer identification number (''TIN''), deferred FFA account, and account receivable for future FFA as described in paragraph (g)(4)(ii) of this section. The Bridge Bank also succeeds to and continues the transferring Institution's taxable year.

(2) *Transfers to a Bridge Bank from multiple Institutions*. If two or more Institutions transfer deposit liabilities to the same Bridge Bank, the rules in paragraph (d)(1) of this section are modified to the extent provided in this paragraph (d)(2). The Bridge Bank succeeds to the TIN and continues the taxable year of the Institution that transfers the largest amount of deposits. The taxable years of the other transferring Institutions close at the time of the transfer. If all the transferor Institutions are members of the same consolidated group, the Bridge Bank's carryback of losses to the Institution that transfers the largest amount of deposits is not limited by section 381(b)(3). The limitations of section 381(b)(3) do apply to the Bridge Bank's carrybacks of losses to all other transferor Institutions. If the transferor Institutions are not all members of the same consolidated group, the limitations of section 381(b)(3) apply with respect to all transferor Institutions. See paragraph (g)(6)(ii) of this section for additional rules that apply if two or more Institutions that are not members of the same consolidated group transfer deposit liabilities to the same Bridge Bank.

(e) *Treatment of Bridge Bank and Residual Entity as a single entity*. A Bridge Bank and its associated Residual Entity or Entities are treated as a single entity for income tax purposes and must file a single combined income tax return. The Bridge Bank is responsible for filing all income tax returns and statements for this single entity and is the agent of each associated Residual Entity to the same extent as if the Bridge Bank were the common parent of a consolidated group including the Residual Entity. The term *Institution* includes a Residual Entity that files a combined return with its associated Bridge Bank.

(f) *Rules applicable to members of consolidated groups*—(1) *Status as members*. Unless an election is made under paragraph (g) of this section, Agency Control of an Institution does not terminate the Institution's membership in a consolidated group. Stock of a subsidiary that is canceled by Agency is treated as held by the members of the consolidated group that held the stock prior to its cancellation. If an Institution is a member of a consolidated group immediately before it transfers deposit liabilities to a Bridge Bank, the Bridge Bank succeeds to the Institution's status as the common parent or, unless an election is made under paragraph (g) of this section, as a subsidiary of the group. If a Bridge Bank succeeds to an Institution's status as a subsidiary, its stock is treated as held by the shareholders of the transferring Institution, and the stock basis or excess loss account of the Institution carries over to the Bridge Bank. A Bridge Bank is treated as owning stock owned by its associated Residual Entities, including for purposes of determining membership in an affiliated group.

(2) *No 30-day election to be excluded from consolidated group*. Neither an Institution nor any of its Consolidated Subsidiaries may be excluded from a consolidated group for a

taxable year under §1.1502–76(b)(5)(ii), as contained in 26 CFR part 1 edition revised April 1, 1994, if the Institution is under Agency Control at any time during the year.

(3) *Coordination with consolidated return regulations*. The provisions of the regulations under section 597 take precedence over conflicting provisions in the regulations under section 1502.

(g) *Elective disaffiliation*—(1) *In general*. A consolidated group of which an Institution is a subsidiary may elect irrevocably not to include the Institution in its affiliated group if the Institution is placed in Agency receivership (whether or not assets or deposit liabilities of the Institution are transferred to a Bridge Bank). See paragraph (g)(6) of this section for circumstances under which a consolidated group is deemed to make this election.

(2) *Consequences of election*. If the election under this paragraph (g) is made with respect to an Institution, the following consequences occur immediately before the subsidiary Institution to which the election applies is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately before the consolidated group is deemed to make the election) and in the following order—

(i) All adjustments of the Institution and its Consolidated Subsidiaries under section 481 are accelerated;

(ii) Deferred intercompany gains and losses with respect to the Institution and its Consolidated Subsidiaries are taken into account and the Institution and its Consolidated Subsidiaries take into account any other items required under the regulations under section 1502 for members that become nonmembers within the meaning of §1.1502–32(d)(4);

(iii) The taxable year of the Institution and its Consolidated Subsidiaries closes and the Institution includes the amount described in paragraph (g)(3) of this section in income as ordinary income as its last item for that taxable year;

(iv) The members of the consolidated group owning the common stock of the Institution include in income any excess loss account with respect to the Institution's stock under §1.1502-19 and any other items required under the regulations under section 1502 for members that own stock of corporations that become nonmembers within the meaning of §1.1502–32(d)(4); and

(v) If the Institution's liabilities exceed the aggregate fair market value of its assets on the date the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, on the date the consolidated group is deemed to make the election), the members of the consolidated group treat their stock in the Institution as worthless. (See §§1.337(d)–1 and 1.1502–20 for potential limitations on the group's worthless stock deduction.) In all other cases, the consolidated group will be treated as owning stock of a nonmember corporation until such stock is disposed of or becomes worthless under rules otherwise applicable.

(3) *Toll charge*. The amount described in this paragraph (g)(3) is the excess of the Institution's liabilities over the adjusted bases of its assets immediately before the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately before the consolidated group is deemed to make the election). In computing this amount, the adjusted bases of an Institution's assets are reduced by the amount of the Institution's reserves for bad debts under section 585 or 593, other than supplemental reserves under section 593. For purposes of this paragraph (g)(3), an Institution is treated as a single entity that includes the assets and liabilities of its Consolidated Subsidiaries, with appropriate adjustments to prevent duplication. The amount described in this paragraph (g)(3) for alternative minimum tax purposes is determined using alternative minimum tax basis, deductions, and all other items required to be taken into account. In computing the increase in the group's taxable income or alternative minimum taxable income, sections 56(d)(1), 382 and 383 and §§1.1502–15, 1.1502–21 and 1.1502–22 do not limit the use of the attributes of the Institution and its Consolidated Subsidiaries to the extent, if any, that the inclusion of the amount described in this paragraph (g)(3) in income would result in the group having taxable income or alternative minimum taxable income (determined without regard to this sentence) for the taxable year. The preceding sentence does not apply to any limitation under section 382 or 383 or §§1.1502–15, 1.1502–21, or 1.1502–22 that arose in connection with or prior to a corporation becoming a Consolidated Subsidiary of the Institution.

(4) *Treatment of Institutions after disaffiliation*—(i) *In general*. If the election under this paragraph (g) is made with respect to an Institution, immediately after the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately after the consolidated group is deemed to make the election), the Institution and each of its Consolidated Subsidiaries are treated for income tax purposes as new corporations that are not members of the electing group's affiliated group. Each new corporation retains the TIN of the corresponding disaffiliated corporation and is treated as having received the assets and liabilities of the corresponding disaffiliated corporation in a transaction to which section 351 applies (and in which no gain was recognized under section 357(c) or otherwise). Thus, the new corporation has no net operating or capital loss carryforwards. An election under this paragraph (g) does not terminate the single entity treatment of a Bridge Bank and its Residual Entities provided in paragraph (e) of this section.

(ii) *FFA*. A new Institution is treated as having a non-interest bearing, nontransferable account receivable for future FFA with a basis equal to the amount described in paragraph (g)(3) of this section. If a disaffiliated Institution has a deferred FFA account at the time of its disaffiliation, the corresponding new Institution succeeds to and takes into account that deferred FFA account.

(iii) *Filing of consolidated returns*. If a disaffiliated Institution has Consolidated Subsidiaries at the time of its disaffiliation, the corresponding new Institution is required to file a consolidated income tax return with the subsidiaries in accordance with the regulations under section 1502.

(iv) *Status as Institution*. If an Institution is disaffiliated under this paragraph (g), the resulting new corporation is treated as an Institution for purposes of the regulations under section 597 regardless of whether it is a bank or domestic building and loan association within the meaning of section 597.

(v) *Loss carrybacks*. To the extent a carryback of losses would result in a refund being paid to a fiduciary under section 6402(i), an Institution or Consolidated Subsidiary with respect to which an election under this paragraph (g) (other than under paragraph (g)(6)(ii) of this section) applies is allowed to carry back losses as if the Institution or Consolidated Subsidiary had continued to be a member of the consolidated group that made the election.

(5) *Affirmative election*—(i) *Original Institution*—(A) *Manner of making election*. Except as otherwise provided in paragraph (g)(6) of this section, a consolidated group makes the election provided by this paragraph (g) by sending a written statement by certified mail to the affected Institution on or before the later of 120 days after its placement in Agency receivership or May 31, 1996. The statement must contain the following legend at the top of the page: ''THIS IS AN ELECTION UNDER §1.597–4(g) TO EXCLUDE THE BELOW-REFERENCED INSTITUTION AND CONSOLIDATED SUBSIDIARIES FROM THE AFFILIATED GROUP,'' and must include the names and taxpayer identification numbers of the common parent and of the Institution and Consolidated Subsidiaries to which the election applies, and the date on which the Institution was placed in Agency receivership. The consolidated group must send a similar statement to all subsidiary Institutions placed in Agency receivership during the consistency period described in paragraph (g)(5)(ii) of this section. (Failure to satisfy the requirement in the preceding sentence, however, does not invalidate the election with respect to any subsidiary Institution placed in Agency receivership during the consistency period described in paragraph (g)(5)(ii) of this section.) The consolidated group must include a copy of any election statement and accompanying certified mail receipt as part of its first income tax return filed after the due date under this paragraph (g)(5) for such statement. A statement must be attached to this return indicating that the individual who signed the election was authorized to do so on behalf of the consolidated group. Agency cannot make this election under the authority of section 6402(i) or otherwise.

(B) *Consistency limitation on affirmative elections*. A consolidated group may make an affirmative election under this paragraph (g)(5) with respect to a subsidiary Institution placed in Agency receivership only if the group made, or is deemed to have made, the election under this paragraph (g) with respect to every subsidiary Institution of the group placed in Agency receivership on or after May 10, 1989 and within five years preceding the date the subject Institution was placed in Agency receivership.

(ii) *Effect on Institutions placed in receivership simultaneously or subsequently*. An election under this paragraph (g), other than under paragraph (g)(6)(ii) of this section, applies to the Institution with respect to which the election is made or deemed made (the original Institution) and each subsidiary Institution of the group placed in Agency receivership or deconsolidated in contemplation of Agency Control or the receipt of FFA simultaneously with the original Institution or within five years thereafter.

(6) *Deemed Election*—(i) *Deconsolidations in contemplation*. If one or more members of a consolidated group deconsolidate (within the meaning of §1.1502-19(c)(1)(ii)(B)) a subsidiary Institution in contemplation of Agency Control or the receipt of FFA, the consolidated group is deemed to make the election described in this paragraph (g) with respect to the Institution on the date the deconsolidation occurs. A subsidiary Institution is conclusively presumed to have been deconsolidated in contemplation of Agency Control or the receipt of FFA if either event occurs within six months after the deconsolidation.

(ii) *Transfers to a Bridge Bank from multiple groups*. On the day an Institution's transfer of deposit liabilities to a Bridge Bank results in the Bridge Bank holding deposit liabilities from both a subsidiary Institution and an Institution not included in the subsidiary Institution's consolidated group, each consolidated group of which a transferring Institution or the Bridge Bank is a subsidiary is deemed to make the election described in this paragraph (g) with respect to its subsidiary Institution. If deposit liabilities of another Institution that is a subsidiary member of any consolidated group subsequently are transferred to the Bridge Bank, the consolidated group of which the Institution is a subsidiary is deemed to make the election described in this paragraph (g) with respect to that Institution at the time of the subsequent transfer.

(h) *Examples*. The following examples illustrate the provisions of this section:

Facts. Corporation X, the common parent of a consolidated group, owns all the stock (with a basis of $4 million) of Institution M, an insolvent Institution with no Consolidated Subsidiaries. At the close of business on April 30, 1996, M has $4 million of deposit liabilities, $1 million of other liabilities, and assets with an adjusted basis of $4 million and a fair market value of $3 million.

Example 1. Effect of receivership on consolidation. On May 1, 1996, Agency places M in receivership and begins liquidating M. X does not make an election under §1.597–4(g). M remains a member of the X consolidated group after May 1, 1996. Section 1.597–4(f)(1).

Example 2. Effect of Bridge Bank on consolidation—(i) *Additional facts*. On May 1, 1996, Agency places M in receivership and causes M to transfer all of its assets and deposit liabilities to Bridge Bank MB.

(ii) *Consequences without an election to disaffiliate*. M recognizes no gain or loss from the transfer and MB succeeds to M's basis in the transferred assets, M's items described in section 381(c) (subject to the conditions and limitations specified in section 381(c)) and TIN. Section 1.597–4(d)(1). (If M had a deferred FFA account, MB would also succeed to that account. Section 1.597–4(d)(1).) MB continues M's taxable year and succeeds to M's status as a member of the X consolidated group after May 1, 1996. Section 1.597–4(d)(1) and (f). MB and M are treated as a single entity for income tax purposes. Section 1.597–4(e).

(iii) *Consequences with an election to disaffiliate*. If, on July 1, 1996, X makes an election under §1.597–4(g) with respect to M, the following consequences are treated as occurring immediately before M was placed in Agency receivership. M must include $1 million ($5 million of liabilities — $4 million of adjusted basis) in income as of May 1, 1996. Section 1.597–4(g)(2) and (3). M is then treated as a new corporation that is not a member of the X consolidated group and that has assets (including a $1 million account receivable for future FFA) with a basis of $5 million and $5 million of liabilities received from disaffiliated corporation M in a section 351 transaction. New corporation M retains the TIN of disaffiliated corporation M. Section 1.597–4(g)(4). Immediately after the disaffiliation, new corporation M is treated as transferring its assets and deposit liabilities to Bridge Bank MB. New corporation M recognizes no gain or loss from the transfer and MB succeeds to M's TIN and taxable year. Section 1.597–4(d)(1). Bridge Bank MB is treated as a single entity that includes M and has $5 million of liabilities, an account receivable for future FFA with a basis of $1 million, and other assets with a basis of $4 million. Section 1.597–4(d)(1).

§1.597–5 Taxable Transfers.

(a) *Taxable Transfers*—(1) *Defined*. The term *Taxable Transfer* means—

(i) A transaction in which an entity transfers to a transferee other than a Bridge Bank—

(A) Any deposit liability (whether or not the Institution also transfers assets), if FFA is provided in connection with the transaction; or

(B) Any asset for which Agency or a Controlled Entity has any financial obligation (*e.g.*, pursuant to a Loss Guarantee or Agency Obligation); or

(ii) A deemed transfer of assets described in paragraph (b) of this section.

(2) *Scope*. This section provides rules governing Taxable Transfers. Rules applicable to both actual and deemed asset acquisitions are provided in paragraphs (c) and (d) of this section. Special rules applicable only to deemed asset acquisitions are provided in paragraph (e) of this section.

(b) *Deemed asset acquisitions upon stock purchase*—(1) *In general*. In a deemed transfer of assets under this paragraph (b), an Institution (including a Bridge Bank or a Residual Entity) or a Consolidated Subsidiary of the Institution (the Old Entity) is treated as selling all of its assets in a single transaction and is treated as a new corporation (the New Entity) that purchases all of the Old Entity's assets at the close of the day immediately preceding the occurrence of an event described in paragraph (b)(2) of this section. However, such an event results in a deemed transfer of assets under this paragraph (b) only if it occurs—

(i) In connection with a transaction in which FFA is provided;

(ii) While the Old Entity is a Bridge Bank;

(iii) While the Old Entity has a positive balance in a deferred FFA account (see §1.597–2(c)(4)(v) regarding the optional accelerated recapture of deferred FFA); or

(iv) With respect to a Consolidated Subsidiary, while the Institution of which it is a Consolidated Subsidiary is under Agency Control.

(2) *Events*. A deemed transfer of assets under this paragraph (b) results if the Old Entity—

(i) Becomes a non-member within the meaning of §1.1502–32(d)(4) of its consolidated group (other than pursuant to an election under §1.597–4(g));

(ii) Becomes a member of an affiliated group of which it was not previously a member (other than pursuant to an election under §1.597–4(g)); or

(iii) Issues stock such that the stock that was outstanding before the imposition of Agency Control or the occurrence of any transaction in connection with the provision of FFA represents 50 percent or less of the vote or value of its outstanding stock (disregarding stock described in section 1504(a)(4) and stock owned by Agency or a Controlled Entity).

(3) *Bridge Banks and Residual Entities*. If a Bridge Bank is treated as selling all of its assets to a New Entity under this paragraph (b), each associated Residual Entity is treated as simultaneously selling its assets to a New Entity in a Taxable Transfer described in this paragraph (b).

(c) *Treatment of transferor*—(1) *FFA in connection with a Taxable Transfer*. A transferor in a Taxable Transfer is treated as having directly received immediately before a Taxable Transfer any Net Worth Assistance that Agency provides to the New Entity or Acquiring in connection with the transfer. (See §1.597–2(a) and (c) for rules regarding the inclusion of FFA in income and §1.597–2(a)(1) for related rules regarding FFA provided to shareholders.) The Net Worth Assistance is treated as an asset of the transferor that is sold to the New Entity or Acquiring in the Taxable Transfer.

(2) *Amount realized in a Taxable Transfer*. In a Taxable Transfer described in paragraph (a)(1)(i) of this section, the amount realized is determined under section 1001(b) by reference to the consideration paid for the assets. In a Taxable Transfer described in paragraph (a)(1)(ii) of this section, the amount realized is the sum of the grossed-up basis of the stock acquired in connection with the Taxable Transfer (excluding stock acquired from the Old or New Entity), plus the amount of liabilities assumed or taken subject to in the deemed transfer, plus other relevant items. The grossed-up basis of the acquired stock equals the acquirors' basis in the acquired stock divided by the percentage of the Old Entity's stock (by value) attributable to the acquired stock.

(3) *Allocation of amount realized*—(i) *In general*. The amount realized under paragraph (c)(2) of this section is allocated among the assets transferred in the Taxable Transfer in the same manner as amounts are allocated among assets under §§1.338(b)–2T(b), (c)(1) and (2).

(ii) *Modifications to general rule*. This paragraph (c)(3)(ii) modifies certain of the allocation rules of paragraph (c)(3)(i) of this section. Agency Obligations and assets covered by Loss Guarantees in the hands of the New Entity or Acquiring are treated as Class II assets. Stock of a Consolidated Subsidiary is treated as a Class II asset to the extent the fair market value of the Consolidated Subsidiary's Class I and Class II assets exceeds the amount of its liabilities. The fair market value of an Agency Obligation is deemed to equal its adjusted issue price immediately before the Taxable Transfer. The fair market value of an asset covered by a Loss Guarantee immediately after the Taxable Transfer is deemed to be not less than the greater of the asset's highest guaranteed value or the highest price at which the asset can be put.

(d) *Treatment of a New Entity and Acquiring*—(1) *Purchase price*. The purchase price for assets acquired in a Taxable Transfer described in paragraph (a)(1)(i) of this section is the cost of the assets acquired. See §1.1060–1T(c)(1). The purchase price for assets acquired in a Taxable Transfer described in paragraph (a)(1)(ii) of this section is the sum of the grossed-up basis of the stock acquired in connection with the Taxable Transfer (excluding stock acquired from the Old or New Entity), plus the amount of liabilities assumed or taken subject to in the deemed transfer, plus other relevant items. The grossed-up basis of the acquired stock equals the acquirors' basis in the acquired stock divided by the percentage of the Old Entity's stock (by value) attributable to the acquired stock. FFA provided in connection with a Taxable Transfer is not included in the New Entity's or Acquiring's purchase price for the acquired assets. Any Net Worth Assistance so provided is treated as an asset of the transferor sold to the New Entity or Acquiring in the Taxable Transfer.

(2) *Allocation of basis*—(i) *In general*. Except as otherwise provided in this paragraph (d)(2), the purchase price determined under paragraph (d)(1) of this section is allocated among the assets transferred in the Taxable Transfer in the same manner as amounts are allocated among assets under §1.338(b)–2T(b), (c)(1) and (2).

(ii) *Modifications to general rule*. The allocation rules contained in paragraph (c)(3)(ii) of this section apply to the allocation of basis among assets acquired in a Taxable Transfer. No basis is allocable to Agency's agreement to provide Loss Guarantees, yield maintenance payments, cost to carry or cost of funds reimbursement payments, or expense reimbursement or indemnity payments. A New Entity's basis in assets it receives from its shareholders is determined under general principles of income taxation and is not governed by this paragraph (d).

(iii) *Allowance and recapture of additional basis in certain cases*. If the fair market value of the Class I and Class II assets acquired in a Taxable Transfer is greater than the New Entity's or Acquiring's purchase price for the acquired assets, the basis of the Class I and Class II assets equals their fair market value. The amount by which the fair market value of the Class I and Class II assets exceeds the purchase price is included ratably as ordinary income by the New Entity or Acquiring over a period of six taxable years beginning in the year of the Taxable Transfer. The New Entity or Acquiring must include as ordinary income the entire amount remaining to be recaptured under the preceding sentence in the taxable year in which an event occurs that would accelerate inclusion of an adjustment under section 481.

(iv) *Certain post-transfer adjustments*—(A) *Agency Obligations*. If an adjustment to the principal amount of an Agency Obligation or cash payment to reflect a more accurate determination of the condition of the Institution at the time of the Taxable Transfer is made before the earlier of the date the New Entity or Acquiring files its first post-transfer income tax return or the due date of that return (including extensions), the New Entity or Acquiring must adjust its basis in its acquired assets to reflect the adjustment. In making adjustments to the New Entity's or Acquiring's basis in its acquired assets, paragraph (c)(3)(ii) of this section is applied by treating an adjustment to the principal amount of an Agency Obligation pursuant to the first sentence of this paragraph (d)(2)(iv)(A) as occurring immediately before the Taxable Transfer. (See §1.597–3(c)(3) for rules regarding other adjustments to the principal amount of an Agency Obligation.)

(B) *Assets covered by a Loss Guarantee*. If, immediately after a Taxable Transfer, an asset is not covered by a Loss Guarantee but the New Entity or Acquiring has the right to designate specific assets that will be covered by a Loss Guarantee, the New Entity or Acquiring must treat any asset so designated as having been subject to the Loss Guarantee at the time of the Taxable Transfer. The New Entity or Acquiring must adjust its basis in the covered assets and in its other acquired assets to reflect the designation in the manner provided by paragraph (d)(2) of this section. The New Entity or Acquiring must make appropriate adjustments in subsequent taxable years if the designation is made after the New Entity or Acquiring files its first post-transfer income tax return or the due date of that return (including extensions) has passed.

(e) *Special rules applicable to Taxable Transfers that are deemed asset acquisitions*—(1) *Taxpayer identification numbers*. Except as provided in paragraph (e)(3) of this section, a New Entity succeeds to the TIN of the transferor in a deemed sale under paragraph (b) of this section.

(2) *Consolidated Subsidiaries*—(i) *In general*. A Consolidated Subsidiary that is treated as selling its assets in a Taxable Transfer under paragraph (b) of this section is treated as engaging immediately thereafter in a complete liquidation to which section 332 applies. The consolidated group of which the Consolidated Subsidiary is a member does not take into account gain or loss on the sale, exchange, or cancellation of stock of the Consolidated Subsidiary in connection with the Taxable Transfer.

(ii) *Certain minority shareholders*. Shareholders of the Consolidated Subsidiary that are not members of the consolidated group that includes the Institution do not recognize gain or loss with respect to shares of Consolidated Subsidiary stock retained by the shareholder. The shareholder's basis for that stock is not affected by the Taxable Transfer.

(3) *Bridge Banks and Residual Entities*—(i) *In general*. A Bridge Bank or Residual Entity's sale of assets to a New Entity under paragraph (b) of this section is treated as made by a single entity under §1.597–4(e). The New Entity deemed to acquire the assets of a Residual Entity under paragraph (b) of this section is not treated as a single entity with the Bridge Bank (or with the New Entity acquiring the Bridge Bank's assets) and must obtain a new TIN.

(ii) *Treatment of consolidated groups*. At the time of a Taxable Transfer described in paragraph (a)(1)(ii) of this section, treatment of a Bridge Bank as a subsidiary member of a consolidated group under §1.597–4(f)(1) ceases. However, the New Entity deemed to acquire the assets of a Residual Entity is a member of the selling consolidated group after the deemed sale. The group's basis or excess loss account in the stock of the New Entity that is deemed to acquire the assets of the Residual Entity is the group's basis or excess loss account in the stock of the Bridge Bank immediately before the deemed sale, as adjusted for the results of the sale.

(4) *Certain returns*. If an Old Entity without Continuing Equity is not a subsidiary of a consolidated group at the time of the Taxable Transfer, the controlling Agency must file all income tax returns for the Old Entity for periods ending on or prior to the date of the deemed sale described in paragraph (b) of this section that are not filed as of that date.

(5) *Basis limited to fair market value*. If all of the stock of the corporation is not acquired on the date of the Taxable Transfer, the Commissioner may make appropriate adjustments under paragraphs (c) and (d) of this section to the extent using a grossed-up basis of the stock of a corporation results in an aggregate amount realized for, or basis in, the assets other than the aggregate fair market value of the assets.

(f) *Examples*. The following examples illustrate the provisions of this section:

Example 1. Branch sale resulting in Taxable Transfer. (i) Institution M is a calendar year taxpayer in Agency receivership. M is not a member of a consolidated group. On January 1, 1997, M has $200 million of liabilities (including deposit liabilities) and assets with an adjusted basis of $100 million. M has no income or loss for 1997 and, except as described below, receives no FFA. On September 30, 1997, Agency causes M to transfer six branches (with assets having an adjusted basis of $1 million) together with $120 million of deposit liabilities to N. In connection with the transfer, Agency provides $121 million in cash to N.

(ii) The transaction is a Taxable Transfer in which M receives $121 million of Net Worth Assistance. Section 1.597–5(a)(1). (M is treated as directly receiving the $121 million of Net Worth Assistance immediately before the Taxable Transfer. Section 1.597–5(c)(1).) M transfers branches having a basis of $1 million and is treated as transferring $121 million in cash (the Net Worth Assistance) to N in exchange for N's assumption of $120 million of liabilities. Thus, M realizes a loss of $2 million on the transfer. The amount of the FFA M must include in its income in 1997 is limited by §1.597–2(c) to $102 million, which is the sum of the $100 million excess of M's liabilities ($200 million) over the total adjusted basis of its assets ($100 million) at the beginning of 1997, plus the $2 million excess for the taxable year, which results from the Taxable Transfer, of M's deductions (other than carryovers) over its gross income other than FFA. M must establish a deferred FFA account for the remaining $19 million of FFA. Section 1.597–2(c)(4).

(iii) N, as Acquiring, must allocate its $120 million purchase price for the assets acquired from M among those assets. Cash is a Class I asset. The branch assets are in Classes III and IV. N's adjusted basis in the cash is its amount, *i.e.,* $121 million. Section 1.597–5(d)(2). Because this amount exceeds N's purchase price for all of the acquired assets by $1 million, N allocates no basis to the other acquired assets and, under §1.597–5(d)(2), must recapture the $1 million excess at an annual rate of $166,667 in the six consecutive taxable years beginning with 1997 (subject to acceleration for certain events).

Example 2. Stock issuance by Bridge Bank causing Taxable Transfer. (i) On April 1, 1996, Institution P is placed in receivership and caused to transfer assets and liabilities to Bridge Bank PB. On August 31, 1996, the assets of PB consist of $20 million in cash, loans outstanding with an adjusted basis of $50 million and a fair market value of $40 million, and other non-financial assets (primarily branch assets and equipment) with an adjusted basis of $5 million. PB has deposit liabilities of $95 million and other liabilities of $5 million. P, the Residual Entity, holds real estate with an adjusted basis of $10 million and claims in litigation having a zero basis. P retains no deposit liabilities and has no other liabilities (except its liability to Agency for having caused its deposit liabilities to be satisfied).

(ii) On September 1, 1996, Agency causes PB to issue 100 percent of its common stock for $2 million cash to X. On the same day, Agency issues a $25 million note to PB. The note bears a fixed rate of interest in excess of the applicable federal rate in effect for September 1, 1996. Agency provides Loss Guarantees guaranteeing PB a value of $50 million for PB's loans outstanding.

(iii) The stock issuance is a Taxable Transfer in which PB is treated as selling all of its assets to a new corporation, New PB. Section 1.597–5(b)(1). PB is treated as directly receiving $25 million of Net Worth Assistance (the issue price of the Agency Obligation) immediately before the Taxable Transfer. Section 1.597–3(c)(2); §1.597–5(c)(1). The amount of FFA PB must include in income is determined under §1.597–2(a) and (c). PB in turn is deemed to transfer the note to New PB in the Taxable Transfer, together with $20 million of cash, all its loans outstanding (with a basis of $50 million) and its other non-financial assets (with a basis of $5 million). The amount realized by PB from the sale is $100 million, the amount of PB's liabilities deemed to be assumed by New PB. This amount realized equals PB's basis in its assets and thus, PB realizes no gain or loss on the transfer to New PB.

(iv) Residual Entity P also is treated as selling all its assets (consisting of real estate and claims in litigation) for $0 (the amount of consideration received by P) to a new corporation (New P) in a Taxable Transfer. Section 1.597–5(b)(3). (P's only liability is to Agency and a liability to Agency is not treated as a debt under §1.597–3(b).) Thus, P realizes a $10 million loss on the transfer to New P. The combined return filed by PB and P for 1996 will reflect a total loss on the Taxable Transfer of $10 million ($0 for PB and $10 million for P). Section 1.597–5(e)(3). That return also will reflect FFA income from the Net Worth Assistance, determined under §1.597–2(a) and (c).

(v) New PB is treated as having acquired the assets it acquired from PB for $100 million, the amount of liabilities assumed. In allocating basis among these assets, New PB treats the Agency note and the loans outstanding (which are covered by Loss Guarantees) as Class II assets. For the purpose of allocating basis, the fair market value of the Agency note is deemed to equal its adjusted issue price immediately before the transfer, $25 million. The fair market value of the loans is deemed not to be less than the guaranteed value of $50 million.

(vi) New P is treated as having acquired its assets for no consideration. Thus its basis in its assets immediately after the transfer is zero. New PB and New P are not treated as a single entity. Section 1.597–5(e)(3).

Example 3. Taxable Transfer of previously disaffiliated Institution. (i) Corporation X, the common parent of a consolidated group, owns all the stock of Institution M, an insolvent Institution with no Consolidated Subsidiaries. On April 30, 1996, M has $4 million of deposit liabilities, $1 million of other liabilities, and assets with an adjusted basis of $4 million and a fair market value of $3 million. On May 1, 1996, Agency places M in receivership. X elects under §1.597–4(g) to disaffiliate M. Accordingly, as of May 1, 1996, new corporation M is not a member of the X consolidated group. On May 1, 1996, Agency causes M to transfer all of its assets and liabilities to Bridge Bank MB. Under §1.597–4(e), MB and M are thereafter treated as a single entity which has $5 million of liabilities, an account receivable for future FFA with a basis of $1 million, and other assets with a basis of $4 million. Section 1.597–4(g)(4).

(ii) During May 1996, MB earns $25,000 of interest income and accrues $20,000 of interest expense on depositor accounts and there is no net change in deposits other than the additional $20,000 of interest expense accrued on depositor accounts. MB pays $5,000 of wage expenses and has no other items of income or expense.

(iii) On June 1, 1996, Agency causes MB to issue 100 percent of its stock to corporation Y. In connection with the stock issuance, Agency provides an Agency Obligation for $2 million and no other FFA.

(iv) The stock issuance results in a Taxable Transfer. Section 1.597–5(b). MB is treated as receiving the Agency Obligation immediately prior to the Taxable Transfer. Section 1.597–5(c)(1). MB has $1 million of basis in its account receivable for FFA. This receivable is treated as satisfied, offsetting $1 million of the $2 million of FFA provided by Agency in connection with the Taxable Transfer. The status of the remaining $1 million of FFA as includible income is determined as of the end of the taxable year under §1.597–2(c). However, under §1.597–2(b), MB obtains a $2 million basis in the Agency Obligation received as FFA.

(v) Under §1.597–5(c)(2), in the Taxable Transfer, Old Entity MB is treated as selling, to New Entity MB, all of Old Entity MB's assets, having a basis of $6,020,000 (the original $4 million of asset basis as of April 30, 1996, plus $20,000 net cash from May 1996 activities, plus $2 million in the Agency Obligation received as FFA), for $5,020,000, the amount of Old Entity MB's liabilities assumed by New Entity MB pursuant to the Taxable Transfer. Therefore, Old Entity MB recognizes, in the aggregate, a loss of $1 million from the Taxable Transfer.

(vi) Because this $1 million loss causes Old Entity MB's deductions to exceed its gross income (determined without regard to FFA) by $1 million, Old Entity MB must include in its income the $1 million of FFA not offset by the FFA receivable. Section 1.597–2(c). (As of May 1, 1996, Old Entity MB's liabilities ($5,000,000) did not exceed MB's $5 million adjusted basis of its assets. For the taxable year, MB's deductions of $1,025,000 ($1,000,000 loss from the Taxable Transfer, $20,000 interest expense and $5,000 of wage expense) exceeded its gross income (disregarding FFA) of $25,000 (interest income) by $1,000,000. Thus, under §1.597–2(c), MB includes in income the entire $1,000,000 of FFA not offset by the FFA receivable.)

(vii) Therefore, Old Entity MB's taxable income for the taxable year ending on the date of the Taxable Transfer is $0.

(viii) Residual Entity M is also deemed to engage in a deemed sale of its assets to New Entity M under §1.597–5(b)(3), but there are no tax consequences as M has no assets or liabilities at the time of the deemed sale.

(ix) Under §1.597–5(d)(1), New Entity MB is treated as purchasing Old Entity MB's assets for $5,020,000, the amount of New Entity MB's liabilities. Of this, $2,000,000 is allocated to the $2 million Agency Obligation, and $3,020,000 is allocated to the other assets New Entity MB is treated as purchasing in the Taxable Transfer.

Example 4. Loss Sharing. Institution N acquires assets and assumes liabilities of another Institution in a Taxable Transfer. Among the assets transferred are three parcels of real estate. In the hands of the transferring Institution, these assets had book values of $100,000 each. In connection with the Taxable Transfer, Agency agrees to reimburse Institution N for 80 percent of any loss (based on the original book value) realized on the disposition or charge-off of the three properties. This arrangement constitutes a Loss Guarantee. Thus, in allocating basis, Institution N treats the three parcels as Class II assets. By virtue of the arrangement with the Agency, Institution N is assured that the parcels will not be worth less to it than $80,000 each, because even if the properties are worthless, Agency will reimburse 80 percent of the loss. Although Institution could obtain payments under the Loss Guarantee if the properties are worth more, it is not guaranteed that it will realize more than $80,000. Accordingly, $80,000 is the highest guaranteed value of the three parcels. Institution N will allocate basis to the Class II assets up to their fair market value. For this purpose, the fair market value of the three parcels is not less than $80,000 each. Section 1.597–5(d)(2)(ii); §1.597–5(c)(3)(ii).

§1.597–6 Limitation on collection of income tax.

(a) *Limitation on collection where tax is borne by Agency*. If an Institution without Continuing Equity (or any of its Consolidated Subsidiaries) is liable for income tax that is attributable to the inclusion in income of FFA or gain from a Taxable Transfer, the tax will not be collected if it would be borne by

Agency. The final determination of whether the tax would be borne by Agency is within the sole discretion of the Commissioner. In determining whether tax would be borne by Agency, the Commissioner will disregard indemnity, tax-sharing, or similar obligations of Agency, an Institution, or its Consolidated Subsidiaries. Collection of the several income tax liability under §1.1502–6 from members of an Institution's consolidated group other than the Institution or its Consolidated Subsidiaries is not affected by this section. Income tax will continue to be subject to collection except as specifically limited in this section. This section does not apply to taxes other than income taxes.

(b) *Amount of tax attributable to FFA or gain on a Taxable Transfer*. For purposes of paragraph (a) of this section, the amount of income tax in a taxable year attributable to the inclusion of FFA or gain from a Taxable Transfer in the income of an Institution (or a Consolidated Subsidiary) is the excess of the actual income tax liability of the Institution (or the consolidated group in which the Institution is a member) over the income tax liability of the Institution (or the consolidated group in which the Institution is a member) determined without regard to FFA or gain or loss on the Taxable Transfer.

(c) *Reporting of uncollected tax*. A taxpayer must specify on the front page of Form 1120 (U.S. Corporate Income Tax Return), to the left of the space provided for ''Total Tax,'' the amount of income tax for the taxable year that is potentially not subject to collection under this section. If an Institution is a subsidiary member of a consolidated group, the amount specified as not subject to collection is zero.

(d) *Assessments of tax to offset refunds*. Income tax that is not collected under this section will be assessed and, thus, used to offset any claim for refund made by or on behalf of the Institution, the Consolidated Subsidiary or any other corporation with several liability for the tax.

(e) *Collection of taxes from Acquiring or a New Entity*—(1) *Acquiring*. No income tax liability (including the several liability for taxes under §1.1502–6) of a transferor in a Taxable Transfer will be collected from Acquiring.

(2) *New Entity*. Income tax liability (including the several liability for taxes under §1.1502–6) of a transferor in a Taxable Transfer will be collected from a New Entity only if stock that was outstanding in the Old Entity remains outstanding as stock in the New Entity or is reacquired or exchanged for consideration.

(f) *Effect on section 7507*. This section supersedes the application of section 7507, and the regulations thereunder, for the assessment and collection of income tax attributable to FFA.

§1.597–7 Effective date.

(a) *FIRREA effective date*. Section 597, as amended by section 1401 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Public Law 101–73, is generally effective for any FFA received or accrued by an Institution on or after May 10, 1989, and for any transaction in connection with which such FFA is provided, unless the FFA is provided in connection with an acquisition occurring prior to May 10, 1989. See §1.597–8 for rules regarding FFA received or accrued on or after May 10, 1989, that relates to an acquisition that occurred before May 10, 1989.

(b) *Effective date of regulations*. Except as otherwise provided in this section, §§1.597–1 through 1.597–6 apply to taxable years ending on or after April 22, 1992. However, the provisions of §§1.597–1 through 1.597–6 do not apply to FFA received or accrued for taxable years ending on or after April 22, 1992, in connection with an Agency assisted acquisition within the meaning of Notice 89–102 (1989–2 C.B. 436; see §601.601(d)(2)) (which does not include a transfer to a Bridge Bank), that occurs before April 22, 1992. Taxpayers not subject to §§1.597–1 through 1.597–6 must comply with an interpretation of the statute that is reasonable in light of the legislative history and applicable administrative pronouncements. For this purpose, the rules contained in Notice 89–102 apply to the extent provided in the Notice.

(c) *Elective application to prior years and transactions*—(1) *In general*. Except as limited in this paragraph (c), an election is available to apply §§1.597–1 through 1.597–6 to taxable years prior to the general effective date of these regulations. A consolidated group may elect to apply §§1.597–1 through 1.597–6 for all members of the group in all taxable years to which section 597, as amended by FIRREA, applies. The common parent makes the election for the group. An entity that is not a member of a consolidated group may elect to apply §§1.597–1 through 1.597–6 to all taxable years to which section 597, as amended by FIRREA, applies for which it is not a member of a consolidated group. The election is irrevocable.

(2) *Election unavailable in certain cases*—(i) *Statute of limitations closed*. The election cannot be made if the period for assessment and collection of tax has expired under the rules of section 6501 for any taxable year in which §§1.597–1 through 1.597–6 would affect the determination of the electing entity's or group's income, deductions, gain, loss, basis, or other items.

(ii) *No section 338 election under Notice 89–102*. The election cannot be made with respect to an Institution if, under Notice 89–102, it was a Target with respect to which a qualified stock purchase was made, a timely election under section 338 was not made, and on April 22, 1992, a timely election under section 338 could not be made.

(iii) *Inconsistent treatment of Institution that would be New Entity*. If, under §1.597–5(b), an Institution would become a New Entity before April 22, 1992, the election cannot be made with respect to that Institution unless elections are made by all relevant persons such that §§1.597–1 through §1.597–6 apply both before and after the deemed sale under §1.597–5. However, this requirement does not apply if, under §§1.597–1 through §1.597–6, the Institution would not have Continuing Equity prior to the deemed sale.

(3) *Expense reimbursements*. Notice 89–102, 1989–2 C.B. 436, provides that reimbursements paid or accrued pursuant to an expense reimbursement or indemnity arrangement are not included in income but the taxpayer may not deduct, or otherwise take into account, the item of cost or expense to which the reimbursement or indemnity payment relates. With respect to an Agency assisted acquisition within the meaning of Notice 89–102 that occurs before April 22, 1992, a taxpayer that elects to apply these regulations retroactively under this paragraph (c) may continue to account for these items under the rules of Notice 89–102.

(4) *Procedural rules*—(i) *Manner of making election*. An Institution or consolidated group makes the election provided by this paragraph (c) by attaching a written statement to, and including it as a part of, the taxpayer's or consolidated group's first annual income tax return filed on or after March 15, 1996. The statement must contain the following legend at the top of the page: ''THIS IS AN ELECTION UNDER §1.597–7(c),'' and must contain the name, address and employer identification number of the taxpayer or common parent making the election. The statement must include a declaration that ''TAXPAYER AGREES TO EXTEND THE STATUTE OF LIMITATIONS ON ASSESSMENT FOR THREE YEARS FROM THE DATE OF THE FILING OF THIS ELECTION UNDER §1.597–7(c), IF THE LIMITATIONS PERIOD WOULD EXPIRE EARLIER WITHOUT SUCH EXTENSION, FOR ANY ITEMS AFFECTED IN ANY TAXABLE YEAR BY THE FILING OF THIS ELECTION,'' and a declaration that either ''AMENDED RETURNS WILL BE FILED FOR ALL TAXABLE YEARS AFFECTED BY THE FILING OF THIS ELECTION WITHIN 180 DAYS OF MAKING THIS STATEMENT, UNLESS SUCH REQUIREMENT IS WAIVED IN WRITING BY THE DISTRICT DIRECTOR OR HIS DELEGATE'' or ''ALL RETURNS PREVIOUSLY FILED ARE CONSISTENT WITH THE PROVISIONS OF §§1.597–1 THROUGH 1.597–6,'' and be signed by an individual who is authorized to make the election under this paragraph (c) on behalf of the taxpayer. An election with respect to a consolidated group must be made by the common parent of the group, not Agency, and applies to all members of the group.

(ii) *Effect of elective disaffiliation*. To make the affirmative election described in §1.597–4(g)(5) for an Institution placed in Agency receivership in a taxable year ending before April 22, 1992, the consolidated group must send the affected Institution the statement described in §1.597–4(g)(5) on or before May 31, 1996. Notwithstanding the requirements of paragraph (c)(4)(i) of this section, a consolidated group sending such a statement is deemed to make the election described in, and to agree to the conditions contained in, this paragraph (c). The consolidated group must nevertheless attach the statement described in paragraph (c)(4)(i) of this section to its first annual income tax return filed on or after March 15, 1996.

(d) *Reliance on prior guidance*—(1) *Notice 89–102*. Taxpayers may rely on Notice 89–102, 1989–2 C.B. 436, to the extent they acted in reliance on that Notice prior to April 22, 1992. Such reliance must be reasonable and transactions with respect to which taxpayers rely must be consistent with the overriding policies of section 597, as expressed in the legislative history.

(2) *Notice FI–46–89*—(i) *In general*. Notice FI–46–89 was published in the Federal Register on April 23, 1992 (57 FR 14804). Taxpayers may rely on the provisions of §§1.597–1 through 1.597–6 of that notice to the extent they acted in reliance on those provisions prior to December 21, 1995. Such reliance must be reasonable and transactions with respect to which taxpayers rely must be consistent with the overriding policies of section 597, as expressed in the legislative history, as well as the overriding policies of notice FI–46–89.

(ii) *Taxable Transfers*. Any taxpayer described in this paragraph (d) that, under notice FI–46–89, would be a New Entity or Acquiring with respect to a Taxable Transfer on or after April 22, 1992, and before December 21, 1995, may apply the rules of that notice with respect to such transaction.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

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

Section 301.7507–1 also issued under 26 U.S.C. 597.

Section 301.7507–9 also issued under 26 U.S.C. 597. * * *

Par. 4. Section 301.7507–1 is amended by adding paragraph (b)(4) to read as follows:

§301.7507–1 Banks and trust companies covered.

* * * * *

(b) * * *

(4) The term *ceased to do business* means the bank no longer accepts deposits or makes loans and discounts, and is winding up its affairs and is in the process of liquidating its assets to pay depositors. A bank will not be considered to have ceased to do business on account of a transaction in which the bank—

(i) Transfers assets and liabilities to a Bridge Bank in a transfer described in §1.597–4 of this chapter;

(ii) Transfers assets and liabilities to any person in a transaction to which section 381(a) applies or in which the transferee receives property with a transferred basis;

(iii) Transfers assets or liabilities to any person in a transaction in which Federal Financial Assistance (as defined in section 597) is provided to any party to the transaction, unless all the Federal Financial Assistance is deposit insurance under §301.7507–9(d); or

(iv) Transfers assets or liabilities to any person in a transaction similar to any transaction described in paragraphs (b)(4)(i) through (iii) of this section.

This paragraph (b)(4) applies to taxable years ending on or after April 22, 1992.

Par. 5. Section 301.7507–9 is amended by adding a sentence to the end of paragraph (d) to read as follows:

§301.7507–9 Termination of immunity.

* * * * * *

(d) * * * For taxable years ending on or after April 22, 1992, deposit insurance does not include Federal Financial Assistance (as defined in section 597) and other payments described in section 597(a) prior to its amendment by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and, therefore, such payments must be taken into account to determine whether a bank's assets are sufficient to meet claims of depositors.

* * * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In §602.101, paragraph (c) is amended by adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control number
* * * * * *	
1.597–2	1545–1300
1.597–4	1545–1300
1.597–6	1545–1300
1.597–7	1545–1300
* * * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 4, 1995.

Cynthia G. Beerbower,
Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1995, 60 F.R. 66091)

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for February 1996.

Rev. Rul. 96–14

This revenue ruling provides various prescribed rates for federal income tax purposes for February 1996 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 96–14 TABLE 1

Applicable Federal Rates (AFR) for February 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.32%	5.25%	5.22%	5.19%
110% AFR	5.86%	5.78%	5.74%	5.71%
120% AFR	6.40%	6.30%	6.25%	6.22%
Mid-Term				
AFR	5.61%	5.53%	5.49%	5.47%
110% AFR	6.17%	6.08%	6.03%	6.00%
120% AFR	6.75%	6.64%	6.59%	6.55%
150% AFR	8.47%	8.30%	8.22%	8.16%
175% AFR	9.91%	9.68%	9.57%	9.49%
Long-Term				
AFR	6.09%	6.00%	5.96%	5.93%
110% AFR	6.71%	6.60%	6.55%	6.51%
120% AFR	7.33%	7.20%	7.14%	7.09%

REV. RUL. 96–14 TABLE 2

Adjusted AFR for February 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.66%	3.63%	3.61%	3.60%
Mid-term adjusted AFR	4.42%	4.37%	4.35%	4.33%
Long-term adjusted AFR	5.27%	5.20%	5.17%	5.14%

REV. RUL. 95–79 TABLE 3

Rates Under Section 382 for February 1996

Adjusted federal long-term rate for the current month	5.27%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	5.46%

REV. RUL. 96–14 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for February 1996

Appropriate percentage for the 70% present value low-income housing credit	8.37%
Appropriate percentage for the 30% present value low-income housing credit	3.59%

REV. RUL. 96–14 TABLE 5

Rate Under Section 7520 for February 1996

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	6.8%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 1996. See Rev. Rul. 96–14, page 20.

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 February 1996. See Rev. Rul. 96–14, page 20.

Estimated Tax Payments for Individuals

Notice 96–5

This notice provides that the Internal Revenue Service will waive penalties for certain individuals for the 4th installment payment of estimated tax if that payment is made on or before January 22, 1996. Under § 6654(c) of the Internal Revenue Code, the due date for the 4th installment payment of estimated tax by individuals is January 15 of the following taxable year. Because January 15, 1996, is a Federal holiday, a payment of the 4th installment of estimated tax made on January 16, 1996, is considered timely.

Due to the blizzard that occurred on January 7 and 8, 1996, the 4th installment payment of estimated tax made by individuals who are residents of the District of Columbia, Connecticut, Delaware, Kentucky, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, Vermont, Virginia, and West Virginia will be considered timely if made on or before January 22, 1996. The waiver is automatic for these individuals.

Alternatively, under § 6654(h), all individuals who file their 1995 individual income tax returns on or before January 31, 1996, and pay the entire balance due with the return, do not have to make the 4th installment payment of estimated tax.

DRAFTING INFORMATION

The principal author of this notice is Margaret A. Owens of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Ms. Owens on (202) 622-6232 (not a toll-free call).

Request for Comments on Further Capitalization Guidance

Notice 96–7

This notice invites public comment on approaches the Service should consider to address issues raised under §§ 162 and 263 of the Internal Revenue Code particularly in light of *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

BACKGROUND

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263 generally prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Under § 263(a)(2), no deduction is allowed for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

In *INDOPCO*, the Supreme Court of the United States concluded that certain legal and professional fees incurred by a corporation to facilitate a friendly acquisition of the corporation created significant long-term benefits for the taxpayer and, therefore, were capital expenditures. In reaching this decision, the Court specifically rejected the argument that its decision in *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971), should be read as holding ''that *only* expenditures that create or enhance separate and distinct assets are to be capitalized under § 263.'' *INDOPCO* at 86–87 (emphasis in original). The Court further stated that ''[a]lthough the mere presence of an incidental future benefit—'*some* future aspect'—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.'' *INDOPCO* at 87 (emphasis in original).

The Service believes that the *INDOPCO* decision did not change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized. Since the decision in *INDOPCO*, the Service has issued a variety of revenue rulings applying §§ 162(a) and 263(a) to specific expenditures. For example, the Service ruled that the *INDOPCO* decision did not change the treatment of advertising costs (Rev. Rul. 92–80, 1992–2 C.B. 57), incidental repair costs (Rev. Rul. 94–12, 1994–1 C.B. 36), or severance payments (Rev. Rul. 94–77, 1994–2 C.B. 19), all of which are generally deductible under § 162.

REQUEST FOR PUBLIC COMMENT

The Service continues to receive numerous informal inquiries regarding issues of capitalization. Taxpayers should be aware that, in appropriate circumstances, they can receive private letter rulings on the deductibility or capitalization of specific expenditures. The Service welcomes comments on possible changes to the private letter ruling process that would facilitate advance resolution of these issues. In addition, the Service requests comments concerning: (1) whether general guidance clarifying the fundamental principles of capitalization would aid in resolving capitalization issues; (2) what specific approaches, principles, or issues such guidance should address; and (3) whether safe-harbor amortization periods should be provided for certain capitalizable expenditures and what data would support any suggested periods.

Written comments should be submitted by May 6, 1996. Written comments should be sent to: Internal Revenue Service, Attn: CC:DOM:CORP:R (IA-Branch 5), Room 5228, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. All materials submitted will be available for public inspection and copying. During its review of the comments, the Service will continue to process private letter rulings and continue to resolve issues under §§ 162 and 263(a) raised in examinations.

DRAFTING INFORMATION

The principal author of this notice is John Moriarty of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Mr. Moriarty on (202) 622-4950 (not a toll-free call).

Cash Balance Pension Plans

Notice 96–8

I. Purpose

This notice describes and requests comments on proposed guidance concerning the application of sections 411 and 417(e) to single sum distributions under defined benefit pension plans that are cash balance plans. The proposed guidance is being described in this notice in order to permit advance public comment in anticipation of the publication of regulations that incorporate the proposed guidance.

II. Background

A. General description of cash balance plans

In general terms, a cash balance plan is a defined benefit pension plan that defines benefits for each employee by reference to the amount of the employee's hypothetical account balance. An employee's hypothetical account balance is credited with hypothetical allocations and hypothetical earnings determined under a formula selected by the employer and set forth in the plan. These hypothetical allocations and hypothetical earnings are designed to mimic the allocations of actual contributions and actual earnings to an employee's account that would occur under a defined contribution plan. Cash balance plans often specify that hypothetical earnings (referred to in this notice as interest credits) are determined using an interest rate or rate of return under a variable outside index (*e.g.*, the annual yield on one-year Treasury securities). Most cash balance plans also are designed to permit, after termination of employment, a distribution of an employee's entire accrued benefit in the form of a single sum distribution equal to the employee's hypothetical account balance as of the date of the distribution. Many cash balance plans also provide that if distribution is in the form of an annuity, the amount of the annuity is determined by dividing the hypothetical account balance by an annuity conversion factor.

As explained below, in order to comply with sections 411(a) and 417(e) in calculating the amount of a single sum distribution under a cash balance plan, the balance of the employee's hypothetical account must be projected to normal retirement age and then the employee must be paid at least the present value, determined in accordance with section 417(e), of that projected hypothetical account balance. If a cash balance plan provides interest credits using an interest rate that is higher than the section 417(e) applicable interest rate, payment of a single sum distribution equal to the hypothetical account balance as a complete distribution of the employee's accrued benefit may result either in a violation of section 417(e) or a forfeiture in violation of section 411(a). This is because, in such a case, the present value of the employee's accrued benefit, determined using the section 417(e) applicable interest rate, will generally exceed the hypothetical account balance. The following example illustrates this potential problem.

Example. A cash balance plan provides for interest credits at a fixed rate of 8% per annum that are not conditioned on continued employment, and for annuity conversions using the section 417(e) applicable interest rate and mortality table. A fully vested employee with a hypothetical account balance of $45,000 terminates employment at age 45 and elects an immediate single sum distribution. At the time of the employee's termination, the section 417(e) applicable interest rate is 6.5%.

The projected balance of the employee's hypothetical account as of normal retirement age is $209,743. If $209,743 is discounted to age 45 at 6.5% (the section 417(e) applicable interest rate), the present value equals $59,524.

Accordingly, if the plan paid the hypothetical account balance of $45,000, instead of $59,524, the employee would receive $14,524 less than the amount to which the employee is entitled.

Even if a cash balance plan provides interest credits using an interest rate that exceeds the section 417(e) applicable interest rate, the plan can satisfy sections 417(e) and 411(a). Such a plan would provide that the amount of any single sum distribution is equal to the present value of the employee's accrued benefit determined in a manner that satisfies sections 411(a) and 417(e) even if the amount of the single sum exceeds the employee's hypothetical account balance. Thus, in the example above, the plan would satisfy sections 411(a) and 417(e) if the employee received a single sum distribution of $59,524 (the present value of the employee's accrued benefit) rather than $45,000 (the employee's hypothetical account balance).

B. Existing regulatory safe harbor for cash balance plans

Section 1.401(a)(4)–8(c) of the Income Tax Regulations, as issued in September 1991, provides a safe harbor testing method for cash balance plans. Under this method, a cash balance plan could be tested for nondiscrimination as though it were a defined contribution plan with actual allocations equal to the amount of the hypothetical allocations credited for the plan year. In order to use the safe harbor, a cash balance plan must satisfy certain design requirements that relate to the accrued benefit and valuation rules that are unique to defined benefit plans.

Comments on the September 1991 regulations expressed concern that the safe harbor plan design requirements reflected an interpretation by the Service and Treasury of the qualification requirements that, in certain cases, would require cash balance plans to pay a single sum distribution in excess of the hypothetical account balance. Guidance was requested on the circumstances in which a cash balance plan (whether or not it qualifies for safe harbor nondiscrimination testing) is permitted to distribute a single sum distribution equal to the hypothetical account balance without violating section 411(a) or 417(e).

When revised regulations under section 401(a)(4) were issued in September 1993, the safe harbor testing method for cash balance plans was left unchanged. The Preamble to those regulations indicated that the safe harbor testing method for cash balance plans had generated significant comment and that further guidance would be issued at a later date.

III. Analysis

A. Nonforfeiture and accrual rules

A cash balance plan is a defined benefit plan, not a defined contribution plan, because the benefits provided are not based solely on actual contributions and forfeitures allocated to an employee's account and the actual investment experience and expenses of the plan allocated to the account. Section 411(a)(7) defines an employee's accrued benefit differently for defined benefit plans than for defined contribution plans. Also, defined benefit plans are subject to a number of statutory provisions that do not apply to defined contribution plans. These include the rules of section 411(b)(1) that limit ''backloading'' of accruals; the valuation rules of section 417(e); and the definitely determinable benefits requirement of section 401(a)(25). These provisions limit the extent to which a cash balance plan can mimic the benefit and accrual structure of a defined contribution plan.

Under section 411(a)(2), an employee's accrued benefit must become nonforfeitable in accordance with one of the schedules specified in that section. Under §1.411(a)–7(a)(1)(ii), the term ''accrued benefits'' generally refers only to pension or retirement benefits. Under section 411(b)(1), the accrual of the retirement benefits payable at normal retirement age must satisfy one of the rules in section 411(b)(1)(A), (B) or (C).

Under a cash balance plan, the retirement benefits payable at normal retirement age are determined by reference to the hypothetical account balance as of normal retirement age, including benefits attributable to interest credits to that age. Thus, benefits attributable to interest credits must be taken into account in determining whether the accrual of the retirement benefits under a cash balance plan satisfies one of the rules in section 411(b)(1)(A), (B) or (C). Moreover, benefits attributable to interest credits are in the nature of accrued benefits within the meaning of §1.411(a)–7(a), rather than ancillary benefits, and thus, once accrued, must become nonforfeitable in accordance with a vesting schedule that satisfies section 411(a).

Cash balance plans can be categorized based on when the benefits attributable to interest credits accrue. Under one type of cash balance plan (referred to in this notice as a frontloaded interest credit plan), future interest credits to an employee's hypothetical account balance are not conditioned upon future service. (Of course, benefits attributable to future interest credits may be forfeited in accordance with the plan's vesting provisions, to the extent permitted under section 411.) Thus, in the case of a frontloaded interest credit plan, the benefits attributable to future interest credits with respect to a hypothetical allocation accrue at the same time that the benefits attributable to the hypothetical allocation accrue. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee's hypothetical account.

A second type of cash balance plan (referred to in this notice as a backloaded interest credit plan) conditions future interest credits upon further service. In the case of a backloaded interest credit plan, benefits attributable to interest credits do not accrue until the interest credits are credited to the employee's account. Because backloaded interest credit plans typically will not satisfy any of the accrual rules in section 411(b)(1)(A), (B) or (C), it is anticipated that the proposed guidance will address only frontloaded interest credit plans.

B. Single sum distributions from frontloaded interest credit plans

As indicated above, most cash balance plans are designed to permit a distribution of an employee's entire accrued benefit, after termination of employment, in the form of a single sum equal to the employee's hypothetical account balance as of the date of the distribution. In order for a defined benefit plan to satisfy section 417(e), any single sum distribution payable to an employee from the plan must not be less than the nonforfeitable portion of the present value of the employee's accrued benefit under section 411(a)(7) (determined using the applicable interest rate and mortality table under section 417(e)).

1. Determination of the accrued benefit

In the case of a frontloaded interest credit plan, an employee's accrued benefit as of any date before attainment of normal retirement age is based on the employee's hypothetical account balance as of normal retirement age, including future interest credits to that age. If such a plan specifies a fixed interest rate for use in determining future interest credits, the employee's hypothetical account balance as of normal retirement age (including future interest credits) can be calculated precisely before normal retirement age. However, if a frontloaded interest credit plan specifies a variable outside index for use in determining the amount of interest credits, the precise dollar amount of an employee's hypothetical account balance as of normal retirement age (including future interest credits to normal retirement age), and thus the precise dollar amount of the employee's accrued benefit as of any date before normal retirement age, cannot be calculated prior to normal retirement age.

A frontloaded interest credit plan that specifies a variable outside index for use in determining the amount of interest credits must prescribe the method for reflecting future interest credits in the calculation of an employee's accrued benefit. In order to comply with section 401(a)(25), the method, including actuarial assumptions, if applicable, must preclude employer discretion. Further, in determining the amount of an employee's accrued benefit, a forfeiture, within the meaning of §1.411(a)–4T, will result if the value of future interest credits is projected using a rate that understates the value of those credits or if the plan by its terms reduces the interest rate or rate of return used for projecting future interest credits. A forfeiture in violation of section 411(a) also will occur if, in determining the amount of an employee's accrued benefit, future interest credits are not taken into account (*i.e.*, there is no projection of future interest credits) and this has the same effect as using a rate that understates the value of future interest credits.

2. Calculation of the present value of the employee's accrued benefit

In the case of a frontloaded interest credit plan, a single sum distribution optional form of benefit equal to the hypothetical account balance will satisfy section 417(e) only if the single sum distribution is not less than the present value of the employee's accrued benefit calculated in accordance with the applicable interest rate and mortality table under section 417(e)(3). As noted above, the amount of the employee's accrued benefit must be determined using a method of reflecting future interest credits that satisfies section 401(a)(25) and that does not create a forfeiture in violation of section 411(a).

3. Situations in which the present value will not exceed the hypothetical account balance

A frontloaded interest credit plan might provide that the amount of interest credits is determined using a variable interest rate or rate of return that, by its terms, is no greater than the applicable interest rate under section 417(e)(3). For example, a plan that has been amended to comply with the changes to section 417(e) made by the Retirement Protection Act of 1994 (RPA '94) might provide that interest credits are determined using the lesser of the current rate of interest on 30-year Treasury securities or the current yield on 1-year Treasury Constant Maturities. Under such a plan, future interest credits can, without violating section 411(a), be projected to normal retirement age using a rate that is no greater than the applicable interest rate under section 417(e)(3). In that case, assuming that the annuity conversion factor under the plan is not less than the annuity conversion factor determined using the applicable interest rate and mortality table under section 417(e)(3), the employee's hypothetical account balance will equal or exceed the present value of the employee's accrued benefit determined in accordance with section 417(e). Thus, a single sum distribution equal to the employee's hypothetical account balance under such a plan will satisfy sections 411(a) and 417(e).

In other cases, a single sum distribution equal to an employee's hypothetical account balance will satisfy sections 417(e) and 411(a) if (a) the annuity conversion factor is not less than the annuity conversion factor determined using the applicable interest rate and mortality table under section 417(e)(3), (b) under the method for reflecting future interest credits in the calculation of an employee's accrued benefit, the future interest credits are projected using a rate that is no greater that the applicable interest rate under section 417(e)(3), and (c) this projection does not result in a forfeiture in violation of section 411(a).

By contrast, if the interest rate or rate of return under the plan used in determining the amount of interest credits is high relative to the section 417(e)(3) interest rate, the plan cannot distribute a single sum equal to the employee's hypothetical account balance and satisfy sections 411(a) and 417(e). If such a plan provided that, in determining an employee's accrued benefit, the rate used for projecting the amount of future interest credits was no greater than the interest rate under section 417(e)(3), the projection would result in a forfeiture. Alternatively, if the plan provided for interest credits to be projected using a rate that exceeded the section 417(e) interest rate but then provided for the benefit to be discounted using that same higher rate, the plan would violate section 417(e).

C. Effect of defining the accrued benefit as the hypothetical account balance

The requirements referred to in this notice apply even in the case of a cash balance plan that defines an employee's accrued benefit as an amount equal to the employee's hypothetical account balance. Section 411(a)(7) defines the accrued benefit in terms of benefits payable under the plan at normal retirement age. In a cash balance plan, for an employee who has not attained normal retirement age, whether the employee's retirement benefit payable at normal retirement age under the plan includes benefits attributable to future interest credits depends on whether those benefits have accrued.

If benefits attributable to future interest credits have accrued, and those benefits are disregarded when benefits commence before normal retirement age, the plan has effectively conditioned entitlement to the benefits attributable to those future interest credits on the employee not taking a distribution prior to normal retirement age. Pursuant to §1.411(a)–4T, a right that is conditioned under the plan on a subsequent forbearance is a forfeitable right. Accordingly, conditioning entitlement to benefits on the employee not taking a distribution violates the nonforfeitability requirements of section 411(a).

Alternatively, if the benefits attributable to future interest credits have not accrued and will accrue only as of the later dates when the interest credits are included in the hypothetical account balance, the timing of those later accruals must be taken into account in applying the accrual rules of section 411(b)(1). As a result, such a plan typically will not satisfy those accrual rules.

IV. Description of proposal

A. Variable interest rates that may be assumed for these purposes to be no greater than the 30-year Treasury interest rate

It is anticipated that the regulations will set forth a list of standard indices and associated margins for use with frontloaded interest credit plans that provide interest credits equal to the product of the balance of the hypothetical account and the current value of a variable index. (It is anticipated that this proposal will apply without regard to how frequently the rate used to determine interest credits is compounded.) Under a frontloaded interest credit plan that, for this purpose, specifies a variable index equal to the PBGC immediate rate or the sum of one of the standard indices and a margin not greater than the specified margin associated with that standard index, no impermissible forfeiture would result from projecting that the rate used to determine future interest credits for an employee is no greater than the applicable interest rate under section 417(e)(3), as amended by RPA '94. Thus, if such a plan has been amended to comply with the changes to section 417(e) made by RPA '94, the employee's entire accrued benefit could be distributed in the form of a single sum distribution equal to the employee's hypothetical account balance without violating section 411(a) or 417(e), provided that the plan provides the appropriate annuity conversion factors.

The table below provides the proposed list of standard indices and associated margins. The discount rates on Treasury bills and the yields on Treasury Constant Maturities are the rates reported in the Federal Reserve Bulletin, and the Consumer Price Index is CPI-U, as reported by the Department of Labor. Authority would be delegated to the Commissioner to approve other indices and associated margins.

Standard Index	Associated Margin
The discount rate on 3-month Treasury Bills	175 basis points
The discount rate on 6-month Treasury Bills or 12-month Treasury Bills	150 basis points
The yield on 1-year Treasury Constant Maturities	100 basis points
The yield on 2-year Treasury Constant Maturities or 3-year Treasury Constant Maturities	50 basis points
The yield on 5-year Treasury Constant Maturities or 7-year Treasury Constant Maturities	25 basis points
The yield on 10-year Treasury Constant Maturities or any longer period Treasury Constant Maturities	0 basis points
Annual rate of change of the Consumer Price Index	3 percentage points

In developing these standard indices and associated margins, the Service and Treasury took into account the historical relationship between each of these indices and the rate of interest on 30-year Treasury securities.

Under the proposal, if a frontloaded interest credit plan specified a variable index for use in determining the amount of interest credits that is equal to the sum of a standard index (listed in the table above) and a margin that exceeds the specified margin associated with that standard index, distribution of a single sum equal to the employee's hypothetical account balance would not satisfy both section 411(a) and section 417(e). If such a plan provided that the rate used for projecting the amount of future interest credits was no greater than the interest rate under section 417(e)(3), the projection would result in a forfeiture. Alternatively, if a frontloaded interest credit plan provided for interest credits to be projected using a rate that exceeded the section 417(e) interest rate but then provided for the benefit to be discounted using that same higher rate, the plan would violate section 417(e).

B. Guidance will be prospective

The anticipated regulations will be effective prospectively. In addition, for plan years beginning before the regulations are effective, a frontloaded interest credit plan would not be disqualified for failing to satisfy section 411(a) or 417(e) if the amount of the distribution satisfied those sections based on a reasonable, good-faith interpretation of the applicable provisions of the Code, taking into account pre-existing guidance. For this purpose, plans that comply with the guidance in this notice are deemed to be applying a reasonable, good faith interpretation.

V. Comments

The Service and Treasury invite comments on the proposal described in this notice. Comments are specifically requested on other indices for which guidance may be appropriate and on guidance that would facilitate the transition to use of an approved index (including possible guidance with respect to the application of section 411(d)(6)). Any suggestion of an index (and associated margin, if any) should include an analysis of the historical relationship between the index and the rate for 30-year Treasury securities. Comments should be submitted in writing, referencing Notice 96–7, and addressed to—

Associate Chief Counsel
(Employee Benefits and Exempt Organizations)
CC:EBEO
ATTN: Cash Balance Guidance
Room 5214
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, D.C. 20224

VI. Drafting information

The principal author of this notice is Marjorie Hoffman of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information, contact Ms. Hoffman at 202-622-6030 (not a toll-free number).

Weighted Average Interest Rate Update

Notice 96–9

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for December 1995 is 6.06 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
January	1996	7.05	6.35 to 7.62	6.35 to 7.76

Drafting Information

The principal author of this notice is Donna Prestia of the Employee Plans Division. For further information regarding this notice, call (202) 622-6076 between 2:30 and 4:00 p.m. Eastern time (not a toll-free number). Ms. Prestia's number is (202) 622-7377 (also not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Disclosure of Returns and Return Information to Procure Property or Services for Tax Administration Purposes

DL–1–95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: These proposed regulations relate to the disclosure of returns and return information in connection with the procurement of property and services for tax administration purposes. The amendments would authorize the Department of Justice, including offices of United States Attorneys, to make such disclosures. Current disclosure authority within the Department of Justice rests only with the Tax Division. The amendments also reflect a change to the law made by the Omnibus Budget Reconciliation Act of 1990 regarding the type of services about which disclosures may be made.

DATES: Comments and requests for a public hearing must be received by March 14, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (DL–01–95), Room 5228, 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:DOM:CORP:R (DL–01–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Donald Squires, 202-622-4570 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 6103(n) of the Internal Revenue Code (Code) authorizes the disclosure of returns and return information, pursuant to regulations prescribed by the Secretary of the Treasury, ''to the extent necessary in connection with the processing, storage, transmission, and reproduction of such returns and return information, the programming, maintenance, repair, testing, and procurement of equipment, and the providing of other services, for purposes of tax administration.''

Existing regulations promulgated under this section prescribe the persons who may make such disclosures, the situations under which such disclosures may be made and the notification and safeguarding procedures to be followed when such disclosures are made. Among the persons who may make such disclosures are officers and employees of the Tax Division of the Department of Justice. The amendments would authorize such disclosures by the Department of Justice (not solely the Tax Division) to third parties who provide services for tax administration purposes under the conditions and restrictions of the regulations. The amendments would provide that, for the purpose of this section, the ''Department of Justice'' includes offices of United States Attorneys.

The amendments would also conform the regulation to the language of section 6103(n), which was amended by the Omnibus Budget Reconciliation Act of 1990 to clarify that the disclosures authorized by this section included those in connection with ''the providing of other services'' (*i.e.* services other than those related to the mechanical processing of returns and return information).

Explanation of Provisions

As currently written, 26 CFR 301.6103(n)–1 authorizes the Tax Division of the Department of Justice, among other entities and individuals, to make disclosures of returns and return information pursuant to section 6103(n) of the Internal Revenue Code. This authority allows the Tax Division to disclose tax information incident to its contracts to private parties for, among other purposes, automated litigation support services.

The Department of Justice has indicated its intention to establish an expanded automated tracking system for all monetary judgments in favor of the United States, which will be operated by a private company under contract with the Department. Although the majority of tax cases are handled by the Tax Division, there are several United States Attorneys' offices that also have litigation responsibility in the civil tax area. In addition, the Tax Division refers some judgments in tax cases to the United States Attorneys for collection. Existing regulations arguably would not permit these offices, which are technically not part of the Tax Division, to disclose tax information incident to their inclusion of tax judgments in the automated tracking system.

The proposed amendment would authorize the Department of Justice, including offices of United States Attorneys, to make disclosures to procure property and services for tax administration purposes. Any such disclosures will be made under the same conditions and restrictions already set forth in the existing regulations. By definition, any office within the Department of Justice without tax administration duties will not have occasion or authority pursuant to these regulations to make such disclosures.

The proposed amendment would also authorize disclosures in connection with ''the providing of other services,'' *i.e.*, services not related to the strict mechanical processing or manipulation of tax returns or return information. This would conform the regulations to the language of the statute, as amended by the Omnibus Budget Reconciliation Act of 1990 (Public Law 101–508, 104 Stat. 1388–353).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations is Donald Squires, Office of the Assistant Chief Counsel (Disclosure Litigation), IRS. However, other personnel from the IRS, Department of Justice and Treasury Department participated in their development.

* * * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Paragraph 2. Section 301.6103(n)–1 is amended as follows:

1. The first sentence of paragraph (a) introductory text is amended by removing the language ''Tax Division,''.

2. Paragraph (a)(2) is amended by removing the language ''or to''.

3. Paragraph (a)(2) is further amended by adding the language ''or the providing of other services,'' immediately following the text ''other property,''.

4. The concluding text following paragraph (a)(2) is amended by removing the language ''Tax Division,''.

5. The second sentence of paragraph (d) introductory text is amended by removing the language ''Tax Division,''.

6. Paragraph (d)(2) is amended by removing the language ''Tax Division,''.

7. Paragraph (e)(1) is amended by removing the language '', and'' at the end of the paragraph and adding a semicolon in its place.

8. Paragraph (e)(2) is amended by removing the period at the end of the paragraph and adding ''; and'' in its place.

9. Paragraph (e)(3) is added.

10. The authority citation immediately following §301.6103(n) is removed.

The addition reads as follows:

§301.6103(n)–1 Disclosure of returns and return information in connection with procurement of property and services for tax administration purposes.

* * * * * *

(e) * * *

(3) The term *Department of Justice* includes offices of the United States Attorneys.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 14, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 15, 1995, 60 F.R. 64402)

Notice of Proposed Rulemaking and Notice of Public Hearing

Source of Income from Sales of Inventory and Natural Resources Produced in One Jurisdiction and Sold in Another Jurisdiction

INTL–3–95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations governing the source of income from sales of natural resources or other inventory produced in the United States and sold in a foreign country or produced in a foreign country and sold in the United States. This document affects persons who produce natural resources or other inventory in the United States and sell in a foreign country, or produce natural resources or other inventory in a foreign country and sell in the United States. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of oral comments to be presented at the public hearing scheduled for April 10, 1996, at 10 a.m. must be received by March 11, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL–0003–95), Room 5228, 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:DOM:CORP:R (INTL–0003–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Consitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Anne Shelburne, (202) 622-3880; concerning submissions and the hearing, Ms. Christina Vasquez, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory

Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by February 9, 1996.

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 collection of information requirements are in proposed §§1.863–1(b)(6) and 1.863–3(e)(2). This information is required by the IRS to monitor compliance with the federal tax rules for determining the source of income from the sale of natural resources or other inventory produced in the United States and sold in a foreign country or produced in a foreign country and sold in the United States. The likely respondents are taxpayers who produce natural resources or other inventory in the United States and sell in a foreign country, or who produce natural resources or other inventory in a foreign country and sell in the United States. Responses to this collection of information are required to properly determine the source of a taxpayer's income from such sales.

Books or records relating to a collection 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.

Estimated total annual reporting burden: 1125 hours. The estimated annual burden per respondent varies from 1 hour to 5 hours, depending on individual circumstances, with an estimated average of 2.6 hours.

Estimated number of respondents: 425.

Estimated annual frequency of responses: One time per year.

Background

These proposed regulations contain rules relating to the source of income from the sale of certain natural resources and other inventory. These regulations are proposed to be effective for taxable years beginning 30 days after publication of final regulations. However, taxpayers may elect to apply these regulations for taxable years beginning after July 11, 1995.

Explanation of provisions

I. Natural resources

A. Current regulations

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning to sources within or without the United States all items of gross income, expenses, losses, and deductions other than those items specified in sections 861(a) and 862(a).

Section 1.863–1 of the existing regulations contains rules for determining the source of income derived from the sale of certain natural resources. Generally, under paragraph (b)(1) of those regulations, income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber located within the United States and from the sale by the producer of the products within or without the United States ordinarily must be included in gross income from sources within the United States. However, if a taxpayer can show to the satisfaction of the District Director that, due to peculiar conditions of production and sale or for other reasons, not all of the gross income derived therefrom should be allocated to sources within the United States, the source of the income generally is determined under the 50/50 method described in §1.863–3(b)(2) *Example 2*. The regulations do not define ''peculiar conditions of production and sale.'' In addition, §1.863–1(b)(2) permits the Commissioner to make an allocation or apportionment that more clearly reflects the proper source of a taxpayer's income, if the Commissioner determines that the application of paragraph (b)(1) does not result in the proper allocation or apportionment of income. Similar rules apply in the case of natural resources produced without the United States and sold within the United States. See §1.863–6. Thus, income from the sale of such products ordinarily will be allocated entirely to foreign sources.

B. Issues under current regulations

The IRS and Treasury have reexamined the existing regulations under section 863 regarding natural resources and arrived at several conclusions. First, certain ambiguities in existing §1.863–1 should be clarified. For example, the regulation does not define the term ''peculiar conditions of production and sale,'' and there is virtually no authoritative guidance as to the scope of that term. To the extent that ''peculiar conditions of production and sale'' is defined narrowly, the regulation may lead to inappropriate results when determining the source of income from the sale of processed natural resources. For example, if a U.S. corporation harvests timber to manufacture furniture for export, all of its income may be from sources within the United States. However, if another U.S. corporation purchases cut timber to manufacture furniture for export from the United States, one-half of that taxpayer's income may be from sources without the United States under the 50/50 method.

Second, the interaction of the existing regulations and the recently-issued consolidated return regulations may cause inappropriate sourcing results. On July 11, 1995, the IRS and Treasury issued final regulations under §1.1502–13 [TD 8597 [1995–32 I.R.B. 6] (60 FR 36671)], treating members of a U.S. consolidated group as a single entity for purposes of determining the source of a taxpayer's income. The IRS and Treasury understand that inappropriate results may occur when the current section 863 regulations are applied to certain consolidated groups on a single entity basis. For example, a U.S. corporation that is a member of a consolidated group may extract oil abroad. The oil is then transported to the United States where it is refined by another member of the consolidated group. It is sold in the United States through other members of the consolidated group. Under §1.1502–13 of the consolidated return rules, the consolidated group is treated as a single entity, and the source of income from the sale of oil must be determined under section 863. Because the consolidated group refines the oil outside the country of extraction, it may be that peculiar conditions of production and sale exist, and the exclusive sourcing rules of paragraph (b)(1) do not apply. Thus, the taxpayer would generally determine the source of its income under the 50/50 method described in §1.863–3(b)(2) *Example 2*. Under this method, 50 percent of the consolidated group's income would be U.S. source income based on the place of sale. However, this calculation may understate the appropriate amount of the taxpayer's foreign source income because the value of the oil as extracted may represent more than 50 percent of the total value of the product that is finally sold in the United States. The preamble to the regulations under §1.1502–13 indicated that the IRS and Treasury would consider amending the regulations under section 863 to address these concerns.

Accordingly, the IRS and Treasury are issuing proposed regulations under section 863 to clarify ambiguities in the existing regulation and to address concerns created by the new §1.1502–13 regulations.

C. Proposed regulations

Section 1.863–1(b) provides special rules for determining the source of income from the sale of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, within the United States and the sale of these products without the United States. The proposed regulations also provide special rules for determining the source of income from the sale of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, without the United States and the sale of these products within the United States. The export terminal rule of paragraph (b)(1) provides that the source of gross receipts from the sale of such products equal to the fair market value of the product immediately prior to export (referred to in the proposed regulations as the export terminal) is determined according to where the farm, mine, oil or gas well, other natural deposit or timber is located. Separate rules are provided for determining the source of any gross receipts in excess of the fair market value of the product at the export terminal. Paragraph (b)(2) provides an exception to the approach of paragraph (b)(1) where, prior to export, the taxpayer engages in substantial production activities in addition to activities related to the ownership or operation of a farm, mine, oil or gas well, other natural deposit, or timber.

1. Export terminal rule

Under the export terminal rule of paragraph (b)(1), gross receipts derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, and sale of the products derived therefrom, are allocated between sources within and without the United States based on the fair market value of the product at the export terminal. The export terminal is the last point from which the product is sent from the United States to a foreign country or the last point from which goods are sent from a foreign country to the United States. For example, if a U.S. corporation extracts oil in one foreign country, sends the crude oil to a port in a second foreign country via pipeline, and delivers the oil to a U.S. refinery by ship, the export terminal would be the port in the second foreign country where the crude oil was loaded onto the ship.

Under the export terminal rule, the source of gross receipts equal to the fair market value of the product at the export terminal is determined by the location of the farm, mine, well, deposit, or uncut timber. The source of gross receipts in excess of the fair market value of the product at the export terminal (excess gross receipts) is determined according to whether the taxpayer engages in any additional production activity following export. A taxpayer will be treated as performing production activities in addition to the activities of owning or operating a farm, mine, oil or gas well, other natural deposit, or timber based on the principles of §1.954–3(a)(4). However, activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, will not be considered additional production activities. Thus, §1.863–1 *Example 2* illustrates that liquefaction of natural gas would not constitute additional production activities. In addition, activities such as delimbing and debarking trees, sorting grain, and treating and stabilizing oil would ordinarily not constitute additional production activities. In contrast, the transformation of timber into furniture is not done to prepare the natural resource itself for export, and would constitute additional production activity. Production activities are defined in §1.863–1(b)(3)(i).

If no additional production occurs following export, paragraph (b)(1)(i) requires that the source of the excess gross receipts be determined according to where the farm, mine, well, deposit, or uncut timber is located.

However, under paragraph (b)(1)(ii), if the taxpayer engages in additional production activities after the export terminal and outside the country of sale, the source of excess gross receipts is determined under the rules of §1.863–3. For example, if a U.S. corporation extracts oil in a foreign country, refines the oil in the United States, and sells the refined product in another foreign country, the source of gross receipts in excess of the fair market value of the product when it is exported from the first foreign country must be determined under one of the three methods described in §1.863–3 (*i.e.*, the 50/50 method as described in §1.863–3(b)(1), the IFP method described in §1.863–3(b)(2), or, if permitted by the District Director, the books and records method as described in §1.863–3(b)(3)).

In any case not described in either paragraph (b)(1)(i) or (ii) of the proposed regulations, the source of the excess gross receipts is determined according to the place of sale pursuant to paragraph (b)(1)(iii). This rule would apply, for example, in the case where the taxpayer engages in additional production activities in the country of sale.

Paragraph (b)(1) addresses the concerns of U.S. corporations involved in the production of natural resources abroad and the application of the new §1.1502–13 consolidated return regulations, by allowing them to treat the value of the natural resources at the point of export as income from sources where the farm, mine, well, deposit, or uncut timber is located. This rule has no effect on the rules governing foreign oil and gas extraction income under section 907(c)(1).

On November 28, 1995, the Tenth Circuit affirmed the Tax Court decision in *Phillips Petroleum v. Comm'r*, 97 T.C. 30 (1991), which held existing §1.863–1(b)(1) invalid to the extent it allocates income from the sale of U.S. natural resources solely to sources within the United States. *Phillips Petroleum v. Comm'r*, No. 94–9021 (10th Cir. Nov. 28, 1995). The IRS and Treasury will consider the implications of this decision when finalizing these proposed regulations.

2. Additional production prior to export terminal

Paragraph (b)(2) provides a special rule for determining the source of income where a taxpayer performs substantial additional production activities before the product leaves the export terminal. Under paragraph (b)(2), the source of gross receipts equal to the fair market value of the product prior to the additional production activities is based on the location of the farm, mine, well, deposit, or uncut timber. The source of gross receipts in excess of the fair market value of the products at the beginning of the additional production activities is determined under the rules of §1.863–3.

3. Other rules

The proposed regulation contains rules for determining the fair market value of relevant products. For this purpose, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Thus, these rules for determining fair market value are consistent with the foreign oil and gas rules contained in §1.907(c)–1(b)(6). In addition, fair market value determinations must be consistent with prices charged in sales, if any, to related parties in a transaction that is subject to section 482. For example, if a member of a U.S. consolidated group extracts natural resources in a foreign country and sells the natural resources to another member of the same group at the export terminal, the value of the natural resources determined at the export terminal should be the price charged by the producing member to the purchasing member for purposes of section 482.

Under paragraph (b)(5), a taxpayer's gross income from sources within or without the United States is determined by reducing its gross receipts from sources within or without the United States by the cost of goods sold properly attributable to such gross receipts. Under paragraph (c), a taxpayer's taxable income from U.S. or foreign sources must be determined under the rules of §§1.861–8 through 1.861–14T.

Under paragraph (b)(6), taxpayers must fully explain the methodology used, the facts describing substantial additional production activities (if any), and the determination of fair market value in a statement attached to the taxpayer's return. In addition, taxpayers must provide such other information as is required by §1.863–3(e)(2).

Taxpayers may elect to apply the rules of these regulations for taxable years beginning after July 11, 1995. Otherwise, these regulations are effective for taxable years beginning 30 days after the publication of this regulation as a final regulation.

II. Inventory other than natural resources

A. Current regulations

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning to sources within or without the United States all items of gross income, expenses, losses, and deductions other than those specified in sections 861(a) and 862(a).

Section 1.863–3 of the current regulations governs the source of income from the sale of inventory produced (in whole or in part) in the United States and sold in a foreign country, or produced (in whole or in part) in a foreign country and sold in the United States (Section 863 Sales). Section 1.863–3 provides three methods, set forth in the form of three examples, to determine the source of income from Section 863 Sales.

§1.861–3(b)(2) *Example 1* of the current regulations illustrates how an independent factory or production price (IFP) applies to determine the income attributable to production (IFP method). An IFP generally is established if a taxpayer regularly sells part of its output to wholly independent distributors in such a way as to reasonably reflect the income attributable to production activity. If an IFP exists, taxpayers must use the IFP method to determine the income attributable to production activities in both the sale establishing the IFP and in sales of similar products. See *Phillips Petroleum v. Comm'r*, 97 T.C. 30 (1991), *aff'd*, No. 94–9021 (10th Cir. Nov. 28, 1995); Rev. Rul. 88–73 (1988–2 C.B. 173). Gross receipts in excess of the IFP are attributable to sales activity. Taxpayers can otherwise establish an IFP by showing to the satisfaction of the District Director that an IFP exists. Notice 89–10 (1989–1 C.B. 631) contains additional rules regarding the application of the IFP method. Section 1.863–3(b)(2) *Example 1* of the current regulations does not provide explicit guidance as to how to determine the source of income attributable to production activities under the IFP method. However, the source of income attributable to sales activities is based generally on where title to the inventory passes to the purchaser as defined in §1.861–7(c).

Section 1.863–3(b)(2) *Example 2* of the current regulations divides a taxpayer's income from Section 863 Sales equally between production activity and sales activity (50/50 method). The source of income attributable to production activity is based on the location of the taxpayer's property. The portion of this production income attributable to sources within the United States is determined by a fraction, the numerator of which is the taxpayer's property located within the United States used to produce income from Section 863 Sales, and the denominator of which is the taxpayer's property both within the United States and within a foreign country used to produce income from Section 863 Sales. The source of the taxpayer's income attributable to sales activity is based on where title to the inventory passes to the purchaser as defined in §1.861–7(c).

Section 1.863–3(b)(2) *Example 3* of the current regulations allows a taxpayer to request permission from the District Director to use the taxpayer's books and records to allocate income to sources within and without the United States if those books reflect more clearly than the other methods the taxable income derived from sources within the United States (books and records method).

B. Issues under current regulations

On July 12, 1995, the IRS and Treasury issued regulations under §1.1502–13, treating members of a consolidated group as a single entity for purposes of determining the source of a taxpayer's income. The IRS and Treasury understand that the current section 863 regulations may raise questions when applied to certain consolidated groups on a single entity basis. The preamble to the regulations under §1.1502–13 indicated that the IRS and Treasury would reevaluate part of the regulations under section 863. As part of this process, the IRS and Treasury also have reexamined the remainder of the existing section 863 regulations and have concluded that several additional changes are necessary.

First, the existing regulations were drafted more than 70 years ago, and have not been amended to reflect the evolution of business practices. As a result, the regulations have been the source of controversies in recent years. See *Intel Corporation v. Comm'r*, 100 T.C. 39 (1993), *aff'd*, No. 94–70105 (9th Cir. Oct. 16, 1995); *Phillips Petroleum v. Comm'r*, 97 T.C. 30 (1991), 101 T.C. 78, 104 (1993) (''there have been no cases interpreting [the 50/50 method] and no administrative pronouncements regarding its application since the regulation was promulgated in 1922 except for necessary inferences to be drawn from *Intel* . . .''), *aff'd*, No. 94–9021 (10th Cir. Nov. 28, 1995). In part, these controversies may be due to the structure of the current regulations, which do not contain operative rules to describe the methods of allocating and apportioning income, but instead rely on examples.

Second, the existing regulations raise important administrative concerns. For example, the IFP method requires an analysis of each of the taxpayer's sales transactions to identify an IFP. If one or more IFPs are so identified, a second analysis is required of each of the taxpayer's sales transactions to identify which transactions are similar to the IFP sale. In some cases, this process may require a review of a multitude of transactions. The IFP method may, therefore, be difficult for both taxpayers and the government to apply. The existing 50/50 method also presents administrative concerns. For example, the 50/50 method may require the taxpayer to determine the fair market value of each of its assets at the end of every tax year. Taxpayers have often commented to the IRS about the difficulties of determining the fair market value of their assets.

Third, the existing regulations result in disparate treatment of similarly situated taxpayers. Although an IFP must be used under current rules if one exists, the mandate applies only to taxpayers selling inventory to certain independent distributors. Taxpayers selling exclusively to related parties are not required to use the IFP method since the IRS may not establish an IFP based on such sales. Instead, these taxpayers use the 50/50 method to source their income from export sales. Thus, taxpayers selling inventory exclusively to related parties may be deemed to generate far more foreign source income than taxpayers selling a portion of their inventory to independent distributors, even though the two taxpayers may perform the same functions. The IRS and Treasury believe that this differing treatment of similarly situated taxpayers is not justified.

Fourth, the existing 50/50 method can result in apportionment of income that is inconsistent with the common understanding of that method. The 50/50 method is generally characterized as a method that would source export sales income one-half in the United States and one-half in a foreign country. For example, in 1984 the Treasury Department stated: ''Generally, [income derived from manufacture and sale of property] is allocated one-half on the basis of the place of manufacture and half on the basis of the place of sale . . . '' Treasury Department, Tax Reform for Fairness, Simplicity, and Economic Growth, Nov. 1984 at 364. In addition, Congress understands the 50/50 method to operate in this fashion. In 1986, the House, Senate and Conference Committees each stated: ''[Under the existing 50/50 method], half of such income generally is sourced in the country of manufacture, and half of the income is sourced on the basis of the place of sale''. House Rep. No. 426, 99th Cong. 1st Sess. 359 (1985); S. Rep. No. 313, 99th Cong. 2d Sess. 329 (1986); H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II–595 (1986). The staff of the Joint Committee on Taxation has referred to the 50/50 method as the ''production/marketing split'' and stated that under this method ''50 percent of such income generally is attributed to the place of production . . .'' Staff of the Joint Comm. on Taxation, Factors Affecting International Competitiveness of the United States 148 (1991).

The existing regulations may, however, allow taxpayers to use the 50/50 method to obtain results that are inconsistent with this common understanding. Under the existing regulations, 50 percent of the income is treated as sales income and sourced on the basis of title passage. The remaining 50 percent is treated as production income and sourced based on the location of assets. This half of the formula is not necessarily, however, limited to production assets. For example, goodwill and accounts receivables are counted as assets in allocating production income. The inclusion of sales assets in the formula allocating production income results in additional income being allocated to sales activities. The contribution of the sales assets to sales income should be reflected only in the 50 percent of the income that is allocated to sales and sourced under title passage. Thus, the production income formula should only take into account assets directly involved in the production of inventory.

B. Proposed Regulations

1. Overview

Section 1.863–3 provides rules for allocating and apportioning income from Section 863 Sales. Generally, §1.863–3(b) provides three methods for determining the amount of gross income attributable to production activity and the amount of gross income attributable to sales activity. The source of gross income attributable to each activity is then determined under the rules of paragraph (c). Paragraph (d) provides rules to determine the source of taxable income. Reporting and election rules are set forth under paragraph (e) of the proposed regulations. The proposed regulations reserve on paragraph (f) (prior paragraph (c)), dealing with income partly from sources within a possession of the United States. The IRS and Treasury solicit comments from taxpayers regarding changes that should be made to new paragraph (f) (if any) to conform to the other changes in §1.863–3.

The proposed regulations generally apply an aggregate approach in taking into account a taxpayer's interest in a partnership. The IRS and Treasury solicit comments on the appropriate treatment of partnerships, including whether there should be special rules for limited partnerships, *de minimis* interests in partnerships, and tiered partnerships.

2. Methods to determine gross income attributable to production activity and sales activity

Section 1.863–3 generally retains the three methods of the current regulations for splitting income between production and sales activity, with several modifications.

a. 50/50 method

The proposed regulations do not change the allocation of half of the taxpayer's income from Section 863 Sales to production activity and half to sales activity. As described below, the proposed regulations modify and clarify the determination of the location of assets. In addition, paragraph (b)(1) of the proposed regulations makes the 50/50 method the general rule to determine the amount of income attributable to production and sales activities. The taxpayer, however, may elect to apply the IFP method, described in paragraph (b)(2), or, with the consent of the District Director, the books and records method, described in paragraph (b)(3).

b. IFP method

By making the IFP method elective, the proposed regulations significantly reduce administrative burdens related to its application and eliminate any bias against taxpayers choosing to export through independent distributors.

Under the proposed regulations, the taxpayer may elect to apply the IFP method if it is able to establish an IFP. As in the current regulations, an IFP is fairly established by actual sales of the taxpayer if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income attributable to production activity. Once the IFP is established, it can be used to determine the amount of income attributable to production activity in other Section 863 Sales if the inventory sold in the other sales is substantially similar in physical characteristics and function, and is sold at a similar level of distribution as the inventory sold in a sale establishing an IFP. A sale will not be considered to establish an IFP if sales activity for the relevant product is significant in relation to all of the activities for that product. The IRS and Treasury intend to supersede Notice 89–10 upon publication of final regulations.

The proposed regulations would also eliminate the existing rule permitting taxpayers to otherwise establish an IFP by showing to the satisfaction of the District Director that a sale reasonably reflecting the income attributable to production exists. This ''otherwise established'' IFP is rarely, if ever, used. American Law Institute, International Aspects of United States Income Taxation 31 (1987). The IRS and Treasury solicit comments from taxpayers on the continued utility of the otherwise established IFP.

The proposed regulations omit the reference in the existing regulation to a sales branch. A taxpayer may elect to use the IFP method even if it does not maintain a sales branch in a foreign country.

c. Books and records method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the income attributable to production and sales activities. The District Director will consider a taxpayer's request if the taxpayer maintains a detailed allocation of receipts and expenditures, clearly reflecting the amount of income from production and sales activities.

The books and records method is rarely, if ever, used. American Law Institute, International Aspects of United States Income Taxation, 31 (1987). The IRS and Treasury solicit comments from taxpayers on the continued utility of the books and records method, or whether the books and records method should be replaced by another method of economic sourcing.

3. Determination of source of gross income

Unlike the current regulations which provide specific rules for determining the source of income attributable to production activity and sales activity only for purposes of the 50/50 method, the proposed regulations adopt rules applicable to each of the three methods. Under the proposed regulations, once gross income attributable to production activity and sales activity has been determined under one of the methods described in paragraph (b), the source of the income is determined separately for each type of income under paragraph (c). The source of gross income attributable to production activity is determined under paragraph (c)(1), based on the location of production assets, and the source of gross income attributable to sales activity is determined under paragraph (c)(2) based on the location of the sale.

a. Source of gross income attributable to production activity

The proposed regulations generally adopt the approach set forth in the current regulations under the 50/50 method, but with modifications and clarifications.

Under §1.863–3(c)(1), the source of income attributable to production activity is determined based on the location of the taxpayer's production assets. Thus, if a taxpayer manufactures inventory exclusively in the United States, all of its income attributable to production activity will be considered from sources within the United States. The rules described below are intended to apply only to taxpayers that produce inventory both within and without the United States.

Under the proposed regulations, the source of a taxpayer's income from production activities is determined by reference to the taxpayer's production assets, instead of all of its assets that produce income from Section 863 Sales. The IRS and Treasury believe that this change is appropriate to ensure that the source of production income corresponds to the location of production activity. Production assets are defined to include tangible and intangible property owned by the taxpayer that are used to produce inventory sold in Section 863 Sales. Any property not directly used to produce inventory is excluded. Thus, accounts receivable and marketing intangibles are excluded because they are sales assets and not production assets. Other assets excluded because they do not directly produce inventory are transportation assets, warehouses, inventory, work-in-process, raw materials, cash, investment assets, and stock of a subsidiary. Working capital is excluded to avoid uncertainty arising from determinations of the appropriate amount of working capital. In addition, working capital would generally be apportioned pro rata in accordance with a taxpayer's production assets. As under the current regulations, leased assets are excluded; only assets owned by the taxpayer are included.

The proposed regulations also provide specific rules for determining where a production asset is located. Tangible assets are located where the assets are used by the taxpayer. Intangible assets are located where the tangible production assets to which they relate are located.

Where production takes place both within the United States and within a foreign country, the regulations apply a property fraction to apportion production income between U.S. and foreign sources. The taxpayer's foreign source gross production income is determined by multiplying its gross production income by a fraction, the numerator of which is the taxpayer's production assets located within a foreign country, and the denominator of which is the taxpayer's production assets located both within the United States and within a foreign country.

The current regulations generally include assets in the property formula at fair market value. The proposed regulations modify this rule to provide that an asset must be included in the property formula at its average adjusted basis (see section 1011). The IRS and Treasury believe that this change to adjusted basis will significantly simplify the application of this formula for both taxpayers and the IRS.

The proposed regulations also contain more detailed guidance than the current regulations for determining the amounts to be included in the property fraction. For example, the proposed regulations would require that if the asset is used to produce inventory sold in Section 863 Sales and is also used to produce other property, the basis of the asset must be prorated to account for such other uses.

The purpose of the property formula is to attribute the source of the taxpayer's production income to the location of its production activity. The IRS and Treasury are concerned that taxpayers may be able to affect the location of assets without changing the situs of economic activity. Accordingly, comments are solicited about whether there should be rules to prevent manipulation of this formula in a manner inconsistent with the purpose of the regulation.

b. Source of gross income attributable to sales activity

The source of gross income that is attributable to sales activity is determined under paragraph (c)(2). As under the current regulations, the source of this income is generally based on where a sale takes place. See §1.861–7(c). Accordingly, if a U.S. producer sells its goods in a foreign country, the income attributable to sales activity is generally foreign source income.

The proposed regulation would retain the language of the existing regulation, which only applies to sales that occur within a foreign country. The IRS and Treasury solicit comments as to whether the regulations should be expanded to apply to sales made in international waters or in space. The IRS and Treasury are concerned, however, that if such a change were made, a U.S. seller may try to use the 50/50 method by selling inventory in international waters to U.S. purchasers, even when the goods were destined for the United States. In view of these concerns, the IRS and Treasury also solicit comments as to whether the regulations should provide an exception to the title passage rule in the case of sales of goods produced in the United States and destined for use in the United States.

4. Determination of source of taxable income

Once the amount and source of gross income are determined under paragraph (c), taxpayers then determine the source of their taxable income. Under proposed paragraph (d), taxpayers must allocate or apportion under §§1.861–8 through 1.861–14T the amounts of expenses, losses and other deductions to its gross income determined under each method described in paragraph (b). In the case of amounts of expenses, losses and other deductions allocated or apportioned to gross income determined under the IFP method or the books and records method, the taxpayer must apply the rules of §§1.861–8 through 1.861–14T to allocate or apportion these amounts between gross income from sources within and without the United States. For amounts of expenses, losses and other deductions allocated or apportioned to gross income determined under the 50/50 method, taxpayers must apportion expenses and other deductions pro rata based on the relative amounts of U.S. and foreign source gross income. These rules are consistent with existing regulations.

5. Election and reporting rules

Under paragraph (e) of the proposed regulations, a taxpayer must use the 50/50 method unless the taxpayer elects to use the IFP method, or elects the Books and Records method. The taxpayer makes the election by using the method on its tax return. Once the tax return is filed, the election is not revokable for that year. In addition, that method must be used in later taxable years unless the Commissioner or her delegate consents to a change. Permission to change methods in later years will not be withheld unless the change would result in a substantial distortion of the source of income.

A taxpayer must fully explain the methodology used in paragraph (b), and the amount of income allocated or apportioned to U.S. and foreign sources in a statement attached to its tax return.

6. Conforming changes

The proposed regulations make conforming changes to §1.863–2 of the regulations. Under §1.863–2, the taxpayer may elect to apply the 50/50 method to its net taxable income, instead of its gross income as specified in §1.863–3. The proposed regulations clarify that income derived from the purchase of personal property within a possession of the United States and its sale within the United States is subject to these regulations only to the extent it is not excluded by §1.936–6(a)(5), Q&A 7. Other changes to §1.863–2 were intended to conform the language of the regulation to the changes in §1.863–3.

Finally, the IRS and Treasury will reconsider the existing regulations issued under section 863 regarding transportation services and cable and telegraph services in light of the Tax Reform Act of 1986. Accordingly, the transportation rules contained in §1.863–4 will only apply to services that are not described in section 863(c) and the telegraph and cable rules contained in §1.863–5 are deleted. No inference is intended as to whether portions of the existing regulations continued to apply after the Tax Reform Act of 1986.

7. Proposed effective dates

These regulations are effective for taxable years beginning 30 days after publication of final regulations. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its 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 (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 10, 1996, at 10 a.m. in the IRS Auditorium. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 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 written comments and an outline of topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 11, 1996.

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

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

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

Section 1.863–1 also issued under 26 U.S.C. 863.

Section 1.863–2 also issued under 26 U.S.C. 863.

Section 1.863–3 also issued under 26 U.S.C. 863.

Section 1.863–4 also issued under 26 U.S.C. 863.

Section 1.863–6 also issued under 26 U.S.C. 863. * * *

Par. 2. Sections 1.863–0 is added to read as follows:

§1.863–0 Table of contents.

This section lists captions contained in §§1.863–1, 1.863–2, and 1.863–3.

§1.863–1 Allocation of gross income.

§1.863–2 Allocation and apportionment of taxable income.

§1.863–3 Allocation and apportionment of income from certain sales of inventory.

Par. 3. Sections 1.863–1, 1.863–2, and 1.863–3 are revised to read as follows:

§1.863–1 Allocation of gross income.

(a) *In general*. Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United

States. See §1.863–2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in §1.863–2(a). See also sections 865(b) and 865(e)(2).

(b) *Natural resources*—(1) *In general*. Except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, are allocated between sources within or without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). Except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States are also allocated between sources within or without the United States based on the fair market value of the product at the export terminal. The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows—

(i) If the taxpayer does not engage in additional production activities (as defined in paragraph (b)(3)(ii) of this section), excess gross receipts will be from sources where the farm, mine, well, deposit, or uncut timber is located;

(ii) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under §1.863–3. For purposes of applying §1.863–3, only production assets used in additional production activity subsequent to the export terminal are taken into account; or

(iii) In all other cases, excess gross receipts will be from sources within the country of sale, as described in §1.861–7(c). This paragraph (b)(1)(iii) applies, for example, to a taxpayer that engages in additional production activities in the country of sale.

(2) *Additional production prior to export terminal*. Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under §1.863–3. For purposes of applying §1.863–3, only production assets used in the additional production activities are taken into account.

(3) *Definitions*—(i) *Production activity*. For purposes of this section, *production activity* means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See §1.864–1.

(ii) *Additional production activities*. For purposes of this section, *additional production activities* are substantial production activities performed by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer performs such additional production activities will be determined under the principles of §1.954–3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) *Export terminal*. Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped from a foreign country to the United States. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) *Determination of fair market value*. For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value under this section must be consistent with the arm's length price determined under section 482.

(5) *Determination of gross income*. To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) *Tax return disclosure*. A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by §1.863–3.

(7) *Examples*. The following examples illustrate the rules of this paragraph (b):

Example 1. No additional production. US Mines, a U.S. corporation, extracts coal in the United States and, without substantial additional production, sells the coal in a foreign country. Under §1.863–1(b) and (b)(1)(i), all of US Mines' income will be from sources within the United States.

Example 2. Scope of additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under §1.863–1(b) and (b)(1)(i), all of US Gas' income will be from sources within the United States.

Example 3. Sale in third country. US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is $40, and that US Gold ultimately sells the gold jewelry in country Y for $100. Under §1.863–1(b), $40 of US Gold's gross receipts will be allocated to sources without the United States. Under §1.863–1(b)(1)(ii), the source of the remaining $60 of gross receipts will be determined under §1.863–3. If US Gold applies the 50/50 method described in §1.863–3, $20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale. US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is $80, and that US Oil ultimately sells the refined product for $100. Under §1.863–1(b)(1), $80 of US Oil's gross receipts will be allocated to sources without the United States, and under §1.863–1(b)(1)(iii) the remaining $20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export. US Furniture, a U.S. corporation, cuts trees in the United States, converts the trees into lumber, uses the lumber to manufacture furniture in the United States, and sells the furniture in another country. Assume that the fair market value of the trees when the conversion into lumber begins is $40, and that US Furniture ultimately sells the furniture for $100. Because the conversion of the trees into lumber is an additional production activity within the United States within the meaning of §1.863–1(b)(3)(ii), the source of US Furniture's income will be determined under §1.863–1(b)(2). Thus, $40 of US Furniture's gross receipts will be allocated to sources within the United States. The source of the remaining $60 of gross receipts will be determined under §1.863–3. If US Furniture applies the 50/50 method described in §1.863–3(b)(1), $20 of cost of goods sold is properly attributable to the additional production activity, and all of US Furniture's production assets used in the additional production activity are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

(c) *Determination of taxable income*. The taxpayer's taxable income from sources within or without the United States will be determined under the rules of §§1.861–8 through 1.861–14T for determining taxable income from sources within the United States.

(d) *Effective dates*. The rules of this section will apply to taxable years beginning 30 days after publication of these regulations as final regulations. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations. For years beginning before 30 days after publication of these regulations as final regulations, see §1.863–1 (as contained in 26 CFR part 1 revised as of April 1, 1995).

§1.863–2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income*. Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income—

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold in a foreign country or produced (in whole or in part) by the taxpayer in a foreign country and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under §1.936–6(a)(5), Q&A 7.

(b) *Determination of source of taxable income*. Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to §1.863–1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see §1.863–4. To determine the source of gross income described in paragraph (a)(2) of this section, see §1.863–3. However, the principles of §1.863–3(b)(1) and (c) may be applied to determine the source of taxable income from sales of inventory property. To determine the source of income described in paragraph (a)(3) of this section, see §1.863–3(f).

(c) *Effective dates*. This section will apply to taxable years beginning 30 days after publication of these regulations as final regulations. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations. For years beginning before 30 days after publication of these regulations as final regulations, see §1.863–2 (as contained in 26 CFR part 1 revised as of April 1, 1995).

§1.863–3 Allocation and apportionment of income from certain sales of inventory.

(a) *In general*. This section applies to determine the source of income derived from the sale of inventory property (inventory) produced (in whole or in part) by a taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by a taxpayer in one or more foreign countries and sold within the United States (Section 863 Sales). For purposes of this section, a taxpayer's production activity includes production activities conducted by members of the same affiliated group as defined under section 1504(a). A taxpayer's production activity also includes production activities conducted through a partnership of which the taxpayer is a partner either directly or through one or more partnerships. A taxpayer subject to this section must divide gross income from Section 863 Sales between production activity and sales activity using one of the methods described in paragraph (b) of this section. The source of gross income from production activity and from sales activity must then be determined under paragraph (c) of this section. Taxable income from Section 863 Sales is determined under paragraph (d) of this section. Paragraph (e) of this section describes the rules for electing the methods described in paragraph (b) of this section and the information that a taxpayer must disclose on a tax return. Paragraph (f) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (g) of this section provides effective dates for the rules in this section. Once a taxpayer has elected a method described in paragraph (b) of this section, the taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales in foreign countries. In addition, the taxpayer must apply the rules of paragraphs (c) and (d) of this section by aggregating all Section 863 Sales to which a method described in paragraph (b) of this section applies. See section 865(i)(1) for the definition of inventory property; §1.861–7(c) for the time and place of sale. See also section 865(e)(2).

(b) *Methods to determine income attributable to production activity and sales activity*—(1) *50/50 method*—(i) *Determination of gross income*. Generally, gross income from Section 863 Sales will be apportioned between production activity and sales activity under the 50/50 method as described in this paragraph (b)(1). Under the 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (c)(1) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under the rules of paragraph (c)(2) of this section. In lieu of the 50/50 method, the taxpayer may elect to determine the source of income from Section 863 Sales under the IFP method described in paragraph (b)(2) of this section or, with the consent of the District Director, the books and records method described in paragraph (b)(3) of this section.

(ii) *Example*. The following example illustrates the rules of this paragraph (b)(1):

Example. *50/50 method*. (i) P, a U.S. corporation, produces widgets in the United States. P sells the widgets for $100 to D, an unrelated foreign distributor, in another country. P's cost of goods sold is $40. Thus, P's gross income is $60.

(ii) Pursuant to the 50/50 method, one-half of P's gross income, or $30, is considered income attributable to production activity, and one-half of P's gross income, or $30, is considered income attributable to sales activity.

(2) *IFP method*—(i) *Establishing an IFP*. A taxpayer may elect to allocate gross income earned from production activity and sales activity using the independent factory price (IFP) method described in this paragraph (b)(2) if an IFP is fairly established. An IFP is fairly established based on a sale by the taxpayer only if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity. A sale will not be considered to fairly establish an IFP if sales activity by the taxpayer with respect to that sale is significant in relation to all of the activities with respect to that product.

(ii) *Applying the IFP method*. If the taxpayer elects to use the IFP method, the amount of the gross sales price equal to the IFP will be treated as attributable to production activity, and the excess of the gross sales price over the IFP will be treated as attributable to sales activity. If a taxpayer elects to use the IFP method, the IFP must be applied to all Section 863 Sales of inventory that are substantially similar in physical characteristics and function, and are sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP. The IFP will only be applied to sales that are reasonably contemporaneous with the sale fairly establishing the IFP. An IFP cannot be applied to sales in other geographic markets if the markets are substantially different. The rules of this paragraph will also apply to determine the division of gross receipts between production activity and sales activity in a Section 863 Sale that itself fairly establishes an IFP. If the taxpayer elects to apply the IFP method, the IFP method must be applied to all sales for which an IFP may be fairly established for that taxable year and each subsequent taxable year. The taxpayer will apply either the 50/50 method described in paragraph (b)(1) of this section or the books and records method described in paragraph (b)(3) of this section to any other Section 863 Sale for which an IFP cannot be established or applied for each taxable year.

(iii) *Determination of gross income*. The amount of a taxpayer's gross income from production activity is determined by reducing the amount of gross receipts from production activity by the cost of goods sold properly attributable to production activity. The amount of a taxpayer's gross income from sales activity is determined by reducing the amount of gross receipts from sales activity by the cost of goods sold (if any) properly attributable to sales activity. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, and the source of gross income from sales activity will be determined under the rules of paragraph (c)(2) of this section.

(iv) *Examples*. The following examples illustrate the rules of this paragraph (b)(2):

Example 1. *IFP method*. (i) P, a U.S. producer, purchases cotton and produces cloth in the United States. P sells cloth in country X to D, a unrelated foreign clothing manufacturer, for $100. Cost of goods sold for cloth is $80, entirely attributable to production activity. P does not engage in significant sales activity in relation to its other activities in the sales to D. Under these facts, the sale to D fairly establishes an IFP of $100. Assume that P elects to use the IFP method. Accordingly, $100 of the gross sales price is treated as attributable to production activity, and no amount of income from this sale is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100-$80).

(ii) P also sells cloth in country X to A, a unrelated foreign retail outlet, for $110. Because P elected the IFP method and the cloth is substantially similar to the cloth sold to D, the IFP fairly established in the sales to D must be used to determine the amount attributable to production activity in the sale to A. Accordingly, $100 of the gross sales price is treated as attributable to production activity and $10 ($110-$100) is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100-$80) and $10 is attributable to sales activity.

Example 2. *Scope of IFP Method*. (i) USCo manufactures three dissimilar products. USCo elects to apply the IFP method. In year 1, an IFP can be established for sales of product X, but not for products Y and Z. In year 2, an IFP cannot be established for any of USCo's products. In year 3, an IFP can be established for products X and Y, but not for product Z.

(ii) In year 1, USCo must apply the IFP method to sales of product X. In year 2, although USCo's IFP election remains in effect, USCo is not required to apply the IFP election to any products. In year 3, USCo is required to apply the IFP method to sales of products X and Y.

(3) *Books and records method*. A taxpayer may elect to determine the

amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpayer's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set forth by the District Director, the District Director may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

(c) *Determination of the source of gross income from production activity and sales activity*—(1) *Income attributable to production activity*—(i) *Production only within the United States or only within foreign countries*—(A) *Source of income*. Where the taxpayer's production assets are located only within the United States or only within a foreign country, the income attributable to production activity is sourced where the taxpayer's production assets are located. For rules regarding the source of income when production assets are located both within the United States and within one or more foreign countries, see paragraph (c)(1)(ii) of this section. For purposes of this section, *production activity* means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See §1.864–1.

(B) *Definition of production assets*. For purposes of this section, production assets include only tangible and intangible assets owned by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section. Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (e.g., marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary. A partner will be treated as owning its proportionate share of the partnership's production assets, determined by reference to the partner's distributive share of partnership income for the year attributable to such production assets.

(C) *Location of production assets*. For purposes of this section, a tangible production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.

(ii) *Production both within the United States and within foreign countries*—(A) *Source of income*. Where the taxpayer's production assets are located both within the United States and within one or more foreign countries, income from sources without the United States will be determined by multiplying the income attributable to production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located in one or more foreign countries and the denominator of which is the average adjusted basis of all production assets in foreign countries and in the United States. The remaining income is treated as from sources within the United States.

(B) *Adjusted basis of production assets*. For purposes of paragraph (c)(1)(ii)(A) of this section, the adjusted basis of an asset is determined under section 1011. The average adjusted basis is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. If production assets are used to produce inventory sold in Section 863 Sales and are also used to produce other property during the taxable year, the portion of its adjusted basis that is included in the fraction described in paragraph (c)(1)(ii)(A) of this section will be determined under any method that reasonably reflects the portion of the assets that produces inventory sold in Section 863 Sales. For example, the portion of such an asset that is included in the formula may be determined by multiplying the asset's average adjusted basis by a fraction, the numerator of which is the gross receipts from sales of inventory from Section 863 Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset. For purposes of this section, a taxpayer's basis in production assets held through a partnership shall be determined by reference to the partnership's adjusted basis in its assets (including a partner's special basis adjustment, if any, under section 743).

(iii) *Examples*. The following examples illustrate the rules of this paragraph (c)(1):

Example 1. Source of production income. (i) A, a U.S. corporation, produces widgets that are sold both within the United States and within a foreign country. The initial manufacture of all widgets occurs in the United States. The second stage of production of widgets that are sold within a foreign country is completed within the country of sale. A's U.S. plant and machinery which is involved in the initial manufacture of the widgets has an average adjusted basis of $200. A also owns warehouses used to store work-in-process. A owns foreign equipment with an average adjusted basis of $25. A's gross receipts from all sales of widgets is $100, and its gross receipts from export sales of widgets is $25. Assume that apportioning average adjusted basis using gross receipts is reasonable. Assume A's cost of goods sold from the sale of widgets in the foreign countries is $13 and thus, its gross income from widgets sold in foreign countries is $12. A uses the 50/50 method to divide its gross income between production activity and sales activity.

(ii) A determines its production gross income from sources without the United States by multiplying one-half of A's $12 of gross income from sales of widgets in foreign countries, or $6, by a fraction, the numerator of which is all relevant foreign production assets, or $25, and the denominator of which is all relevant production assets, or $75 ($25 foreign assets + ($200 U.S. assets × $25 gross receipts from export sales/$100 gross receipts from all sales)). Therefore, A's gross production income from sources without the United States is $2 ($6 × ($25/$75)).

Example 2. Location of intangible property. Assume the same facts as *Example 1*, except that A employs a patented process that applies only to the initial production of widgets. In computing the formula used to determine the source of income from production activity, A's patent, if it has an average adjusted basis, would be located in the United States.

(2) *Income attributable to sales activity*. The source of the taxpayer's income that is attributable to sales activity will be determined under the provisions of §1.861–7(c).

(d) *Determination of source of taxable income*. Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion separately under §§1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Sales determined separately under each method described in paragraph (b) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Sales under §1.861–8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of §1.861–8(e)(3)-(i)(A). In the case of gross income from Section 863 Sales determined under the IFP method or the books and records method, the rules of §§1.861–8 through 1.861–14T must apply to properly allocate or apportion amounts of expenses, losses and other deductions allocated and apportioned to such gross income between gross income from sources within and without the United States. In the case of gross income from Section 863 Sales determined under the 50/50 method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under the 50/50 method.

(e) *Election and reporting rules*—(1) *Elections under paragraph (b) of this section*. If a taxpayer does not elect a method specified in paragraph (b)(2) or (3) of this section, the taxpayer must apply the method specified in paragraph (b)(1) of this section. The taxpayer may elect to apply the method specified in paragraph (b)(2) of this section by using the method on a timely filed original return (including extensions). A taxpayer may elect to apply the method specified in paragraph (b)(3) of this section by using the method on a timely filed original return (including extensions), but only if the taxpayer has received permission from the District Director to apply that method. Once a method under paragraph (b) of this section has been used, that method must be used in later taxable years unless the Commissioner consents to a change. See *e.g.*, paragraph (b)(2)(ii) *Example 2* of this section. However, if a taxpayer elects to change to or from the method specified in paragraph (b)(3) of this section, the taxpayer must obtain permission from the District Director instead of the Commissioner. Permission to change methods from one year to another year will not be withheld unless the change would result in a substantial distortion of the source of the taxpayer's income.

(2) *Disclosure on tax return*. A taxpayer who uses one of the methods described in paragraph (b) of this section must fully explain the methodology used, the circumstances justifying use of that method, the extent that sales are aggregated, and the amount of income so allocated.

(f) *Income partly from sources within a possession of the United States*. [Reserved]

(g) *Effective dates*. The rules of paragraphs (a) through (e) of this section will apply to taxable years beginning 30 days after publication of final regulations. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and before 30 days after publication of these regulations as final regulations. For years beginning before 30 days after the publication of these regulations as final regulations, see §1.863–3 (as contained in 26 CFR part 1 revised as of April 1, 1995).

Par. 4. Section 1.863–4 is amended by revising the section heading and paragraph (a) to read as follows:

§1.863–4 Certain transportation services.

(a) *General*. A taxpayer carrying on the business of transportation service (other than an activity giving rise to transportation income described in section 863(c) or to income subject to other specific provisions of this title) between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

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§1.863–5 [Removed]

Par. 5. Section 1.863–5 is removed 30 days after publication of this regulation as a final regulation.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 7, 1995, 2:00 p.m., and published in the issue of the Federal Register for December 11, 1995, 60 F.R. 63478)

Announcement of the Disbarment, Suspension, or Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Isdaner, Thomas M.	Crofton, MD	CPA	October 31, 1995 to October 30, 1996
Cacciola, Marlene	Pittsburg, CA	Enrolled Agent	November 9, 1995 to May 8, 1996
Goldman, William D.	Hot Springs, AR	Attorney	November 9, 1995 to November 8, 1996
Armstrong, David L.	Norman, OK	CPA	Indefinite from November 10, 1995
Heckathorn, Ben	Red Oak, TX	CPA/ Attorney	Indefinite from November 28, 1995
Tisdel, Linda	Seattle, WA	Enrolled Agent	November 28, 1995 to May 27, 1997
Webb, Herbert M.	Gainsville, FL	Attorney	December 21, 1995 to June 20, 1997
Hipp, Robert J.	Evanston, IL	CPA	December 28, 1995 to April 27, 1996
Ruff, James M.	Willmar, MN	CPA	January 1, 1996 to March 31, 1996
Mulkerin, John J.	Wheaton, IL	CPA	January 5, 1996 to April 4, 1996
Redwitz, Robert	Irvine, CA	CPA	February 15, 1996 to May 14, 1996
Lind, Stanley L.	Milwaukee, WI	Attorney	March 1, 1996 to February 28, 1997
Dais, Robert E.	Plano, TX	CPA	March 1, 1996 to February 28, 1997

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Muraskin, David	New York, NY	Attorney	November 6, 1995
Kelsey, Patrick	Poolesville, MD	CPA	November 13, 1995

Announcement of the Expedited Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under title 31 of the Code of Federal Regulations, section 10.76, the Director of Practice is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years, from the date the expedited proceeding is instituted, (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause; or (2) has been convicted of any crime under title 26 of the United States Code or, of a felony under title 18 of the United States Code involving dishonesty or breach of trust.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions of the applicable regulations:

Name	Address	Designation	Date of Suspension
Trebatch, Henry T.	Great Neck, NY	CPA	Indefinite from November 6, 1995
Roomberg, Alan	Minersville, PA	CPA	Indefinite from November 10, 1995
Elfenbein, Emanuel B.	Miami, FL	Enrolled Agent	Indefinite from November 27, 1995
Cerullo, Louis, J.	Boca Raton, FL	CPA	Indefinite from November 27, 1995
Fogel, Harold	St. Paul, MN	CPA	Indefinite from December 13, 1995
Glover, Paul L.	Downers Grove, IL	Attorney	Indefinite from December 13, 1995
Miller, John R.	Akron, OH	Attorney	Indefinite from December 13, 1995
Pofahl, Charles	Dallas, TX	Attorney	Indefinite from December 18, 1995
Walburg, Douglas	Mahtomedi, MN	CPA	Indefinite from December 18, 1995
Hibler, Thomas M.	Plymouth, MI	CPA/ Attorney	Indefinite from December 18, 1995
Oringer, Ronald	Flanders, NJ	CPA	Indefinite from December 29, 1995
Butcher, Frederick	Stillwater, NJ	CPA	Indefinite from December 29, 1995
Tokars, Frederic	Atlanta, GA	Attorney	Indefinite from December 29, 1995
Atkins, Sanford I.	Moreland Hills, OH	Attorney	Indefinite from December 29, 1995

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as ''rulings'') that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified, below*).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

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[1]A cumulative list of all Revenue Rulings, Revenue Procedures, Treasury Decisions, etc., published in Internal Revenue Bulletins 1995–27 through 1995–52 will be found in Internal Revenue Bulletin 1996–1, dated January 2, 1996.

Finding List of Current Action on Previously Published Items[1]

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*Denotes entry since last publication

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Superseded by
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Superseded by
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Superseded in part by
96–17, 1996–4 I.R.B. *69*

Superseded by
96–18, 1996–4 I.R.B. *73*

95–1
Superseded by
96–1, 1996–1 I.R.B. *8*

95–2
Superseded by
96–2, 1996–1 I.R.B. *60*

95–3
Superseded by
96–3, 1996–1 I.R.B. *82*

95–4
Superseded by
96–4, 1996–1 I.R.B. *94*

95–5
Superseded by
96–5, 1996–1 I.R.B. *129*

95–6
Superseded by
96–6, 1996–1 I.R.B. *151*

95–7
Superseded by
96–7, 1996–1 I.R.B. *185*

95–8
Superseded by
96–8, 1996–1 I.R.B. *187*

95–13
Superseded by
96–20, 1996–4 I.R.B. *88*

95–20
Superseded by
96–24, 1996–5 I.R.B. *28*

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96–3, 1996–1 I.R.B. *82*

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[1]A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1995–27 through 1995–52 will be found in Internal Revenue Bulletin 1996–1, dated January 2, 1996.