Internal Revenue
bulletin

Bulletin No. 2000–8
February 22, 2000

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. 2000–10, page 643.

LIFO; price indexes; department stores. The December 1999 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 1999.

T.D. 8870, page 647.

Final regulations under section 1295 of the Code relate to making and maintaining qualified electing fund (QEF) elections. Notices 88–125 and 98–22 obsoleted.

T.D. 8872, page 639.
REG–209135–88, page 681.

Temporary and proposed regulations under section 337(d) of the Code provide guidance with respect to the built-in gain of C corporation assets that become assets of a Regulated Investment Company (RIC) or a Real Estate Investment Trust (REIT) by (1) the qualification of the corporation as RIC or REIT or (2) the transfer of assets to a RIC or REIT in a carryover basis transaction. A public hearing on the proposed regulations is scheduled for May 10, 2000.

EMPLOYEE PLANS

T.D. 8871, page 641.

Final regulations under section 401(b) of the Code relate to the remedial amendment period during which an employer that maintains, or a sponsor of, a qualified retirement plan can make retroactive amendments to the plan to eliminate certain qualification defects for the entire period.

EXEMPT ORGANIZATIONS

T.D. 8874, page 644.

Final regulations under section 513 of the Code relate to travel and tour activities of tax-exempt organizations.

ADMINISTRATIVE

REG–208280–86, page 654.

Proposed regulations under section 883 of the Code provide guidance for excluding from a foreign corporation's

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
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gross income the income from international operations of ships or aircraft if the corporation is a qualified foreign corporation and the income is qualified income. A public hearing is scheduled for April 27, 2000.

REG–100276–97, page 682.

Proposed regulations under sections 860H-860L of the Code provide guidance concerning financial asset securitization investment trusts (FASITs). A public hearing is scheduled for May 15, 2000.

REG–103882–99, page 706.

Proposed regulations under section 263A of the Code provide guidance for the payor of a delay rental in deducting the delay rental as an expense or charging it to depletable capital account under section 266. A public hearing is scheduled for May 26, 2000.

REG–105279–99, page 707.

Proposed regulations under section 6071(b) of the Code extend the due date to March 31 for those electronically filed information returns having a due date of February 28. They also provide that under section 6651(h) failure to pay penalties will be reduced from 0.5% to 0.25% per month for certain individuals who enter into an installment agreement under section 6159.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

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 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 Miscellaneous.
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.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

Section 337.—Nonrecognition for Property Distributed to Parent in Complete Liquidation of Subsidiary

26 CFR 1.337(d)–5T: Tax on C assets becoming RIC or REIT assets (temporary).

T.D. 8872

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

Certain Asset Transfers to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that apply with respect to the net built-in gain of C corporation assets that become assets of a Regulated Investment Company [RIC] or Real Estate Investment Trust [REIT] by the qualification of a C corporation as a RIC or REIT or by the transfer of assets of a C corporation to a RIC or REIT in a carryover basis transaction. The regulations generally require the corporation to recognize gain as if it had sold the assets transferred or converted to RIC or REIT assets at fair market value and immediately liquidated. The regulations permit the transferee RIC or REIT to elect, in lieu of liquidation treatment, to be subject to the rules of section 1374 of the Internal Revenue Code and the regulations thereunder. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking REG–209135–88 on page 681.

DATES: *Effective Date*: These regulations are effective February 4, 2000.

Applicability Dates: For dates of applicability, see the Effective Dates portion of the preamble under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Christopher W. Schoen, (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. section 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-1672. Responses to this collection of information are required to obtain a benefit, i.e., to elect to be subject to section 1374 of the Internal Revenue Code (Code) and the regulations thereunder.

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 OMB control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions as to reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking, REG–209135–88, on page 681.

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. section 6103.

Background

Sections 631 and 633 of the Tax Reform Act of 1986 (the 1986 Act) (Public Law 99-514), as amended by sections 1006(e) and (g) of the Technical and Miscellaneous Revenue Act of 1988 (the 1988 Act) (Public Law 100-647), amended the Code to repeal the *General Utilities* doctrine. The 1986 Act amended sections 336 and 337 of the Code, generally requiring corporations to recognize gain when appreciated property is distributed in connection with a complete liquidation. Section 337(d) directs the Secretary to prescribe regulations as may be necessary to carry out the purposes of *General Utilities* repeal, including rules to "ensure that such purposes shall not be circumvented ... through the use of a regulated investment company [RIC], a real estate investment trust [REIT], or a tax exempt entity...." The transfer of the assets of a C corporation to a RIC or REIT could result in permanently removing the built-in gain inherent in those assets from the reach of the corporate income tax because RIC and REIT income is not subject to a corporate-level income tax if such income is distributed to the RIC or REIT shareholders.

Accordingly, on February 4, 1988, the IRS issued Notice 88–19 (1988–1 C.B. 486). Notice 88–19 announced that the IRS intended to promulgate regulations under the authority of section 337(d) with respect to transactions or events that result in the ownership of C corporation assets by a RIC or REIT with a basis determined by reference to the corporation's basis (a carryover basis). Notice 88–19 served as an "administrative pronouncement," and could be relied upon to the same extent as a revenue ruling or revenue procedure. Notice 88–19 also indicated that the regulations would be applicable retroactively to June 10, 1987. See also Notice 88–96 (1988–2 C.B. 420).

As a result of the issuance of Notice 88–19, many taxpayers have become uncertain about the current law applicable to their transactions, as well as the proper method of making a valid election to be subject to the rules of section 1374 and the regulations thereunder. In order to resolve this uncertainty and to provide taxpayers with guidance, the IRS and Treasury are issuing these temporary regulations.

Explanation of Provisions

These regulations implement Notice 88–19 by providing that when a C corporation (1) qualifies to be taxed as a RIC or REIT, or (2) transfers assets to a RIC or REIT in a carryover basis transaction, the C corporation is treated as if it sold all of its assets at their respective fair market

values and immediately liquidated, unless the RIC or REIT elects to be subject to tax under section 1374. Any resulting net built-in gain is recognized by the C corporation and the bases of the assets in the hands of the RIC or REIT are generally adjusted to their fair market values to reflect the recognized net built-in gain. The regulations do not permit a C corporation to recognize a net built-in loss, and, in this case, the carryover bases of the assets in the hands of the RIC or REIT are preserved.

If the RIC or REIT elects to be subject to treatment under section 1374, its built-in gain, and the corporate-level tax imposed on that gain, is subject to rules similar to the rules applying to the net income of foreclosure property of REITs.

Effective Dates

In the case of carryover basis transactions involving the transfer of property of a C corporation to a RIC or REIT, the regulations apply to transactions occurring on or after June 10, 1987. In the case of a C corporation that qualifies to be taxed as a RIC or REIT, the regulations apply to such qualifications that are effective for taxable years beginning on or after June 10, 1987.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Christopher W. Schoen of the Office of Assistant Chief Counsel (Corporate). Other personnel from the IRS and Treasury participated in their development.

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Adoption of Amendments to the Regulations

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

PART I–INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 is amended by adding an entry in numerical order to read as follows:

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

Section 1.337(d)–5T also issued under 26 U.S.C. 337. * * *

Par. 2. Section 1.337(d)–5T is added to read as follows:

§1.337(d)–5T Tax on C assets becoming RIC or REIT assets (temporary).

(a) *Treatment of C corporations*--(1) *Scope*. This section applies to the net built-in gain of C corporation assets that become assets of a RIC or REIT by—

(i) The qualification of a C corporation as a RIC or REIT; or

(ii) The transfer of assets of a C corporation to a RIC or REIT in a transaction in which the basis of such assets are determined by reference to the C corporation's basis (a carryover basis).

(2) *Net built-in gain*. Net built-in gain is the excess of aggregate gains (including items of income) over aggregate losses.

(3) *General rule*. Unless an election is made pursuant to paragraph (b) of this section, the C corporation will be treated, for all purposes including recognition of net built-in gain, as if it had sold all of its assets at their respective fair market values on the deemed liquidation date described in paragraph (a)(7) of this section and immediately liquidated.

(4) *Loss*. Paragraph(a)(3) of this section shall not apply if its application would result in the recognition of net built-in loss.

(5) *Basis adjustment*. If a corporation is subject to corporate-level tax under paragraph (a)(3) of this section, the bases of the assets in the hands of the RIC or REIT will be adjusted to reflect the recognized net built-in gain. This adjustment is made by taking the C corporation's basis in each asset, and, as appropriate, increasing it by the amount of any built-in gain attributable to that asset, or decreasing it by the amount of any built-in loss attributable to that asset.

(6) *Exception*—(i) *In general*. Paragraph (a)(3) of this section does not apply to any C corporation that—

(A) Immediately prior to qualifying to be taxed as a RIC was subject to tax as a C corporation for a period not exceeding one taxable year; and

(B) Immediately prior to being subject to tax as a C corporation was subject to the RIC tax provisions for a period of at least one taxable year.

(ii) *Additional requirement*. The exception described in paragraph (a)(6)(i) of this section applies only to assets acquired by the corporation during the year when it was subject to tax as a C corporation in a transaction that does not result in its basis in the asset being determined by reference to a corporate transferor's basis.

(7) *Deemed liquidation date*—(i) *Conversions*. In the case of a C corporation that qualifies to be taxed as a RIC or REIT, the deemed liquidation date is the last day of its last taxable year before the taxable year in which it qualifies to be taxed as a RIC or REIT.

(ii) *Carryover basis transfers*. In the case of a C corporation that transfers property to a RIC or REIT in a carryover basis transaction, the deemed liquidation date is the day before the date of the transfer.

(b) *Section 1374 treatment*—(1) *In general*. Paragraph (a) of this section will not apply if the transferee RIC or REIT elects (as described in paragraph (b)(3) of this section) to be subject to the rules of section 1374, and the regulations thereunder. The electing RIC or REIT will be subject to corporate-level taxation on the built-in gain recognized during the 10-year period on assets formerly held by the transferor C corporation. The built-in gains of electing RICs and REITs, and the corporate-level tax imposed on such gains, are subject to rules similar to the rules relating to net income from foreclosure property of REITs. See sections 857(a)(1)(A)(ii), and 857(b)(2)(B), (D), and (E). An election made under this paragraph (b) shall be irrevocable.

(2) *Ten-year recognition period*. In the case of a C corporation that qualifies to be taxed as a RIC or REIT, the 10-year recognition period described in section 1374(d)(7) begins on the first day of the

RIC's or REIT's taxable year for which the corporation qualifies to be taxed as a RIC or REIT. In the case of a C corporation that transfers property to a RIC or REIT in a carryover basis transaction, the 10-year recognition period begins on the day the assets are acquired by the RIC or REIT.

(3) *Making the election*. A RIC or REIT validly makes a section 1374 election with the following statement: "[Insert name and employer identification number of electing RIC or REIT] elects under §1.337(d)–5T(b) to be subject to the rules of section 1374 and the regulations thereunder with respect to its assets which formerly were held by a C corporation, [insert name and employer identification number of the C corporation, if different from name and employer identification number of RIC or REIT]." This statement must be signed by an official authorized to sign the income tax return of the RIC or REIT and attached to the RIC's or REIT's Federal income tax return for the first taxable year in which the assets of the C corporation become assets of the RIC or REIT.

(c) *Special rule*. In cases where the first taxable year in which the assets of the C corporation become assets of the RIC or REIT ends after June 10, 1987 but before March 8, 2000, the section 1374 election may be filed with the first Federal income tax return filed by the RIC or REIT after March 8, 2000.

(d) *Effective date*. In the case of carryover basis transactions involving the transfer of property of a C corporation to a RIC or REIT, the regulations apply to transactions occurring on or after June 10, 1987. In the case of a C corporation that qualifies to be taxed as a RIC or REIT, the regulations apply to such qualifications that are effective for taxable years beginning on or after June 10, 1987.

Par. 3. In §1.852–12, paragraph (d) is added to read as follows:

§1.852–12 Non-RIC earnings and profits.

* * * * *

(d) For treatment of net built-in gain assets of a C corporation that become assets of a RIC, see §1.337(d)–5T.

Par. 4. In §1.857–11, paragraph (e) is added to read as follows:

§1.857–11 Non-REIT earnings and profits.

* * * * *

(e) For treatment of net built-in gain assets of a C corporation that become assets of a REIT, see §1.337(d)–5T.

PART 602–OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101—OMB Control numbers.

* * * * *

(b) ***

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved January 21, 2000.

Jonathan Talisman,
Acting Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on February 4, 2000, 8:45 a.m., and published in the issue of the Federal Register for February 7, 2000, 65 F.R. 5775)

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.337(d)–5T	1545–1672
* * * * *	

Section 401.—Qualified Pensions, Profit-sharing, and Stock Bonus Plans

26 CFR 1.401(b)–1: Certain retroactive changes in plan.

T.D. 8871

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Remedial Amendment Period

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the remedial amendment period, during which a sponsor of a qualified retirement plan or an employer that maintains a qualified retirement plan can make retroactive amendments to the plan to eliminate certain qualification defects for the entire period. These final regulations clarify the scope of the Commissioner's authority to provide relief from plan disqualification under the regulations. These clarifications confirm the Commissioner's authority to provide appropriate relief for plan amendments relating to changes to the plan qualification rules made in recent legislation. These final regulations affect sponsors of qualified retirement plans, employers that maintain qualified retirement plans, and qualified retirement plan participants.

EFFECTIVE DATES: These regulations are effective February 4, 2000.

FOR FURTHER INFORMATION CONTACT: Linda S.F. Marshall at (202)622-6030 or Lisa A. Tavares at (202) 622-6090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 401(b). These regulations provide guidance to clarify the

scope of the Commissioner's authority to provide relief from plan disqualification under section 401(b) and the regulations. On August 1, 1997, temporary regulations (T.D. 8727, 1997–2 C.B. 47) under section 401(b) were published in the **Federal Register** (62 F.R. 41272). A notice of proposed rulemaking (REG–106043–97, 1997–2 C.B. 654) cross-referencing the temporary regulations, was published in the **Federal Register** (62 F.R. 41322) on the same day. The temporary regulations enabled the Commissioner to provide appropriate relief concerning the timing of plan amendments relating to changes to the plan qualification rules made in recent legislation, as well as for other plan amendments that may be needed as a result of future changes to the Internal Revenue Code (Code).

No written comments responding to the notice of proposed rulemaking were received. No public hearing was requested or held. The proposed regulations under section 401(b) are adopted by this Treasury decision, and the corresponding temporary regulations are removed.

Explanation of Provisions

Section 401(b) provides that a plan is considered to satisfy the qualification requirements of section 401(a) for the period beginning with the date on which it was put into effect, or for the period beginning with the earlier of the date on which any amendment that caused the plan to fail to satisfy those requirements was adopted or put into effect, and ending with the time prescribed by law for filing the employer's return for the taxable year in which that plan or amendment was adopted (including extensions) or such later time as the Secretary may designate, if all provisions of the plan needed to satisfy the qualification requirements are in effect by the end of the specified period and have been made effective for all purposes for the entire period.

Section 1.401(b)–1(b) lists the plan provisions that may be amended retroactively pursuant to the rules of section 401(b). These plan provisions, termed *disqualifying provisions*, include the plan provisions described in section 401(b), as well as plan provisions that result in failure of a plan to satisfy the qualification requirements of the Code by reason of a change in those requirements effected by the legislation listed in §1.401(b)–1(b)(2)(i) and (ii). Under §1.401(b)–1(b)(2)(ii), a disqualifying provision also includes a plan provision that is integral to a qualification requirement changed by specified legislation. As in effect prior to the previously issued final and temporary regulations, §1.401(b)–1(b)(2)(iii) provided that a disqualifying provision includes a plan provision that results in failure of the plan to satisfy the Code's qualification requirements by reason of a change in those requirements effected by amendments to the Code, that is designated by the Commissioner, at the Commissioner's discretion, as a disqualifying provision.

Section 1.401(b)–1(d) provides rules for determining the period for which the relief provided under section 401(b) applies (the "remedial amendment period"). Section 1.401(b)–1(d)(1) defines the beginning of the remedial amendment period for the disqualifying provisions listed in §§1.401(b)–(1)(b)(1) and 1.401(b)–1(b)(2)(i) and (ii).

The final regulations retain the rules set forth in the temporary regulations to clarify the scope of the Commissioner's authority to provide relief from plan disqualification under section 401(b). These changes are needed to clarify the rules relating to the plan provisions that may be designated by the Commissioner as disqualifying provisions based on amendments to the plan qualification requirements of the Internal Revenue Code. Section 1.401(b)–1(b)(3) retains the rule set forth in the temporary regulations to provide that a disqualifying provision includes a plan provision designated by the Commissioner, at the Commissioner's discretion, as a disqualifying provision that either (1) results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements; or (2) is integral to a qualification requirement of the Code that has been changed. Section 1.401(b)–1(c)(2) retains the rule set forth in the temporary regulations to provide the Commissioner with explicit authority to impose limits and provide additional rules regarding the amendments that may be made with respect to disqualifying provisions during the remedial amendment period. Section 1.401(b)–1(d)(1)(iv) and (v) provide conforming rules, as previously provided in the temporary regulations, regarding the beginning of the remedial amendment period for disqualifying provisions described in §1.401(b)–1(b)(3).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal authors of these regulations are Linda S. F. Marshall and Lisa A. Tavares, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.401(b)–1 is amended by:

1. Revising paragraphs (b)(3), (c), and (d)(1)(iv).

2. Adding paragraph (d)(1)(v).

The addition and revisions read as follows:

§1.401(b)–1 Certain retroactive changes in plan.

* * * * *

(b) * * *

(3) A plan provision designated by the Commissioner, at the Commissioner's discretion, as a disqualifying provision that either—

(i) Results in the failure of the plan to satisfy the qualification requirements of the Internal Revenue Code by reason of a change in those requirements; or

(ii) Is integral to a qualification requirement of the Internal Revenue Code that has been changed.

(c) *Special rules applicable to disqualifying provisions– –* (1) *Absence of plan provision*. For purposes of paragraphs (b)(2) and (3) of this section, a disqualifying provision includes the absence from a plan of a provision required by, or, if applicable, integral to the applicable change to the qualification requirements of the Internal Revenue Code, if the plan was in effect on the date the change became effective with respect to the plan.

(2) *Method of designating disqualifying provisions*. The Commissioner may designate a plan provision as a disqualifying provision pursuant to paragraph (b)(3) of this section only in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2) of this chapter.

(3) *Authority to impose limitations*. In the case of a provision that has been designated as a disqualifying provision by the Commissioner pursuant to paragraph (b)(3) of this section, the Commissioner may impose limits and provide additional rules regarding the amendments that may be made with respect to that disqualifying provision during the remedial amendment period. The Commissioner may provide guidance in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2) of this chapter.

(d) ***

(1) ***

(iv) In the case of a disqualifying provision described in paragraph (b)(3)(i) of this section, the date on which the change effected by an amendment to the Internal Revenue Code became effective with respect to the plan; or

(v) In the case of a disqualifying provision described in paragraph (b)(3)(ii) of this section, the first day on which the plan was operated in accordance with such provision, as amended, unless another time is specified by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2) of this chapter.

* * * * *

§1.401(b)–1T [Removed]

Par. 3. Section 1.401(b)–1T is removed.

John M. Dalrymple,
Acting Deputy Commissioner of Internal Revenue.

Approved January 19, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 3, 2000, 8:45 a.m., and published in the issue of the Federal Register for February 4, 2000, 65 F.R. 5432)

Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The December 1999 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 1999.

Rev. Rul. 2000–10

The following Department Store Inventory Price Indexes for December 1999 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, December 31, 1999.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS

(January 1941 = 100, unless otherwise noted)

Groups	Dec. 1998	Dec. 1999	Percent Change from Dec. 1998 to Dec. 1999[1]
1. Piece Goods	546.8	512.9	-6.2
2. Domestics and Draperies	631.2	619.5	-1.9
3. Women's and Children's Shoes	660.9	631.0	-4.5
4. Men's Shoes	905.3	887.4	-2.0
5. Infants' Wear	628.7	650.0	3.4
6. Women's Underwear	559.6	561.6	0.4
7. Women's Hosiery	304.1	325.0	6.9
8. Women's and Girls' Accessories	536.4	526.2	-1.9
9. Women's Outerwear and Girls' Wear	401.0	393.5	-1.9
10. Men's Clothing	603.3	610.1	1.1

11. Men's Furnishings	591.9	626.0	5.8
12. Boys' Clothing and Furnishings	493.7	506.4	2.6
13. Jewelry	953.0	924.8	-3.0
14. Notions	771.9	768.3	-0.5
15. Toilet Articles and Drugs	939.4	981.7	4.5
16. Furniture and Bedding	691.1	688.5	-0.4
17. Floor Coverings	602.5	602.7	0.0
18. Housewares	806.5	786.9	-2.4
19. Major Appliances	236.0	234.9	-0.5
20. Radio and Television	69.6	63.2	-9.2
21. Recreation and Education[2]	101.6	95.3	-6.2
22. Home Improvements[2]	130.6	129.3	-1.0
23. Auto Accessories[2]	107.7	107.3	-0.4
Groups 1 - 15: Soft Goods	595.0	596.7	0.3
Groups 16 - 20: Durable Goods	458.0	445.6	-2.7
Groups 21 - 23: Misc. Goods[2]	106.6	102.1	-4.2
Store Total[3]	544.8	540.2	-0.8

[1] Absence of a minus sign before the percentage change in this column signifies a price increase.
[2] Indexes on a January 1986=100 base.
[3] The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Alan J. Tomsic of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Tomsic on (202) 622-4970 (not a toll-free call).

Section 513.—Unrelated Trade or Business

26 CFR 1.513–7: Travel and tour activities of tax exempt organizations.

T.D. 8874

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Travel and Tour Activities of Tax-Exempt Organizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations clarifying when the travel and tour activities of tax-exempt organizations are substantially related to the purposes for which exemption was granted. This action provides needed guidance for tax-exempt organizations concerning when travel tour activities may be subject to tax as an unrelated trade or business. This action affects tax-exempt organizations that engage in travel tour activities.

DATES: *Effective Date*: These regulations are effective on February 7, 2000.

Applicability Date: These regulations are applicable for taxable years beginning after February 7, 2000.

FOR FURTHER INFORMATION CONTACT: Robin Ehrenberg, (202) 622-6080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On April 23, 1998, the IRS published in the **Federal Register** (63 F.R. 20156) a notice of proposed rulemaking (REG–121268–97, 1998–20 I.R.B. 12) under section 513 to clarify when the travel and tour activities of tax-exempt organizations are substantially related to the purposes for which exemption was granted. The notice of proposed rulemaking added Treas. Reg. §1.513–7, which provides that whether travel tour activities are substantially related to an organization's exempt purposes is determined by examining all the relevant facts and circumstances. The proposed regulations also contain examples applying the facts and circumstances test.

The notice of proposed rulemaking solicited comments from the public. Nineteen commentators submitted written comments. A public hearing was held on February 10, 1999, at which eight speakers presented testimony. After consideration of all the comments, the proposed regulations under section 513 are adopted as revised by this Treasury Decision. The comments and revisions are discussed below.

Explanation of Provisions and Summary of Comments

Many of the commentators welcomed the proposed regulationsas workable guidance that will promote tax compliance. Commentators differed on the approach that the IRS should adopt in final regulations. Some commentators suggested that the final regulations should adopt specific, weighted standards to be used in evaluating relatedness to exempt purpose. Other commentators recommended against adopting specific standards, arguing that no single set of standards would be appropriate given the broad range of tax-exempt organizations. One commentator suggested that the final regulations adopt a set of specific standards that would apply to test relatedness of tours in the educational context and a more general consistency standard that would evaluate whether the marketing, location, and execution of a tour are consistent with the organization's core exempt activities.

Section 513(a) generally defines an unrelated trade or business as any trade or business the conduct of which is not substantially related to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a). *See also United States v. American Bar Endowment*, 477 U.S. 105, 109-110 (1986). Treas Reg. § 1.513–1(d)(2) provides that, for the conduct of a trade or business to be substantially related to the purposes for which exemption was granted, the production or distribution of the goods or the performance of services must contribute importantly to the accomplishment of those purposes. Whether activities generating gross income contribute importantly to accomplishing any purpose for which an organization was granted exemption depends in each case upon the particular facts and circumstances. *Id*. This rule applies to travel tours.

Organizations exempt from tax under section 501(a) have diverse exempt purposes (for example: charities; social welfare organizations; labor, agricultural and horticultural organizations; business leagues; fraternal beneficiary societies). Accordingly, no one set of factors could be sufficiently comprehensive as to define relatedness for the variety of exempt organizations to which these travel tour regulations apply. Even among exempt organizations that share a common exempt purpose, such as education, the methods of accomplishing that purpose vary considerably. For this reason, the final regulations do not enumerate any specific factors that determine relatedness of travel tour activities to exempt purposes. The final regulations adopt the general facts and circumstances approach of the proposed regulations. *See e.g*, *Hi-Plains Hospital v. United States*, 670 F.2d 528 (5th Cir. 1982) (need for case-by-case analysis identifying exempt purpose and analysis of how activity in each case contributes to exempt purpose); *Louisiana Credit Union League v. United States*, 693 F.2d 525, 534 (5th Cir. 1982) (resolution of the substantial relationship test requires "an examination of the relationship between the business activities that generate the income in question ... and the accomplishment of the organization's exempt purposes"). However, as discussed below, the final regulations include new examples that provide additional guidance regarding the application of this facts and circumstances approach in both educational and noneducational contexts.

Another commentator suggested that the final regulations should clarify that the manner in which an organization develops and promotes a tour is relevant to determining whether the tour activity is substantially related to exempt purposes. The development, promotion and operation of a tour are all indicators of whether an organization's offering of a tour is related or unrelated to its exempt purpose. *See International Postgraduate Medical Found. v. Commissioner*, 1989-36 T.C. Memo., 56 T.C.M. (CCH) 1140 (1989) (brochures promoting the trips emphasized recreational sightseeing activity and omitted educational course descriptions). Language has been added to the final regulations stating that relevant facts and circumstances include (but are not limited to) how a travel tour is developed, promoted and operated. Examples in the final regulations also illustrate the relevance of these factors.

Many commentators requested more examples addressing specific areas. As noted above, examples have been added that further illustrate the application of the facts and circumstances rule. Some commentators raised concerns regarding the number of hours of related activities a travel tour must offer. Examples in the final regulation clarify that the number of hours spent on any related travel tour activity is only one factor in determining relatedness of the tour as a whole to exempt purposes and is not by itself determinative. Examples in the final regulation clarify that the nature of the related activities, and the practicalities of engaging in such activities (for example, the hours during which the activity normally would be conducted), must also be taken into account.

One commentator suggested adding an example addressing whether income from travel tour activity is a royalty under section 512(b)(2) where the exempt organization does not operate the tour, but provides member names to a for-profit tour operator. Section 512(b)(2) excludes royalties from the computation of unrelated business taxable income. The question of what constitutes a royalty is beyond the scope of these regulations. For guidance as to whether income received by a tax-exempt organization from travel tour activities is excludable from unrelated business taxable income as a royalty, *see generally* Treas. Reg. §1.512(b)–1(b) and *Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996).

Some commentators suggested that the final regulations should contain provisions that prevent tax-exempt organizations from competing unfairly with taxable travel businesses. However, the test under section 513 is substantial relatedness to exempt purposes, not the presence or absence of unfair competition. Section 513 was enacted to prevent unfair competition between exempt organizations and taxable businesses. H.R. Rep. No. 2319, 81st Cong., 2d Sess. (1950), *reprinted in* 1950-2 C.B. 380, 409; S. Rep. No. 2375, 81st Cong., 2d Sess. (1950), *reprinted in* 1950-2 C.B. 483, 504; *Portland Golf Club v. Commissioner*, 497 U.S. 154, 161-162, fn. 12 (1990); Treas. Reg. §1.513–1(b). Nevertheless, "Congress did not force exempt organizations to abandon all commercial ventures", but rather imposed a tax on ventures that are not substantially related to an organization's exempt purposes. *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986). *See also Louisiana Credit Union League v. United States*, 693 F.2d 525, 541 (5th Cir. 1982). Following this approach, the section 513(a) regulations, published in 1967, state that "any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute 'trade or business' within the meaning of section 162– and which, in addition, is not substantially related to the performance of exempt functions— presents sufficient likelihood of unfair competition to be within the policy of the tax [imposed by section 511(a)]." Treas. Reg. §1.513–1(b). In expanding the categories of organizations subject to unrelated business income tax in 1969, Congress revisited the unfair competition issue. "[A] business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free *unless* the business contributes importantly to the exempt function." H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess., 44, 50 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1689, 1695 (emphasis added). If an organization's trade or business is substan-

tially related to its exempt purposes, the tax under section 511 is not imposed, regardless of the existence of competition with taxable entities. Accordingly, the final regulations continue to focus on relatedness to exempt purposes, as required by section 513.

The preamble to the proposed regulations requested comments on whether the final regulations should include documentation and recordkeeping requirements specific to travel tours. Commentators split on the preferred approach. Some commentators requested general guidance as to the types of records that an organization should keep to establish a tour's purpose, but did not want the IRS to mandate specific recordkeeping requirements. Other commentators asked that the IRS specify what documentation is required. Section 6001 authorizes the Secretary to prescribe regulations that require taxpayers to keep records sufficient to establish whether a taxpayer is liable for any tax imposed under the Code. Currently, any person subject to tax under subtitle A of the Code, including the tax imposed under section 511, or required to file a return of information with respect to income, must keep permanent books or records sufficient to establish the amount of gross income, deductions, credits or other matters required to be shown by such person in any return of tax or information. *See* Treas. Reg. §1.6001–1(a). In addition, every organization exempt from tax under section 501(a) must keep permanent books of account or records sufficient to show specifically items of gross income, receipts and disbursements, and to substantiate the information required by section 6033. *See* Treas. Reg. §1.6001– 1(c).

The IRS and Treasury Department believe that, with respect to travel tours, it is unnecessary to supplement the existing recordkeeping requirements under sections 6001 and 6033. Therefore, the final regulations do not impose additional recordkeeping requirements. However, in response to commentators' suggestions, examples in the final regulations illustrate that contemporaneous documentation showing how an organization develops, promotes and operates the travel tour is relevant to the facts and circumstances analysis.

Special Analyses

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) 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, 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 Robin Ehrenberg, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.513–7 is added to read as follows:

§1.513–7 Travel and tour activities of tax exempt organizations.

(a) Travel tour activities that constitute a trade or business, as defined in §1.513–1(b), and that are not substantially related to the purposes for which exemption has been granted to the organization constitute an unrelated trade or business with respect to that organization. Whether travel tour activities conducted by an organization are substantially related to the organization's exempt purpose is determined by looking at all relevant facts and circumstances, including, but not limited to, how a travel tour is developed, promoted and operated. Section 513(c) and §1.513–1(b) also apply to travel tour activity. Application of the rules of section 513(c) and §1.513–1(b) may result in different treatment for individual tours within an organization's travel tour program.

(b) *Examples*. The provisions of this section are illustrated by the following examples. In all of these examples, the travel tours are priced to produce a profit for the exempt organization. The examples are as follows:

Example 1. O, a university alumni association, is exempt from federal income tax under section 501(a) as an educational organization described in section 501(c)(3). As part of its activities, O operates a travel tour program. The program is open to all current members of O and their guests. O works with travel agencies to schedule approximately 10 tours annually to various destinations around the world. Members of O pay $x to the organizing travel agency to participate in a tour. The travel agency pays O a per person fee for each participant. Although the literature advertising the tours encourages O's members to continue their lifelong learning by joining the tours, and a faculty member of O's related university frequently joins the tour as a guest of the alumni association, none of the tours includes any scheduled instruction or curriculum related to the destinations being visited. The travel tours made available to O's members do not contribute importantly to the accomplishment of O's educational purpose. Rather, O's program is designed to generate revenues for O by regularly offering its members travel services. Accordingly, O's tour program is an unrelated trade or business within the meaning of section 513(a).

Example 2. N is an organization formed for the purpose of educating individuals about the geography and culture of the United States. It is exempt from federal income tax under section 501(a) as an educational and cultural organization described in section 501(c)(3). N engages in a number of activities to accomplish its purposes, including offering courses and publishing periodicals and books. As one of its activities, N conducts study tours to national parks and other locations within the United States. The study tours are conducted by teachers and other personnel certified by the Board of Education of the State of P. The tours are directed toward students enrolled in degree programs at educational institutions in P, as reflected in the promotional materials, but are open to all who agree to participate in the required study program. Each tour's study program consists of instruction on subjects related to the location being visited on the tour. During the tour, five or six hours per day are devoted to organized study, preparation of reports, lectures, instruction and recitation by the students. Each tour group brings along a library of material related to the subject being studied on the tour. Examinations are given at the end of each tour and the P State Board of Education awards academic credit for tour participation. Because the tours offered by N include a substantial amount of required study, lectures, report preparation, examinations and qualify for academic credit, the tours are substantially related to N's educational purpose. Accordingly, N's tour program is not an unrelated trade or business within the meaning of section 513(a).

Example 3. R is a section 501(c)(4) social welfare organization devoted to advocacy on a particu-

lar issue. On a regular basis throughout the year, R organizes travel tours for its members to Washington, DC. While in Washington, the members follow a schedule according to which they spend substantially all of their time during normal business hours over several days attending meetings with legislators and government officials and receiving briefings on policy developments related to the issue that is R's focus. Members do have some time on their own in the evenings to engage in recreational or social activities of their own choosing. Bringing members to Washington to participate in advocacy on behalf of the organization and learn about developments relating to the organization's principal focus is substantially related to R's social welfare purpose. Therefore, R's operation of the travel tours does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 4. S is a membership organization formed to foster cultural unity and to educate X Americans about X, their country of origin. It is exempt from federal income tax under section 501(a) and is described in section 501(c)(3) as an educational and cultural organization. Membership in S is open to all Americans interested in the X heritage. As part of its activities, S sponsors a program of travel tours to X. The tours are divided into two categories. Category A tours are trips to X that are designed to immerse participants in the X history, culture and language. Substantially all of the daily itinerary includes scheduled instruction on the X language, history and cultural heritage, and visits to destinations selected because of their historical or cultural significance or because of instructional resources they offer. Category B tours are also trips to X, but rather than offering scheduled instruction, participants are given the option of taking guided tours of various X locations included in their itinerary. Other than the optional guided tours, Category B tours offer no instruction or curriculum. Destinations of principally recreational interest, rather than historical or cultural interest, are regularly included on Category B tour itineraries. Based on the facts and circumstances, sponsoring Category A tours is an activity substantially related to S's exempt purposes, and does not constitute an unrelated trade or business within the meaning of section 513(a). However, sponsoring Category B tours does not contribute importantly to S's accomplishment of its exempt purposes and, thus, constitutes an unrelated trade or business within the meaning of section 513(a).

Example 5. T is a scientific organization engaged in environmental research. T is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). T is engaged in a long-term study of how agricultural pesticide and fertilizer use affects the populations of various bird species. T collects data at several bases located in an important agricultural region of country U. The minutes of a meeting of T's Board of Directors state that, after study, the Board has determined that nonscientists can reliably perform needed data collection in the field, under supervision of T's biologists. The Board minutes reflect that the Board approved offering one-week trips to T's bases in U, where participants will assist T's biologists in collecting data for the study. Tour participants collect data during the same hours as T's biologists. Normally, data collection occurs during the early morning and evening hours, although the work schedule varies by season. Each base has rustic accommodations and few amenities, but country U is renowned for its beautiful scenery and abundant wildlife. T promotes the trips in its newsletter and on its Internet site and through various conservation organizations. The promotional materials describe the work schedule and emphasize the valuable contribution made by trip participants to T's research activities. Based on the facts and circumstances, sponsoring trips to T's bases in country U is an activity substantially related to T's exempt purpose, and, thus, does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 6. V is an educational organization devoted to the study of ancient history and cultures and is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). In connection with its educational activities, V conducts archaeological expeditions around the world, including in the Y region of country Z. In cooperation with the National Museum of Z, V recently presented an exhibit on ancient civilizations of the Y region of Z, including artifacts from the collection of the Z National Museum. V instituted a program of travel tours to V's archaeological sites located in the Y region. The tours were initially proposed by V staff members as a means of educating the public about ongoing field research conducted by V. V engaged a travel agency to handle logistics such as accommodations and transportation arrangements. In preparation for the tours, V developed educational materials relating to each archaeological site to be visited on the tour, describing in detail the layout of the site, the methods used by V's researchers in exploring the site, the discoveries made at the site, and their historical significance. V also arranged special guided tours of its exhibit on the Y region for individuals registered for the travel tours. Two archaeologists from V (both of whom had participated in prior archaeological expeditions in the Y region) accompanied the tours. These experts led guided tours of each site and explained the significance of the sites to tour participants. At several of the sites, tour participants also met with a working team of archaeologists from V and the National Museum of Z, who shared their experiences. V prepared promotional materials describing the educational nature of the tours, including the daily trips to V's archaeological sites and the educational background of the tour leaders, and providing a recommended reading list. The promotional materials do not refer to any particular recreational or sightseeing activities. Based on the facts and circumstances, sponsoring trips to the Y region is an activity substantially related to V's exempt purposes. The scheduled activities, which include tours of archaeological sites led by experts, are part of a coordinated educational program designed to educate tour participants about the ancient history of the Y region of Z and V's ongoing field research. Therefore, V's tour program does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 7. W is an educational organization devoted to the study of the performing arts and is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). In connection with its educational activities, W presents public performances of musical and theatrical works. Individuals become members of W by making an annual contribution to W of $q. Each year, W offers members an opportunity to travel as a group to one or more major cities in the United States or abroad. In each city, tour participants are provided tickets to attend a public performance of a play, concert or dance program each evening. W also arranges a sightseeing tour of each city and provides evening receptions for tour participants. W views its tour program as an important means to develop and strengthen bonds between W and its members, and to increase their financial and volunteer support of W. W engaged a travel agency to handle logistics such as accommodations and transportation arrangements. No educational materials are prepared by W or provided to tour participants in connection with the tours. Apart from attendance at the evening cultural events, the tours offer no scheduled instruction, organized study or group discussion. Although several members of W's administrative staff accompany each tour group, their role is to facilitate member interaction. The staff members have no special expertise in the performing arts and play no educational role in the tours. W prepared promotional materials describing the sightseeing opportunities on the tours and emphasizing the opportunity for members to socialize informally and interact with one another and with W staff members, while pursuing shared interests. Although W's tour program may foster goodwill among W members, it does not contribute importantly to W's educational purposes. W's tour program is primarily social and recreational in nature. The scheduled activities, which include sightseeing and attendance at various cultural events, are not part of a coordinated educational program. Therefore, W's tour program is an unrelated trade or business within the meaning of section 513(a).

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

Approved January 21, 2000.

Jonathan Talisman,
Acting Assistant Secretary
of the Treasury.

(Filed by the Office of the Federal Register on February 4, 2000, 8:45 a.m., and published in the issue of the Federal Register for February 7, 2000, 65 F.R. 5772)

Section 1295.—Qualified Electing Fund

26 CFR 1.1295–1: Qualified electing funds.

T.D. 8870

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

General Rules for Making and Maintaining Qualified Electing Fund Elections

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance to a passive foreign investment company (PFIC) shareholder that makes the election under section 1295 (section 1295 election) to treat the PFIC as a qualified electing fund (QEF), and for PFIC shareholders that wish to make a section 1295 election that will apply on a retroactive basis (retroactive election). In addition, this document contains a final regulation that provides guidance under section 1291 to a PFIC shareholder that is a tax-exempt organization. Lastly, this document contains final regulations under section 1293 for calculating and reporting net capital gain by a QEF, and also clarifies the application of the current income inclusion rules of section 1293 to interest in a QEF held through a domestic pass through entity.

DATES: *Effective Date*. These regulations are effective February 7, 2000.

Applicability Date. In general, these regulations are applicable as of January 2, 1998. For special dates of applicability see §1.1295–1(k).

FOR FURTHER INFORMATION CONTACT: Margaret A. Fung, (202) 622-3840 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545 - 1555. Responses to these collections of information are mandatory for PFIC shareholders that wish to make the section 1295 election to treat the PFIC as a QEF.

Comments on the collections of information should be sent 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, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224.

The estimated average annual burden per respondent and/or recordkeeper varies from fifteen minutes to three hours, depending on individual circumstances, with an estimated average of twenty-nine minutes.

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 assigned by the Office of Management and Budget.

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.

Background

On January 2, 1998, the Treasury and the IRS published temporary regulations regarding the section 1295 election and rules applicable to a PFIC shareholder under sections 1291, 1293, 1295 and 1297 (redesignated as section 1298 by the Taxpayer Relief Act of 1997, and hereafter referred to as section 1298) (T.D. 8750, 1998–8 I.R.B. 4 [63 F.R. 6]). On that same date, the Treasury and the IRS published a proposed rulemaking (REG–115795–97, 1998–8 I.R.B. 33) in the **Federal Register** (63 F.R. 35). The text of the temporary regulations served as the text of the proposed regulations.

Sections 1291, 1293, 1295 and 1298 were added by the Tax Reform Act of 1986, effective for taxable years of foreign corporations beginning after December 31, 1986. As originally enacted, the section 1295 election was an election made by the PFIC. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) amended section 1295, effective for taxable years of foreign corporations beginning after December 31, 1986, to change the section 1295 election to a shareholder-by-shareholder election. Sections 1291, 1293 and 1298 were also amended by TAMRA, and sections 1293 and 1298 were further amended by the Omnibus Budget Reconciliation Act of 1993. Section 1298 also was amended by the Revenue Reconciliation Act of 1989 and the Small Business Job Protection Act of 1996. In addition, the Taxpayer Relief Act of 1997 (1997 TRA) amended section 1 to provide categories of long-term capital gain and the maximum rates of tax to which the categories are subject. In certain cases, this amendment affects the calculation of net capital gain for purposes of section 1293.

No written comments were received on the proposed regulations, and no public hearing was requested or held. The proposed regulations are adopted as final regulations as revised by this Treasury Decision. The revisions are summarized in the explanations below.

Explanation of Revisions

A foreign corporation is a PFIC for a taxable year if the foreign corporation satisfies either the income or asset test of section 1297(a) for that year. A foreign corporation is a PFIC under the income test if 75 percent or more of its gross income for its taxable year is passive, or investment-type, income. Alternatively, under the asset test, a foreign corporation is a PFIC if 50 percent or more of the average fair market value of its assets during its taxable year are assets that produce or are held for the production of passive income. A shareholder of a foreign corporation that qualifies as a PFIC is subject to the interest charge regime of section 1291 with respect to certain distributions by the PFIC and certain dispositions of its stock. Generally, a shareholder of a PFIC may avoid the interest charge regime by making a timely election under section 1295 to treat a PFIC as a QEF, in which case the shareholder will be taxed annually pursuant to section 1293 on its pro rata share of the ordinary earnings and net capital gain of the PFIC. Under section 1295(a), a section 1295 election will apply with respect to the PFIC if the PFIC complies with requirements prescribed by the Secretary for purposes of determining the ordinary earnings and net capital gain of the PFIC and otherwise carrying out the purposes of the PFIC provisions.

Section 1295(b)(1), as enacted by TAMRA, provides that a shareholder may make a section 1295 election with respect to a PFIC for any taxable year of the shareholder (shareholder election year). Once made, the election will apply to that year and to all subsequent years of the shareholder unless revoked by the share-

holder with the consent of the Secretary. Section 1295(b)(2) prescribes the time for making the election. In general, for the section 1295 election to be applicable to a taxable year, the shareholder must make the election by the due date, as extended under section 6081, for the shareholder's return for that taxable year. However, to the extent provided in the regulations, a section 1295 election may be made for a taxable year after the prescribed due date if the shareholder failed to make a timely election because the shareholder reasonably believed that the foreign corporation was not a PFIC.

Under temporary regulations §1.1295–1T(d)(1) and (f)(1), the shareholder, as defined in §1.1291–9(j)(3), of a PFIC makes the section 1295 election by filing a Form 8621 with the shareholder's Federal income tax return by the election due date for the shareholder election year, and by filing a copy of that form with the Philadelphia Service Center. In addition, under temporary regulation §1.1295–1T(f)(2), the shareholder must file an annual Form 8621 with its Federal income tax return to report the shareholder's pro rata share of the ordinary earnings and net capital gain of the QEF. Temporary regulation §1.1295–1T(f)(2) also required that a copy of the annual Form 8621 be filed with the Philadelphia Service Center. To reduce taxpayer burden, this final regulation eliminates the requirement for filing a copy of Form 8621 with the Philadelphia Service Center when the shareholder makes the section 1295 election or reports the shareholder's annual pro rata share of the ordinary earnings and net capital gain of the QEF.

In addition, this final regulation clarifies the rule in temporary regulation §1.1295–1T(c)(2)(ii) for income inclusion by the shareholder of a QEF under section 1293 for any taxable year that the foreign corporation is not a PFIC under section 1297(a) and is not treated as a PFIC under section 1298(b)(1). This final regulation clarifies that in such case, the shareholder is not required to include pursuant to section 1293 the shareholder's pro rata share of ordinary earnings and net capital gain for such year, and the shareholder shall not be required to satisfy the section 1295 annual reporting requirement for such year. Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1295 election. Thus, if the foreign corporation is a PFIC in any taxable year after a year in which it is not treated as a PFIC, the shareholder's original election under section 1295 continues to apply and the shareholder must take into account its pro rata share of ordinary earnings and net capital gain for such year and comply with the section 1295 annual reporting requirement.

The Taxpayer Relief Act of 1997 added section 1296 to provide PFIC shareholders with an alternative method for current income inclusion by making a mark-to-market election with respect to their PFIC stock that qualifies as marketable stock. The election is available to shareholders whose taxable years begin after December 31, 1997 for stock in a foreign corporation whose taxable year ends with or within the shareholder's taxable year. The effect of a mark-to-market election on a section 1295 election will be addressed in subsequent regulations under section 1296. In addition, temporary regulation §1.1297–3T(c) governing the deemed dividend election by a United States person that is a shareholder of a PFIC will be finalized in a future regulation project.

Notice 98–22 (1998–17 I.R.B. 5) provides that taxpayers will be permitted to apply the rules of the temporary regulations under §1.1295–1T(b)(4) (section 1295 election by shareholders who file a joint return) and §1.1295–1T(f) and (g) (procedures for making a section 1295 election and annual information requirements by the PFIC or intermediary) to taxable years beginning before January 1, 1998, for which the statute of limitations on the assessment of tax has not expired and, with respect to § 1.1295–1T(b)(4), if certain consistency requirements are met. The rule of Notice 98–22 has been incorporated into §1.1295–1(k) of this regulation. Final regulation §1.1295–1(k) is changed to reflect the special effective dates for §1.1295–1(b)(4), (f) and (g) as provided by Notice 98–22. Accordingly, Notice 98–22 is obsoleted since the effective date provisions are contained in this final regulation.

Notice 88–125 described the requirements a shareholder must satisfy to make and maintain a section 1295 election for taxable years beginning before January 1, 1998. As a result of the procedures and requirements set forth first in the temporary regulations published on January 2, 1998, and now in these final regulations, Notice 88–125 is obsoleted effective February 7, 2000.

Effect On Other Documents

Notice 88–125 and Notice 98–22 are obsoleted as of February 7, 2000.

Special Analyses

It has been determined that the final regulations are not a significant regulatory action as defined in Executive Order 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) does not apply to these regulations. Further, it is hereby certified, pursuant to sections 603(a) and 605(b) of the Regulatory Flexibility Act (5 U.S.C. chapter 6), that the collection of information contained in these regulations will not have a significant economic impact on substantial number of small entities. The cost of collection of information to small entities is insignificant because the primary reporting burden is on individual PFIC shareholders who make the section 1295 election. Therefore, the collection of information will not have a substantial economic impact. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act 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 the final regulations is Margaret A. Fung, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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 in part as follows:

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

Sec. 1.1291–1 also issued under 26 U.S.C. 1291. * * *

Sec. 1.1293–1 also issued under 26 U.S.C. 1293. * * *

Sec. 1.1295–3 also issued under 26 U.S.C. 1295. * * *

§1.1291–1T [Redesignated as §1.1291–1]

Par. 2. Section 1.1291–1T is redesignated as §1.1291–1 and the section heading is revised to read as follows:

§1.1291–1 Taxation of U.S. persons that are shareholders of PFICs that are not pedigreed QEFs.

* * * * *

Par. 3. Section 1.1293–1T is redesignated as §1.1293–1 and the newly designated section is amended by revising the section heading and the first sentence of paragraph (c)(1) to read as follows:

§1.1293–1 Current taxation of income from qualified electing funds.

* * * * *

(c) *Application of rules of inclusion with respect to stock held by a pass through entity* — (1) *In general*. If a domestic pass through entity makes a section 1295 election, as provided in paragraph (d)(2) of this section, with respect to the PFIC shares that it owns, directly or indirectly, the domestic pass through entity takes into account its pro rata share of the ordinary earnings and net capital gain attributable to the QEF shares held by the pass through entity. * * *

* * * * *

Par. 4. Section 1.1295–0 is amended by:

1. Revising the introductory text of the section.

2. Removing the entry for the heading of §1.1295–1T and adding an entry for the heading of §1.1295–1 in its place.

3. Revising the entries for §1.1295–1(d)(3) through (d)(5).

4. Adding entries for §1.1295–1(d)(6) and (e)(1) and (e)(2).

5. Removing the entry for the heading of §1.1295–3T and adding an entry for the heading of §1.1295–3 in its place.

The revisions and additions read as follows:

§1.1295–0 Table of contents.

This section contains a listing of the headings for §§1.1295–1 and 1.1295–3.

§1.1295–1 Qualified electing funds.

* * * * *

(d) * * *

(3) Indirect ownership of a PFIC through other PFICs.

(4) Member of consolidated return group as shareholder.

(5) Option holder.

(6) Exempt organization.

(e) * * *

(1) General rule.

(2) Examples.

* * * * *

§1.1295–3 Retroactive elections.

* * * * *

§1.1295–1T [Redesignated as §1.1295–1]

Par. 5. Section §1.1295–1T is redesignated as §1.1295–1 and the newly designated section is amended by:

1. Revising the section heading.

2. Revising paragraph (b)(3)(iv)(B).

3. Adding paragraph (b)(3)(v).

4. Adding a sentence to the end of paragraph (b)(4).

5. Revising paragraphs (c)(2)(ii) and (iii).

6. Revising the third sentence in paragraph (c)(2)(v) *Example 3*.

7. Redesignating paragraphs (d)(3), (d)(4) and (d)(5) as paragraphs (d)(4), (d)(5) and (d)(6), respectively.

8. Adding a new paragraph (d)(3).

9. Revising paragraph (e).

10. In the last sentence of paragraph (f)(1)(iii), the language "capital gain; and" is removed and the language "capital gain." is added in its place.

11. Adding the word "and" at the end of paragraph (f)(1)(ii).

12. Removing paragraph (f)(1)(iv).

13. Adding the word "and" at the end of paragraph (f)(2)(i)(B).

14. In the last sentence of paragraph (f)(2)(i)(C), the language "capital gain; and" is removed and the language "capital gain." is added in its place.

15. Removing paragraph (f)(2)(i)(D).

16. Adding a new paragraph (f)(3).

17. Revising the introductory language of paragraph (g)(3).

18. Adding paragraph (g)(5).

19. Revising the first sentence of paragraph (h).

20. Revising paragraph (k).

The revisions and additions read as follows:

§1.1295–1 Qualified electing funds.

* * * * *

(b) * * *

(3) * * *

(iv) * * *

(B) In the case of PFIC stock transferred by an interest holder or beneficiary to a pass through entity in a transaction in which gain is not fully recognized (including pursuant to regulations under section 1291(f)), the pass through entity makes the section 1295 election with respect to the PFIC stock transferred for the taxable year in which the transfer was made. The PFIC stock transferred will be treated as stock of a pedigreed QEF by the pass through entity, however, only if that stock was treated as stock of a pedigreed QEF with respect to the interest holder or beneficiary at the time of the transfer, and the PFIC has been a QEF with respect to the pass through entity for all taxable years of the PFIC that are included wholly or partly in the pass through entity's holding period of the PFIC stock during which the foreign corporation was a PFIC within the meaning of §1.1291–9(j).

(v) *Characterization of stock distributed by a partnership*. In the case of PFIC stock distributed by a partnership to a partner in a transaction in which gain is not fully recognized, the PFIC stock will be treated as stock of a pedigreed QEF by the partners only if that stock was treated as stock of a pedigreed QEF with respect to the partnership for all taxable years of the PFIC that are included wholly or partly in the partnership's holding period of the PFIC stock during which the foreign corporation was a PFIC within the meaning of §1.1291–9(j), and the partner has a section 1295 election in effect with respect to the distributed PFIC stock for the partner's taxable year in which the distribution was made. If the partner does not have a section 1295 election in effect, the stock shall be treated as stock in a section 1291 fund. See paragraph (k) of this section for special applicability date of paragraph (b)(3)(v) of this section.

(4) * * * See paragraph (k) of this section for special applicability date of paragraph (b)(4) of this section.

(c) * * *

(2) * * *

(ii) *Effect of PFIC status on election*. A foreign corporation will not be treated as a QEF for any taxable year of the foreign corporation that the foreign corporation is not a PFIC under section 1297(a) and is not treated as a PFIC under section 1298(b)(1). Therefore, a shareholder shall not be required to include pursuant to section 1293 the shareholder's pro rata share of ordinary earnings and net capital gain for such year and shall not be required to satisfy the section 1295 annual reporting requirement of paragraph (f)(2) of this section for such year. Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1295 election. Thus, if the foreign corporation is a PFIC in any taxable year after a year in which it is not treated as a PFIC, the shareholder's original election under section 1295 continues to apply and the shareholder must take into account its pro rata share of ordinary earnings and net capital gain for such year and comply with the section 1295 annual reporting requirement.

(iii) *Effect on election of complete termination of a shareholder's interest in the PFIC*. Complete termination of a shareholder's direct and indirect interest in stock of a foreign corporation will not terminate a shareholder's section 1295 election with respect to the foreign corporation. Therefore, if a shareholder reacquires a direct or indirect interest in any stock of the foreign corporation, that stock is considered to be stock for which an election under section 1295 has been made and the shareholder is subject to the income inclusion and reporting rules required of a shareholder of a QEF.

* * * * *

(v) * * *

Example 3. * * * If P does not make the section 1295 election with respect to the FC stock, C will continue to be subject, in C's capacity as an indirect shareholder of FC, to the income inclusion and reporting rules required of shareholders of QEFs in 1999 and subsequent years for that portion of the FC stock C is treated as owning indirectly through the partnership. * * *

(d) * * *

(3) *Indirect ownership of a PFIC through other PFICs* — (i) *In general.* An election under section 1295 shall apply only to the foreign corporation for which an election is made. Therefore, if a shareholder makes an election under section 1295 to treat a PFIC as a QEF, that election applies only to stock in that foreign corporation and not to the stock in any other corporation which the shareholder is treated as owning by virtue of its ownership of stock in the QEF.

(ii) *Example*. The following example illustrates the rules of paragraph (d)(3)(i) of this section:

Example. In 1988, T, a U.S. person, purchased stock of FC, a foreign corporation that is a PFIC. FC also owns the stock of SC, a foreign corporation that is a PFIC. T makes an election under section 1295 to treat FC as a QEF. T's section 1295 election applies only to the stock T owns in FC, and does not apply to the stock T indirectly owns in SC.

* * * * *

(e) *Time for making a section 1295 election* — (1) *In general*. Except as provided in §1.1295–3, a shareholder making the section 1295 election must make the election on or before the due date, as extended under section 6081 (election due date), for filing the shareholder's income tax return for the first taxable year to which the election will apply. The section 1295 election must be made in the original return for that year, or in an amended return, provided the amended return is filed on or before the election due date.

(2) *Examples*. The following examples illustrate the rules of paragraph (e)(1) of this section:

Example 1. In 1998, C, a domestic corporation, purchased stock of FC, a foreign corporation that is a PFIC. Both C and FC are calendar year taxpayers. C wishes to make the section 1295 election for its taxable year ended December 31, 1998. The section 1295 election must be made on or before March 15, 1999, the due date of C's 1998 income tax return as provided by section 6072(b). On March 14, 1999, C files a request for a three-month extension of time to file its 1998 income tax return under section 6081(b). C's time to file its 1998 income tax return and to make the section 1295 election is thereby extended to June 15, 1999.

Example 2. The facts are the same as in *Example 1* except that on May 1, 1999, C filed its 1998 income tax return and failed to include the section 1295 election. C may file an amended income tax return for 1998 to make the section 1295 election provided the amended return is filed on or before the extended due date of June 15, 1999.

* * * * *

(f) * * *

(3) *Effective date*. See paragraph (k) of this section for special applicability date of paragraph (f) of this section.

(g) * * *

(3) *Annual Intermediary Statement*. In the case of a U.S. person that is an indirect shareholder of a PFIC that is owned through an intermediary, as defined in paragraph (j) of this section, an Annual Intermediary Statement issued by an intermediary containing the information described in paragraph (g)(1) of this section and reporting the indirect shareholder's pro rata share of the ordinary earnings and net capital gain of the QEF as described in paragraph (g)(1)(ii)(A) of this section, may be provided to the indirect shareholder in lieu of the PFIC Annual Information Statement if the following conditions are satisfied —

* * * * *

(5) *Effective date*. See paragraph (k) of this section for special applicability date of paragraph (g) of this section.

(h) *Transition rules*. Taxpayers may rely on Notice 88–125 (1988–2 C.B. 535) (see §601.601(d)(2) of this chapter), for rules on making and maintaining elections for shareholder election years (as defined in paragraph (j) of this section) beginning after December 31, 1986, and before January 1, 1998. * * *

* * * * *

(k) *Effective dates*. Paragraphs (b)(2)(iii), (b)(3), (b)(4) and (c) through (j) of this section are applicable to taxable years of shareholders beginning after December 31, 1997. However, taxpayers may apply the rules under paragraphs (b)(4), (f) and (g) of this section to a taxable year beginning before January 1, 1998, provided the statute of limitations on the assessment of tax has not expired as of April 27, 1998 and, in the case of paragraph (b)(4) of this section, the taxpayers who filed the joint return have consistently applied the rules of that section to all taxable years following the year the election was made. Paragraph (b)(3)(v) of this section is applicable as of February 7, 2000, however a taxpayer may apply the rules to a taxable year prior to the applicable date provided the statute of limitations on the assessment of tax for that taxable year has not expired.

§1.1295–3T [Redesignated as §1.1295–3]

Par. 6. Section §1.1295–3T is redesignated as §1.1295–3 and the newly designated section is amended by revising the section heading and paragraphs (b)(1) and (c)(5)(i) to read as follows:

§1.1295–3 Retroactive elections.

* * * * *

(b) * * *

(1) Reasonably believed, within the

meaning of paragraph (d) of this section, that as of the election due date, as defined in § 1.1295–1(e), the foreign corporation was not a PFIC for its taxable year that ended during the retroactive election year;
* * * * *

(c) * * *

(5) *Time of and manner for filing a Protective Statement*—(i) *In general*. Except as provided in paragraph (c)(5)(ii) of this section, a Protective Statement must be attached to the shareholder's federal income tax return for the shareholder's first taxable year to which the Protective Statement will apply. The shareholder must file its return and the copy of the Protective Statement by the due date, as extended under section 6081, for the return.
* * * * *

Par. 7. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column.

Affected Section	Remove	Add
1.1293–1(c)(1), last sentence	§1.1295–1T(j).	§1.1295–1(j).
1.1293–1(c)(2)(i), first sentence	§1.1295–1T(D)(2),	§1.1295–1(d)(2),
1.1295–1(b)(3)(iv)(A)	stock), and	stock) and
1.1295–1(c)(2)(ii), first sentence	1296(a)	1297(a)
1.1295–1(c)(2)(ii), first sentence	1297(b)(1).	1298(b)(1).
1.1295–1(c)(2)(iv), last sentence	§1.1293–1T(c).	§1.1293–1(c).
1.1295–1(d)(1), last sentence	(d)(5)	(d)(6)
1.1295–1(d)(2)(i)(A), last sentence	§1.1293–1T(c)(1),	§1.1293–1(c)(1),
1.1295–1(d)(2)(ii), last sentence	§1.1293–1T(c)(1),	§1.1293–1(c)(1),
1.1295–1(d)(2)(iii), last sentence	§1.1293–1T(c)(1),	§1.1293–1(c)(1),
1.1295–1(d)(6), first sentence	§1.1291–1T(e),	§1.1291–1(e),
1.1295–1(f)(1)(iii), last sentence	QEF calculated the QEF's	PFIC calculated the PFIC's
1.1295–1(g)(1) introductory text, second sentence, last word	representation —	representations —
1.1295–1(g)(1)(ii)(A)	§1.1293–1T(a)(2)	§1.1293–1(a)(2)
1.1295–1(h), second sentence	§1.1295–1T	§1.1295–1
1.1295–1(i)(1)(iii), last sentence	never was made.	was never made.
1.1295–1(i)(3)(iii)	through 1297	through 1298
1.1295–3(a), first sentence	§1.1295–1T(j),	§1.1295–1(j),
1.1295–3(a), first sentence	§1.1295–1T(e)	§1.1295–1(e)
1.1295–3(b)(2)	and 1297	and 1298
1.1295–3(c)(3)	§1.1295–1T(d).	§1.1295–1(d).
1.1295–3(c)(4)(i)(A), third sentence	assessment of taxes	assessment of all PFIC related taxes
1.1295–3(c)(6)(i), last sentence	see §1.1295–1T(c)(2)(iii).	see §1.1295–1(c)(2)(iii).
1.1295–3(d)(1), first sentence	section 1296(a)	section 1297(a)
1.1295–3(d)(1), second sentence	section 1296(a)	section 1297(a)
1.1295–3(f)(2)(i) introductory text, second sentence	PFIC and the availability	PFIC and of the availability
1.1295–3(f)(4)(vi), first sentence	§1.1295–1T(d).	§1.1295–1(d).
1.1295–3(g)(3), first sentence	§1.1295–1T(d).	§1.1295–1(d).

PART 602- - OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. In § 602.101, paragraph (b) is amended by removing the entries for §§1.1295–1T and 1.1295–3T and adding entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved January 14, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 4, 2000, 8:45 a.m., and published in the issue of the Federal Register for February 7, 2000, 65 F.R. 5777)

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1295–1	1545–1555
1.1295–3	1545–1555
* * * * *	

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Exclusions From Gross Income of Foreign Corporations

REG–208280–86

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed rules implementing the portions of section 883(a) and (c) of the Internal Revenue Code (Code) that relate to income derived by foreign corporations from the international operation of a ship or ships or aircraft. The proposed rules reflect changes made by the Tax Reform Act of 1986 and subsequent legislative amendments. The proposed rules provide, in general, that a foreign corporation organized in a qualified foreign country and engaged in the international operation of ships or aircraft shall exclude qualified income from gross income for purposes of United States Federal income taxation, provided that the corporation can satisfy certain ownership and related documentation requirements. The proposed rules explain when a foreign country is a qualified foreign country and what income is considered to be qualified income. The proposed rules specify how a foreign corporation may satisfy the ownership and related documentation requirements. In addition, the proposed rules describe the information that the foreign corporation must include on its United States income tax return in order to claim an exemption. This document provides notice of a public hearing on these proposed rules.

DATES: Written comments must be received by May 8, 2000. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Thursday, April 27, 2000, at 10 a.m. must be received by Wednesday, April 5, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–208280–86), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–208280–86), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed rules, Patricia A. Bray, (202) 622-3880; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (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 for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent 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, with copies to the IRS, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by April 10, 2000. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §§1.883–1, 1.883–2, 1.883–3, 1.883–4, and 1.883–5. The information required in these sections will enable a foreign corporation to determine if it is eligible to exclude its income from the international operation of a ship or ships or aircraft from gross income on its U.S. Federal income tax return. The information required in these sections will also enable the IRS to monitor compliance with the provisions of the proposed regulations with respect to the stock ownership requirements of §1.883–1(c)(2), and to make a preliminary determination of whether the foreign corporation is eligible to claim such an exemption and is accurately reporting income as required under section 6012.

The collection of information and responses to these collections of information are mandatory. The likely respondents are foreign corporations engaged in the international operation of a ship or ships or aircraft that wish to claim an exemption from U.S. tax under section 883, and certain of their shareholders owning (directly or indirectly) a majority of the value of the shares of such corporations.

Estimated total annual reporting/recordkeeping burden on corporations: 1,400 hours.

The estimated annual burden per respondent varies from 30 minutes to eight hours, depending on the circumstances of the foreign corporation, with an estimated average of one hour.

Estimated number of respondents: 1,400.

Estimated annual frequency of responses: Once.

Estimated total annual reporting burden on shareholders: 22,500 hours.

The estimated annual burden per respondent varies from 15 minutes to eight hours, depending on the circumstances of

the shareholder or intermediary, with an estimated average of 90 minutes.

Estimated number of respondents: 15,000.

Estimated annual frequency of responses: Once.

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 assigned by the Office of Management and Budget.

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.

Background

Section 883 provides an exemption from gross income for earnings of a foreign corporation derived from the international operation of a ship or ships or aircraft (hereinafter ships or aircraft) if an equivalent exemption from tax is granted by the applicable foreign country to corporations organized in the United States. Section 883 has generally been referred to as the reciprocal exemption provision. Before 1986, section 883 eliminated U.S. tax on earnings from the operation of ships or aircraft derived by foreign persons, including U.S.-controlled foreign corporations, based on whether the country of documentation of the ship or registry of the aircraft provided an exemption to U.S. persons. Section 883 did not require a foreign transportation company to be organized or resident in the country of registration or documentation. Many countries offered various incentives, including no taxation, to non-resident shipping companies that registered ships in that jurisdiction (referred to as flagging-out or documenting ships under flags of convenience). Thus, foreign corporations that documented their ships in such flag of convenience countries could claim a reciprocal exemption from U.S. income tax.

Congress concluded in 1986 that the reciprocal exemption provisions were not meeting their original goal of reserving the right to tax transportation income to the country of residence of the taxpayer (and therefore to eliminate double taxation). In cases where residents of a country with which the United States might desire a reciprocal exemption used vessels or aircraft documented or registered under another flag, the unilateral U.S. concession provided under prior law left the country of residence little incentive to exempt U.S. shippers. Congress was concerned that U.S.-based transportation companies were at a competitive disadvantage because U.S. companies remained potentially subject to tax by the countries in which their foreign competitors were organized and resident.

Congress amended the reciprocal exemption provisions of section 883 to rectify this situation. Tax Reform Act of 1986, section 1212, Public Law 99-514, ((1986–3 C.B. 1) (the 1986 Act)), as amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Public Law 100–647 (1988–3 C.B. 1), and by the Omnibus Budget Reconciliation Act of 1989, Public Law 101–239 (1990–1 C.B. 210), (the 1986 Act, as amended). It is now irrelevant under section 883 where a ship is documented or an aircraft is registered. Instead, section 883 provides that a foreign corporation may qualify for the reciprocal exemption only if it is organized in a foreign country that grants corporations organized in the United States an equivalent exemption with respect to income derived from the international operation of ships or aircraft. In addition, more than 50 percent of the value of the stock of the foreign corporation must be owned by individuals who are residents of a foreign country that grants corporations organized in the United States an equivalent exemption. The 50 percent ownership requirement generally does not apply if the corporation is either a qualifying controlled foreign corporation (CFC) or if its stock is primarily and regularly traded on an established securities market in a qualified foreign country or the United States.

Since 1986, the United States and more than 30 foreign countries have entered into reciprocal exemption agreements incorporating the statutory amendments of section 883. In addition, more than 60 countries now provide an equivalent exemption through domestic law or an income tax convention. The current regulations under §1.883–1, however, have not been amended to reflect the statutory changes enacted since 1986. This document proposes updated rules reflecting the statutory changes.

Explanation of Provisions

General Rule

Section 1.883–1(a) provides the general rule. A foreign corporation engaged in the international operation of a ship or aircraft shall exclude from its gross income for U.S. Federal income tax purposes any income it derives from the international operation of ships or aircraft if such income is qualified income under paragraph (b) and if the corporation is a qualified foreign corporation under paragraph (c).

Section 1.883–1(b) provides that qualified income is income that is properly includible in an income category described in paragraph (h)(2) of this section and that is the subject of an equivalent exemption granted by the foreign country in which the foreign corporation seeking qualified foreign corporation status is organized.

Section 1.883–1(c)(1) describes the general requirements that a foreign corporation must satisfy to be considered a qualified foreign corporation. A qualified foreign corporation is a corporation, as defined in §§301.7701–2(b) and 301.7701–3, that is engaged in the international operation of ships or aircraft and that is organized in a qualified foreign country. A qualified foreign corporation must also satisfy one of the three stock ownership tests described in paragraph (c)(2) of this section as well as the substantiation and reporting requirements described in paragraph (c)(3) of this section.

Paragraph (c)(2) describes the three stock ownership tests. Generally, a foreign corporation must be able to demonstrate and document that more than fifty percent of the value of its stock is owned by qualified shareholders, as determined under §1.883–4 (qualified shareholder stock ownership test). However, a foreign corporation will not be required to demonstrate that it satisfies the qualified shareholder stock ownership test if it can demonstrate either that its stock is primarily and regularly traded on an established securities market in a qualified foreign country or in the United States, as determined under §1.883–2 (publicly-traded test), or that it is a qualifying controlled foreign corporation as determined under §1.883–3 (CFC test).

To satisfy the substantiation and reporting requirements described in paragraph (c)(3) of this section, a foreign corporation must include the information set out in that paragraph in its Form 1120F, "U.S. Income Tax Return of a Foreign Corporation," in such form and manner as the Form 1120F and its accompanying instructions prescribe. The information to be submitted with the return includes information set out in §§1.883–2(f), 1.883–3(d) and 1.883–4(e), as applicable, relating to information demonstrating that the foreign corporation satisfies one of the three stock ownership tests. Section 1.883–5(c) provides a transition rule that will require such information to be included in a statement attached to the return until the Form 1120F and its instructions are amended to conform to final regulations under this section.

Paragraph (c)(3)(ii) provides that if the Commissioner requests in writing that the foreign corporation substantiate representations made under paragraph (c)(3)(i) of this section, or under §1.883–2(f), 1.882–3(d) or 1.883–4(e), the foreign corporation must provide the supporting documentation or substantiation within 60 days following the written request. If the foreign corporation does not provide all of the information requested within the 60 day period but demonstrates that the failure was due to reasonable cause and not willful neglect, the Commissioner may grant the foreign corporation a 30-day extension to provide the supporting documentation or substantiation. Whether a failure to obtain the documentation or substantiation in a timely manner was due to reasonable cause shall be determined by the Commissioner after considering all the facts and circumstances.

Paragraph (c)(4) contains a rule that allows the Commissioner to retain the right to cure any defects in the documentation where the Commissioner is satisfied that the foreign corporation would otherwise be a qualified foreign corporation.

Paragraph (d) defines a *qualified foreign country* as a foreign country that grants an equivalent exemption to corporations organized in the United States for the relevant category of qualified income earned by the foreign corporation seeking qualified foreign corporation status. A foreign country may be a qualified foreign country with respect to one category of income but not with respect to other categories of income.

Operation of Ships or Aircraft

Section 1.883–1(e) explains what it means to be engaged in the operation of ships or aircraft for purposes of these proposed rules and provides examples of activities that are not treated as the operation of ships or aircraft. Under the general rule, only a corporation that is an owner, lessor, or lessee of an entire ship or aircraft used to carry cargo or persons for hire can be considered engaged in the operation of ships or aircraft.

The term *operation of ships or aircraft*, which includes the operation of a single ship or aircraft, means: the carrying of cargo or passengers for hire; the time or voyage charter of a ship or the wet lease of an aircraft, as those terms are defined in the regulations; and the bareboat charter of a ship or the dry lease of an aircraft, as those terms are defined in the regulations. The term also includes active participation by a corporation that is otherwise engaged in the operation of ships or aircraft in a pool, partnership, strategic alliance, joint operating agreement or code sharing arrangement, or other joint venture that is itself engaged in the operation of ships or aircraft.

Paragraph (e)(2) provides as examples that activities of the following will not be considered *operation of ships or aircraft*: a non-vessel operating common carrier (an NVOCC); a space or slot charterer; a ship management company; a company that obtains ships crews; a ship's agent; a ship or aircraft broker; a freight forwarder; a travel agent; a tour operator; a pure container leasing company; a passive investor in a shipping or aircraft business; or a concessionaire. The proposed rule also provides the definitions of a number of relevant terms.

International Operation of Ships or Aircraft

Section 1.883–1(f) distinguishes international from domestic operation of ships or aircraft. In TAMRA, Congress directed that transportation income derived solely from sources within the United States under section 863(c)(1) should not be granted exemption from U.S. income taxation under section 883. Congress also specified, however, that the reciprocal exemption generally should be available for income from international transport activity that is treated as 50 percent U.S. source income under section 863(c)(2). This is the same type of income on which the gross basis tax of section 887 generally would be imposed. See, S. Rep. No. 100-445, 100th Cong., 2d Sess. 241-242 (1988). However, the reciprocal exemption may not necessarily be available to all types of persons earning that type of income.

To carry out Congress's intent, §1.883–1(f)(1) defines the term *international operation* to mean the operation of ships or aircraft on voyages or flights that begin or end in the United States and correspondingly end or begin in a foreign country, determined on a passenger-by-passenger or cargo-by-cargo basis, as discussed below. The term specifically excludes a "cruise to nowhere" that begins in a U.S. port, travels out into open waters beyond the territorial limits of the United States, and then returns to the U.S. port of origin without touching a foreign port during the voyage. The fact that a ship travels beyond United States territorial limits does not, in itself, constitute international operation of ships or aircraft if there is no stop in a foreign country, as determined under paragraph (f)(2). The same rules apply for aircraft.

Paragraph (f)(2) provides rules for determining the beginning and ending points of a voyage for purposes of the definition of the term *international operation*. Except in the case of a round trip cruise, the carriage of a passenger will be treated as ending at the passenger's final destination even if, en route to the passenger's final destination, a stop is made at a U.S. intermediate point for refueling, maintenance, or other business reasons, provided the passenger does not change aircraft or ships at the U.S. intermediate point. Similarly, carriage of a passenger will be treated as beginning at the passenger's point of origin even if en route to the passenger's final destination, a stop is made at a U.S. intermediate point provided the passenger does not change aircraft or ships at the U.S. intermediate point. Carriage of a passenger will be treated as beginning or ending at a U.S. intermediate point if the passenger changes aircraft or ships at that location. See, H.R. Rep No. 432, 98th Cong., 2d Sess. 1340 (1984); H.R. Rep. No. 861, 98th Cong., 2d Sess. 934 (1984).

The carriage of a passenger on a round trip cruise that begins in the United States and stops at one or more foreign ports for day excursions, maintenance or other business reasons, and returns to the same or another U.S. port will be treated as the international operation of a ship. Pursuant to paragraph (f)(2)(i)(A) such a round trip cruise may also include one or more intermediate stops at a U.S. port or ports for similar purposes.

Carriage of cargo will be treated as ending at the final destination of the cargo even if, en route to that final destination, a stop is made at a U.S. intermediate point, provided that the cargo is transported to its ultimate destination on the same ship or aircraft, or provided the same taxpayer transports the cargo to and from the U.S. intermediate point and the cargo does not pass through customs at the U.S. intermediate point. Similarly, carriage of cargo will be treated as beginning at the cargo's point of origin even if, en route to its final destination, a stop is made at a U.S. intermediate point, provided that the cargo is transported to its ultimate destination on the same ship or aircraft or provided both that the same taxpayer transports the cargo on both legs of the trip and that the cargo does not pass through customs at the U.S. intermediate point. Repackaging, recontainerization, or any other activity involving the unloading of the cargo at the U.S. intermediate point will not change these results. See, H.R. Rep No. 432, 98th Cong., 2d Sess. 1340 (1984); H.R. Rep. No. 861, 98th Cong., 2d Sess. 934 (1984), reprinted in 1984–3 C.B. Vol.2., 1, 188.

Whether income is from international operation is generally to be determined on a passenger-by-passenger and item of cargo-by-item of cargo basis. In the case of income from the bareboat charter of a ship or the dry lease of an aircraft, whether the charter income is derived from international operation is determined by reference to the use of the ship or aircraft by the lowest-tier lessee-operator in the chain of lessees.

A person that is the lessor of a ship under a bareboat charter or of an aircraft under a dry lease will be treated as engaged in the international operation of such ship or aircraft to the extent that the lowest-tier lessee-operator in the chain of ownership uses such ship or aircraft for the international carriage of passengers or cargo for hire during the shorter of the period of the charter or the taxable year. Paragraph (f)(2)(iii) adopts the guidance in section 5.02 of Rev. Proc. 91–12 (1991–1 C.B. 473), for determining the amount of income from the bareboat charter of a ship or the dry lease of an aircraft that is treated as derived from the international operation of the ship or aircraft. The rule provides that a foreign corporation must use a reasonable method for determining the proportion of the charter income that is attributable to such international operation.

One reasonable method, described in §1.883–1(f)(2)(iii)(A), is based on the proportion of the days in the term of the charter or the taxable year, whichever is shorter, that the ship or aircraft is used in international operation by the lowest tier lessee-operator in its chain of lessees. For this purpose, the number of days during which the ship or aircraft is not generating transportation income, within the meaning of section 863(c)(2) (for example, days during which the ship or aircraft is out of service while being repaired or maintained) should not be included in the numerator of the ratio. Another reasonable method described in paragraph (f)(2)(iii)(B) is based on the proportion of the gross income of the lowest tier lessee-operator of the ship or aircraft derived from the international operation of the ship or aircraft during the taxable year. An allocation based on the net income of such lessee-operator will not be considered reasonable for this purpose due to the administrative difficulties involved in determining and verifying the proper allocation of the operator's expenses.

Activities Incidental to International Operations

Some corporations engaged in the operation of ships or aircraft earn income from activities that are so closely related to the primary activity of operation of ships or aircraft that it is appropriate to exclude income from these activities from taxation under section 883 of the Code. By contrast, in cases where the operator's activities are not so closely related to the primary activity of operation of ships or aircraft, it is not appropriate to exclude the income from such activities from taxation.

The purpose of §1.883–1(g) is to provide rules for determining when a closely related activity is incidental to the business of the international operation of ships or aircraft. Paragraph (g)(1) provides examples of activities that will be considered incidental to the international operation of ships or aircraft. For example, where a ship operator contracts for the international carriage of cargo or passengers on a second operator's ship, the activity may be incidental to the international operation of a ship by the first operator. Other examples are: the temporary investment of working capital funds; the sale of tickets for international travel by a ship operator for another ship operator, or by an air carrier for another air carrier; the rental by the operator of a ship or aircraft of containers and related equipment used in connection with the international operation of its ship or aircraft; and bareboat charter of ships or aircraft normally operated on international voyages or flights but currently not needed by the operator, and that are used for international voyages or flights by the lessee/charterer.

If an operator enters into a contract that requires a concessionaire to provide services onboard during the international operation of the operator's ship or aircraft and if the operator receives income from such services, then the income of the operator is appropriately treated as incidental to the operation of the ship or aircraft by the operator.

Paragraph (g)(2) provides examples of activities that are not considered incidental to the international operation of ships or aircraft. These examples include: the sale of or arranging for train travel, bus transfers, land tour packages, or port city hotel accommodations within the United States or a foreign country; and the sale of airline tickets by a cruise ship operator or cruise tickets by an air carrier. Further examples include the sale or rental of U.S. real property; treasury activities involving the investment of excess funds or funds awaiting repatriation generated by the operation of ships or aircraft; rental of containers for a domestic leg of transportation in connection with international carriage of cargo; mere passive investment in an enterprise engaged in the international operation of ships or aircraft; services performed by the operator for parties other than passengers, consignors or consignees; or the carriage of passen-

gers or cargo on ships or aircraft on domestic legs, not treated as international operation, either by the foreign operator or by a U.S. member of a joint operating agreement, such as a code sharing arrangement, pooling or alliance.

Determining Whether a Foreign Country Grants an Equivalent Exemption

Section 1.883–1(h)(1) addresses the conditions under which a foreign country's exemption of certain categories of income from income tax may constitute an "equivalent exemption" within the meaning of section 883 of the Code. A foreign country will be considered to grant an equivalent exemption if: the foreign country generally imposes no tax on income, including income from the international operation of ships or aircraft; the foreign country specifically provides a domestic law exemption from a tax on income from the international operation of ships or aircraft either by statute, decree, or otherwise; or the foreign country provides for a reciprocal exemption by means of an exchange of diplomatic notes or other agreement with the United States. In addition, solely with respect to determining whether a shareholder is a resident of a qualified foreign country in §1.883–4 (for purposes of the qualified shareholder stock ownership test), the foreign country may provide a reciprocal exemption with respect to income from the international operation of ships or aircraft by means of an income tax convention with the United States. Paragraph (h)(3) of this section discusses under what circumstances an income tax convention will be considered to provide an equivalent exemption.

Whether a foreign country provides an equivalent exemption is determined separately with respect to each of the following categories of income—

(A) Income from the carriage of cargo and passengers;

(B) Time or voyage (full) charter income;

(C) Bareboat charter income;

(D) Incidental bareboat charter income;

(E) Incidental container-related income;

(F) Any other income that is incidental to the business of operating ships or aircraft; or

(G) Gains of the operator from the sale, exchange or other disposition of a ship, aircraft, container or related equipment or other moveable property used by that operator in international operation.

If an equivalent exemption is not granted by the foreign country for a category of income, income in that category cannot be exempted from U.S. tax regardless of whether the foreign country grants an equivalent exemption for other categories of income. Furthermore, an equivalent exemption may be available for income derived from the international operation of ships even though income derived from the international operation of aircraft may not be exempt, and vice versa.

Section 1.883–1(h)(3) contains a special rule regarding income tax conventions. If a foreign corporation is organized in a foreign country that provides an equivalent exemption only through an income tax convention with the United States, the foreign corporation may claim benefits under section 894 and the income tax convention, but not under section 883. See, H.R. Rep. No. 841, 99th Cong., 2d Sess., (1986); Staff of joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 931 (1987). If, however, the foreign corporation is organized in a country that offers an equivalent exemption under an income tax convention and also by some other means, such as by a diplomatic note, the foreign corporation may choose annually whether it will claim an exemption under section 894 and the income tax convention or under section 883 by means of the diplomatic note. Such an election must be made with respect to all income of the foreign corporation from the international operation of ships or aircraft and cannot be made separately with respect to each category of such income. If a foreign corporation elects to be covered under section 883 rather than under the income tax convention, the foreign corporation must satisfy the requirements of this proposed rule, including demonstrating that it satisfies the stock ownership test of paragraph (c)(2) of this section.

Section 1.883–1(h)(4) describes certain foreign residence-based taxation systems that may not satisfy the equivalent exemption requirements of this section. For example, the exemption granted by a foreign country's law or income tax convention must be a complete exemption and not merely a reduction to a non-zero rate of tax levied against corporations organized in the United States engaged in the international operation of ships or aircraft, except in the case of a reduction to a zero rate for an unlimited period of time. An exemption granted by a foreign country's law that reduces the rate of tax to a zero rate for only a limited period of time, such as in the case of a tax holiday, would not be considered a complete exemption for purposes of this rule.

Similarly, many foreign countries impose tax only on the income of ships or aircraft derived from transporting cargoes into, but not out of, the country or vice versa. Such a foreign country will not be treated as granting an equivalent exemption on the non-taxed income. For example, a foreign country that imposes tax only on the transportation of cargo carried out of the country (outbound freight) will not be treated as granting an equivalent exemption for income from the transporting of cargo into that country (inbound freight). Thus, if a corporation organized in such a country derives U.S. source income from voyages that end in the United States, it cannot claim an exemption on the basis of an equivalent exemption granted by the foreign country for inbound freight income. With respect to the carriage of cargo, the foreign country must provide an exemption from tax for income from transporting cargo both inbound and outbound before it will be considered to grant an equivalent exemption.

An equivalent exemption also does not arise where a foreign country only exempts tax on specific types of cargo. Unless a country exempts income from transporting all types of cargo, it will not be considered to grant an equivalent exemption for purposes of this section.

A foreign country that has a territorial tax system will be considered to grant an equivalent exemption only if the tax system treats income from the international operation of ships or aircraft as 100 percent foreign source, and thereby not subject to tax, even if the income is derived from a voyage or flight that begins or ends in that foreign country.

Pursuant to authority provided in section 883(a)(5) of the Code, these rules provide that if a foreign country generally grants an equivalent exemption to corporations organized in the United States, but

also imposes a residence-based tax on certain corporations organized in the United States, the foreign country may nevertheless be considered to grant an equivalent exemption and to be a qualified foreign country if the residence-based tax is imposed only on a corporation organized in the United States that is treated as a resident of the other country because its place of management or control, or other comparable standard, is in that foreign country. See, H.R. Rep. No. 247, 101st Cong., 1st Sess. 1415 (1989). If instead the residence-based tax is imposed on a corporation organized in the United States that is not managed and controlled in that foreign country, the foreign country would not be treated as a qualified foreign country and would not grant an equivalent exemption for purposes of this section.

Finally, a foreign country must provide an exemption from tax for all income in a category of income, as defined in paragraph (h)(2) of this section. For example, a country that exempts income from the bareboat charter of passenger aircraft but not the bareboat charter of cargo aircraft does not provide an equivalent exemption for income from bareboat charter of aircraft.

Pursuant to section 872(b)(7), the proposed rule explains in §1.883–1(i) that a possession of the United States is considered to be a foreign country for purposes of this proposed rule. Thus, a possession on a mirror system is a qualified foreign country and is considered to grant an equivalent exemption to corporations organized in the United States. The term *mirror system* refers to the general applicability of the Code in the possession with the name of the possession substituted for *United States* in the Code where appropriate. Therefore, a qualified foreign corporation that is organized in a possession on a mirror system, and that operates a transportation business between the possession and the United States, could exclude its income from the international operation of ships or aircraft from its gross income for purposes of U.S. Federal income tax and such income could be exempt from U.S. income tax. In cases where a possession is not on a mirror system, the possession may nevertheless be a qualified foreign country if, for example, it provides for an equivalent exemption through its internal law.

Section 1.883–1(j) confirms the rule of section 265(a)(1). If a qualified foreign corporation derives income from a non-exempt activity as well as qualified income, and both are effectively connected with the conduct of a U.S. trade or business, the foreign corporation may not deduct from any income derived from the non-exempt activity any amount otherwise allowable as a deduction from qualified income that is excluded from gross income and exempt under this proposed rule.

Stock Ownership Tests

As provided in §1.883–1(c)(2), a foreign corporation must satisfy one of three stock ownership tests to be considered a qualified foreign corporation. It must demonstrate that more than fifty percent of the value of its stock is owned by qualified shareholders, as determined under §1.883–4 (qualified shareholder test) or that its stock is primarily and regularly traded on an established securities market in a qualified foreign country or in the United States, as determined under §1.883–2 (publicly-traded test), or that it is a controlled foreign corporation as determined under §1.883–3 (CFC test). Separate reporting and documentation requirements apply to each test. A foreign corporation that satisfies the publicly-traded test or the CFC test and its relevant reporting and documentation requirements does not have to comply with the reporting and documentation requirements of the qualified shareholder test.

The Publicly-Traded Stock Ownership Test

The branch profits tax rules under §1.884–5(d) provide the framework for the publicly traded test due to the strong similarities between the statutory language in sections 883(c) and 884(d)(4)(B) and the fact that both statutes were first enacted as part of the Tax Reform Act of 1986. Section 1.883–2(a) provides that a corporation is a publicly-traded corporation if its stock is primarily and regularly traded on one or more established securities markets in any qualified foreign country or in the United States. The proposed rule generally follows §1.884–5(d)(2) of the branch profits tax regulations in defining the term *established securities market*, except that the proposed rule does not require the foreign securities exchange to be the principal exchange in a country. In addition, the proposed rule follows §1.884–5(d)(3) in defining the term *primarily traded*, except that in the proposed rule the corporation's stock may be traded in any qualified foreign country or the United States and is not limited to trading only in the country where the corporation is organized or the United States.

Similarly, the proposed rule follows §1.884–5(d)(4)(i) in defining the general rule for the term *regularly traded*. Section 1.883–2(d) provides that stock of a foreign corporation is regularly traded if one or more classes of stock of the corporation that, in the aggregate, represent 80 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote and 80 percent or more of the total value of all classes of stock of such corporation are listed on an established securities market or markets during the taxable year; and, with respect to each class relied on to meet the 80 percent requirement, trades in each such class are effected, other than in de minimis quantities, on such market or markets on at least 60 days during the taxable year (or 1/6 of the number of days in a short taxable year). In addition, the aggregate number of shares in each such class that are traded on such market or markets during the taxable year must be at least 10 percent of the average number of shares outstanding in that class during the taxable year (or, in the case of a short taxable year, a percentage that equals at least 10 percent of the average number of shares outstanding in that class during the short taxable year multiplied by the number of days in the short taxable year, divided by 365).

In addition, if a class of stock of the foreign corporation is traded on an established securities market in the United States, and it is regularly quoted by brokers or dealers making a market in the stock, it can also be treated as meeting the trading requirements, provided that the closely-held exception, described below, does not apply. A broker or dealer makes a market in a stock only if the broker or dealer holds himself out to buy or sell the stock at the quoted price.

A closely-held class of stock, as set out in §1.883– 2(d)(3)(i), cannot be treated as

meeting the trading requirements of the publicly-traded stock ownership test. See, §1.884–5(d)(4)(iii)(A). Section 1.883–2(d)(3)(i) provides that a class of stock is closely held if at any time during the taxable year, one or more 5 percent shareholders own, in the aggregate, 50 percent or more of the value of the outstanding shares of the class of stock at any time during the taxable year. A five percent shareholder is any person who owns at least five percent of the value of the outstanding shares of the class of stock, taking into account stock owned by related persons. See §1.883– 2(d)(3)(iii). See also §1.884–5(d)(4)(iii)(B).

For this purpose, persons will be treated as related if they are related within the meaning of section 267(b). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). Further, in determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

The closely-held test in this proposed rule differs in one significant respect from the rule in the branch profits tax regulations. The proposed rule allows the foreign corporation to look through the five percent shareholders of the closely-held class to the ultimate owners and to demonstrate that such owners are qualified shareholders, provided no shares of stock in the chain of ownership are issued in bearer form. In the proposed rule, a class of stock of a foreign corporation that is otherwise regularly traded but is also closely-held will be treated as regularly traded if the foreign corporation demonstrates that more than 50 percent of the value of that class of stock is owned, or is treated as owned by applying the rules of attribution contained in §1.883–4(c), by qualified shareholders for more than half of the days of the taxable year. The requirements for being treated as a qualified shareholder are described in §1.883–4(b). Under this rule, an individual cannot be treated as a qualified shareholder if any corporation in the relevant chain of ownership issues stock in bearer form.

Thus, a foreign corporation with a class of stock that is closely-held may nevertheless count that class as regularly traded provided that the foreign corporation is able to establish that more than 50 percent of the value of the entire class of stock is owned (for example, through a partnership, trust or holding company) by persons who would themselves be qualified shareholders. The branch profits tax regulations do not treat a closely-held class of stock as regularly traded if 50 percent or more of the value of the closely-held block is owned by one or more 5 percent shareholders who are not qualifying shareholders, as defined in §1.884–5(b)(1) and those regulations do not permit the foreign corporation to look beyond the 5 percent shareholders to the owners. The IRS is considering whether to make conforming changes to §1.884–5(d)(4)(iii).

Paragraph (d)(4) is similar to §1.884–5(d)(4)(iv) and provides that trades between related persons described in section 267(b), as modified by §1.883–2(d)(3)(iii), and trades conducted in order to meet the regularly traded requirements are disregarded. A class of stock shall not be treated as meeting the trading requirements if there is a pattern of trades conducted to meet such requirements. For example, trades between two persons that occur several times during the taxable year may be treated as an arrangement or a pattern of trades conducted to meet the trading requirements of paragraph (d) of this section.

Section 1.883–2(d)(5) provides an example to illustrate the application of the rules regarding regularly traded stock and the closely-held exception.

Section 1.883–2(e) provides that a foreign corporation relying on the publicly-traded stock ownership test to establish that it satisfies the stock ownership test of §1.883–1(c)(2) must substantiate that it meets such requirements. The proposed rule requires, for example, that if a class of stock of a foreign corporation is closely-held within the meaning of paragraph (d)(3)(i), then the foreign corporation must obtain an ownership statement from each qualified shareholder upon whom it relies to meet the exception to the closely-held test. The ownership statements are described in §1.883–4(d). In addition, the foreign corporation must maintain and provide to the Commissioner upon request a list of its shareholders of record and any other relevant information.

Section 1.883–2(f) describes the information that the foreign corporation must include in its Form 1120F in order to rely on the publicly-traded stock ownership test to satisfy the stock ownership test of §1.883–1(c)(2).

Controlled Foreign Corporation Stock Ownership Test

Section 1.883–3 provides rules that a foreign corporation must follow if the foreign corporation relies on this section to satisfy the stock ownership test of §1.883–1(c)(2). A controlled foreign corporation (CFC) satisfies the stock ownership test of §1.883–1(c)(2) if it is organized in a qualified foreign country, satisfies the income inclusion test of paragraph (b) of this section, and satisfies the documentation and reporting requirements of paragraphs (c) and (d) of this section, respectively (the CFC test). For purposes of these proposed rules, a CFC that fails the income inclusion test may only satisfy the stock ownership test of §1.883–1(c)(2) if the CFC demonstrates that it meets either the publicly traded test of §1.883–2 or the qualified shareholder test of §1.883–4.

To satisfy the income inclusion test of paragraph (b), the foreign corporation must be a CFC as defined in section 957(a) if such section were applied without regard to section 318(a)(4). In addition, more than 50 percent of the CFC's subpart F income (as defined in section 952) derived from the international operation of ships or aircraft must be included, pursuant to section 951, in the gross income of one or more U.S. citizens, individual residents of the United States or domestic corporations for the taxable years of such persons in which the taxable year of the CFC ends. This additional requirement was included in order to prevent inappropriate extension of benefits under section 883. The rule is illustrated by two examples.

Paragraph (c) provides that a CFC relying on this section to satisfy the stock ownership test of §1.883–1(c)(2) must establish all the facts necessary to satisfy the Commissioner that it qualifies under the CFC stock ownership test. To meet this requirement with respect to the in-

come inclusion test, the CFC must obtain the documentation described in paragraph (c)(2). This documentation includes a copy for the taxable year of the Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations (if otherwise required to be filed) prepared by or on behalf of any U.S. shareholder that is a partnership, estate or trust. In addition, the documentation must include a written statement from each such U.S. shareholder that is a partnership, estate or trust providing the name, address, taxpayer identification number and percentage of interest in the U.S. shareholder held by each partner, beneficiary or other interest owner that is a U.S. citizen, individual resident of the United States or domestic corporation.

Finally, paragraph (d) explains that if a CFC is relying on this section to satisfy the stock ownership test of §1.883–1(c)(2), it must include certain additional information in its Form 1120F for the taxable year, along with the information required to be included in its return by §1.883–1(c)(3). This additional information is set out in paragraph (d) and should be current as of the end of the corporation's taxable year.

Qualified Shareholder Stock Ownership Test

Section 1.883–4(a) provides that a foreign corporation shall satisfy the stock ownership test of §1.883–1(c)(2) if more than 50 percent of its stock (by value) is owned, or treated as owned by applying the attribution rules of paragraph (c) of this section, for at least half of the number of days in the foreign corporation's taxable year by one or more qualified shareholders. In addition, a foreign corporation must meet the substantiation and reporting requirements of paragraphs (d) and (e) of this section (qualified shareholder stock ownership test).

Paragraph (b)(1) of this section explains that a shareholder is a qualified shareholder only if the shareholder meets certain criteria. First, the shareholder must be a resident in a country that offers an equivalent exemption for the same type of income as that earned by the foreign corporation. Second, the shareholder must not own its interest in the foreign corporation through bearer shares either directly or by applying the attribution rules of paragraph (c) of this section. Third, the shareholder must provide to the foreign corporation the documentation required in paragraph (d) of this section and the foreign corporation must meet the reporting requirements of paragraph (e) of this section with respect to such shareholder. Finally, the shareholder must be described in one of the following categories of qualified shareholders—

(A) An individual who is not a beneficiary of a pension fund, as described in paragraph (E), and who is a resident of a qualified foreign country, as determined under paragraph (b)(2);

(B) The government of a qualified foreign country (or a political subdivision or local authority of such country);

(C) A foreign corporation that is organized in a qualified foreign country and meets the publicly traded rules of §1.883–2;

(D) A not-for-profit organization described in paragraph (b)(4) of this section that is not a pension fund as defined in paragraph (b)(5) of this section and that is organized in a qualified foreign country; or

(E) A beneficiary of a pension fund (as defined in paragraph (b)(5)(iv) of this section) administered in or by a qualified foreign country (whose residency is determined under paragraph (d)(3)).

Paragraph (b)(2) of this section explains when an individual is a resident of a qualified foreign country for purposes of this proposed rule. An individual is a resident of a qualified foreign country only if the individual is fully liable to tax as a resident in such country (for example, an individual who is liable to tax only on a remittance basis in a foreign country may not be treated as a resident of that country), and in addition, either: (1) the individual's tax home, within the meaning of paragraph (b)(2)(ii) of this section, is within that qualified foreign country 183 days or more of the taxable year; or (2) the individual is treated as a resident of a qualified foreign country based on special rules pursuant to paragraphs (d)(3) of this section.

Paragraph (b)(2)(ii) explains that for purposes of this section an individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of his business (or lack of a business), then the individual's tax home is located at his regular place of abode in a real and substantial sense. If an individual has no regular or principal place of business and no regular place of abode in a real and substantial sense in a qualified foreign country for 183 days or more of the taxable year, that individual does not have a tax home for purposes of this section and, therefore, is not a qualified shareholder unless either a special rule in paragraphs (d)(3)(ii) through (v) of this section applies or the individual demonstrates that he is fully liable to tax as a resident in such country. If further guidance is needed to determine the tax home of an individual for the purpose of determining whether the individual is a qualified shareholder under this paragraph, the proposed rule anticipates that the foreign corporation would look to published guidance under section 911(d)(3), with the exception of guidance relating to the treatment of itinerants.

Paragraph (b)(3) provides that a shareholder otherwise described in paragraph (b)(1) of this section may be a resident of a foreign country that provides an equivalent exemption for the category of income at issue through an income tax convention with the United States. If the shareholder relies on the convention to demonstrate that the country of residence provides an equivalent exemption and the convention has a requirement in the shipping and air transport article other than residence, such as place of registration or documentation of the ship or aircraft, or in the limitation on benefits article, such as a percentage of resident ownership, the shareholder is not a qualified shareholder unless the corporation seeking qualified foreign corporation status would satisfy any such additional requirement if it were organized in such foreign country. The proposed rule offers two examples to illustrate this rule.

Paragraph (b)(4) explains the requirements for a not-for- profit organization to be a qualified shareholder. This rule generally follows the rules in the first paragraph of §1.884–5(b)(1)(iv) of the branch profits tax regulations. Similarly, paragraph (b)(5) explains the requirements that a pension fund must satisfy in order for its beneficiaries to be qualified shareholders. The proposed rule addresses

both government and non-government pension funds and defines the term beneficiary of a pension fund. This paragraph generally follows §1.884–5(b)(8)(i) through (iii) of the branch profits tax regulations.

Paragraph (c) of this section contains the rules for determining constructive ownership for purposes of applying the stock ownership test of §1.883–1(c)(2) and the qualified shareholder stock ownership test of paragraph (a) of this section. Paragraph (c)(1) provides that stock owned by or for a corporation, partnership, trust, estate, or mutual insurance company or similar entity shall be treated as owned proportionately by its shareholders, partners, beneficiaries, grantors, or other interest holders as provided in paragraphs (c)(2)through (6) of this section. The proportionate interest rules of this paragraph apply successively upward through a chain of ownership, and a person's proportionate interest shall be computed for the relevant days or period that is taken into account in determining whether a foreign corporation satisfies the requirements of paragraph (a) of this section. Stock treated as owned by a person by reason of this paragraph shall be treated as actually owned by such person for purposes of this section. An owner of an interest in an association taxable as a corporation shall be treated as a shareholder of such association for purposes of this paragraph (c).

Paragraph (c)(2) explains that a partner shall be treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the least of three distributive shares: the partner's percentage distributive share of the partnership's dividend income from the stock; the partner's percentage distributive share of gain from disposition of the stock by the partnership; or the partner's percentage distributive share of the stock (or proceeds from the disposition of the stock) upon liquidation of the partnership. This rule generally follows the constructive ownership rules in §1.884–5(b)(2)(ii) of the branch profits tax regulations. It differs, however, because all qualified shareholders that are partners in a partnership and that are residents of, or organized in, the same qualified foreign country shall be treated as one partner. Thus, the percentage distributive shares of dividend income, gain and liquidation rights of all qualified shareholders that are partners in a partnership and that are residents of, or organized in, the same qualified foreign country are aggregated prior to determining the least of the three percentages set out in paragraph (c)(2)(i) of this section. This divergence was necessary because one country may be a qualified foreign country while another may not and it is necessary for the foreign corporation to identify the value of the stock owned by residents of each country. Several examples illustrate the rules of this paragraph.

Paragraph (c)(3) of this section provides rules for determining the owners of stock owned by or for a trust or estate. These rules generally adopt the rules of §1.884–5(b)(2)(iii) of the branch profits tax regulations. Similarly, paragraphs (c)(4) and (5) provide rules for determining the owners of stock owned by corporations that issue stock and by mutual insurance companies and similar entities, respectively. These rules adopt the rules of §1.884–5(b)(2)(iv) and (v) of the branch profits tax regulations, respectively.

Paragraph (c)(6) explains how to compute the beneficial interests of individuals in non-government pension funds. This rule differs from the rule in §1.884–5(b)(8)(iv) of the branch profits tax regulations in that the proposed rule provides that stock held by a non-government pension fund shall be considered owned by the beneficiaries of the fund equally on a pro-rata basis if certain conditions are met. For example, the trustees, directors or other administrators of the pension fund must have no knowledge, and no reason to know, that a pro-rata allocation of interests of the fund to all beneficiaries would differ significantly from an actuarial allocation of interests in the fund (or, if the beneficiaries' actuarial interest in the stock held directly or indirectly by the pension fund differs from the beneficiaries's actuarial interest in the pension fund, that a pro-rata allocation of interests of the fund to all beneficiaries would differ significantly from the actuarial interests computed by reference to the beneficiaries' actuarial interest in the stock).

The branch profits tax regulations determine such beneficial interests on an actuarial basis. The other conditions that must be satisfied generally follow those set out in §1.884–5(b)(8)(iv).

Paragraph (d)(1) provides that a foreign corporation that relies on this section to satisfy the ownership requirements of §1.883–1(c)(2), must establish all the facts necessary to satisfy the Commissioner that more than 50 percent of the value of its shares is owned, or treated as owned by applying paragraph (c) of this section, by qualified shareholders. A foreign corporation cannot meet this requirement with respect to any stock issued in bearer form. A shareholder that holds shares in the foreign corporation either directly or indirectly in bearer form cannot be a qualified shareholder.

Paragraph (d)(2)(i) provides that, except as provided in paragraph (d)(3), a person may only be a qualified shareholder if for the relevant period, the person completes an ownership statement, which is described in paragraph (d)(4) of this section. In the case of a person owning stock in the foreign corporation indirectly through one or more intermediaries (including mere legal owners or recordholders acting as nominees), each intermediary in the chain of ownership between that person and the foreign corporation seeking qualified foreign corporation status must also complete an intermediary ownership statement, which is described in paragraph (d)(4)(v). In addition, the foreign corporation must receive such ownership statements and retain them with the corporate books and records until the close of statute of limitations for the taxable year to which the statements relate.

The ownership statements required in paragraph (d)(2)(i) remain valid until the earlier of the last day of the third calendar year following the year in which the ownership statement is signed or the day that a change of circumstance occurs that makes any information on the ownership statement incorrect. For example, an ownership statement signed on September 30, 2000, remains valid through December 31, 2003, unless circumstances change that make the information of the statement no longer correct.

Paragraph (d)(3) contains special rules for determining the residence of certain shareholders. These rules are intended to simplify and reduce the effort needed by the foreign corporation and its intermediary shareholders to obtain the documenta-

tion required to substantiate whether the foreign corporation satisfies the qualified shareholder stock ownership test. If one of these special rules applies, the foreign corporation is not required to obtain an ownership statement from the individual owners covered by that rule.

Paragraph (d)(3)(ii) provides a special rule for registered shareholders owning less than one percent of widely-held corporations. This rule is adopted from §1.884–5(b)(3)(iii) of the branch profits tax regulations. A foreign corporation with at least 250 registered individual shareholders, that is not a publicly-traded corporation, as described in §1.883–2, (a widely-held corporation), may not be required to obtain an ownership statement from an individual shareholder owning less than one percent of the widely-held corporation at all times during the taxable year. If such widely-held foreign corporation is the foreign corporation seeking qualified foreign corporation status, or an intermediary that meets the documentation requirements of paragraphs (d)(4)(v)(A) and (B) of this section, relating to ownership statements from widely-held intermediaries with registered shareholders owning less that one percent of such intermediary, the widely-held foreign corporation may treat the address of record in its ownership records as the residence of any less than one percent individual shareholder if the individual's address of record is not a non-residential address, such as a post office box or in care of a financial intermediary or stock transfer agent and the officers and directors of the widely-held corporation neither know nor have reason to know that the individual does not reside at that address.

Paragraph (d)(3)(iii) provides special rules for pension funds. An individual who is a beneficiary of a government pension fund shall be treated as a resident of the country in which the pension fund is administered if the pension fund satisfies the documentation requirements of paragraphs (d)(4)(v)(A) and (C)(*1*) of this section, relating to ownership statements from pension funds. An individual who is a beneficiary of a non-government pension fund having more than 100 beneficiaries shall be treated as a resident of the country of the beneficiary's address as it appears on the records of the fund, provided it is not a nonresidential address, such as a post office box or an address in care of a financial intermediary, and provided none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not an individual resident of such foreign country. This rule applies only if the non-government pension fund satisfies the documentation requirements of paragraphs (d)(4)(v)(A) and (C)(*2*) of this section.

Paragraph (d)(3)(iv) provides a special rule for publicly- traded corporations owning a direct or indirect interest in the foreign corporation seeking qualified foreign corporation status. Any stock in a foreign corporation seeking qualified foreign corporation status that is owned by a publicly traded corporation will be treated as owned by a person resident in the country where the publicly traded corporation is organized if the foreign corporation receives the statement described in paragraph (d)(4)(iii) of this section from the publicly-traded shareholder along with copies of any relevant ownership statements that the publicly traded shareholder relies on to satisfy the exception to the closely-held class of stock rule of §1.883–2(d)(3)(ii).

Finally, paragraph (d)(3)(v) provides a special rule for not-for-profit organizations. For purposes of meeting the ownership requirements of paragraph (a) of this section, a not-for-profit organization may rely on the addresses of record of its individual beneficiaries and supporters to determine where such persons are resident, provided that: the addresses of record are not nonresidential addresses such as a post office box or in care of a financial intermediary; the officers, directors or administrators or the organization do not know or have reason to know that the individual beneficiaries or supporters do not reside at that address; and the foreign corporation seeking qualified foreign corporation status receives the statement required in paragraph (d)(4)(iv) of this section from the not-for profit organization.

Paragraph (d)(4) describes the information that must be obtained by a corporation seeking qualified foreign corporation status for each taxable year if the foreign corporation relies on §1.883–4 to meet the stock ownership requirements of §1.883–1(c)(2), or to demonstrate that it is not a closely-held corporation. Treasury and the IRS solicit comments with respect to the appropriateness of these information requirements.

Paragraph (d)(4)(i) provides that an ownership statement from an individual shareholder is a written statement signed under penalties of perjury stating certain general information about a shareholder's ownership interest and country of residence. Paragraph (d)(4)(ii) provides additional information that must be included if the shareholder is a foreign government. Paragraph (d)(4)(iii) provides additional information that must be included if the shareholder is a publicly traded corporation. Paragraph (d)(4)(iv) provides additional information that must be included if the shareholder is a not-for-profit organization.

The foreign corporation seeking qualified foreign corporation status must obtain an intermediary ownership statement from each intermediary standing in the chain of ownership between it and the qualified shareholders upon whom it relies to meet the qualified shareholder stock ownership test. Paragraph (d)(4)(v) provides that an intermediary ownership statement is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or a person who would be authorized to sign a tax return on behalf of the intermediary (if the intermediary is not an individual) stating certain general information about the intermediary's ownership interest and residence. Paragraph (d)(4)(v)(B) provides additional information that must be included if the shareholder is a widely-held intermediary with registered shareholders owning less than one percent of the widely-held intermediary. Paragraph (d)(4)(v)(C) provides additional information that must be included if the shareholder is a pension fund. This paragraph describes the information to be included in the intermediary ownership statement by both government and non-government pension funds and provides that the determinations required to be made under this paragraph (d)(4)(v)(C) shall be made using information shown on the records of the pension fund for a date during the foreign corporation's taxable year to which the determination is relevant.

Paragraph (d)(5) requires the foreign corporation seeking qualified foreign cor-

poration status to retain the documentation described in paragraphs (d)(3) and (4) of this section until the expiration of the statute of limitations for the taxable year of the foreign corporation to which the documentation relates. Such documentation must be made available for inspection by the Commissioner at such place as the Commissioner may request.

A foreign corporation relying on the ownership requirements of this section to demonstrate that it is a qualified foreign corporation for purposes of §1.883–1(c)(2) must provide the information described in paragraph (e) in addition to the information required in §1.883–1(c)(3) to be included in its Form 1120F for each taxable year. The information should be current as of the end of the corporation's taxable year. This information is to be based on an analysis of the ownership records of the foreign corporation, as well as on the ownership statements and other documentation that are obtained from its shareholders.

Proposed Effective Dates

The effective date provisions for the proposed rule are contained in §1.883–5. The proposed rule applies to taxable years of the foreign corporation ending 30 days or more after the date the proposed rule is published as a final regulation in the **Federal Register**. When the regulation is final, taxpayers may rely on all the provisions of this section for guidance and may elect to apply all such substantive provisions for any open taxable year beginning after December 31, 1986, and ending before the date the final regulation is effective. Such election will be applicable for the year of the election and for all subsequent taxable years. However, in no event will §1.883–1(c)(3) (relating to the substantiation and reporting required to be treated as a qualified foreign corporation) or §§1.883–2(f), 1.883–3(d) and 1.883–4(e) (relating to additional information to be included in the return to demonstrate whether the foreign corporation satisfies one of three stock ownership tests) apply to any taxable years ending prior to the effective date of this regulation.

Section 1.883–1(c)(3) (relating to the substantiation and reporting required to be treated as a qualified foreign corporation) requires that certain information be included in the foreign corporation's Form 1120F, "U.S. tax Return of Foreign Corporation." Sections 1.883–2(f), 1.883–3(d) and 1.883–4(e) (relating to information to be included to demonstrate whether the foreign corporation satisfies one of three stock ownership tests) require that additional information also be included in such return. When this regulation becomes generally applicable, and until the taxable year for which the Form 1120F and its instructions are revised to conform to this regulation and the foreign corporation seeking qualified foreign corporation status is otherwise directed by such instructions, the information required in §1.883–1(c)(3) and §1.883–2(f), 1.883–3(d) or 1.883–4(e), as applicable, must be included in a written statement signed under penalties of perjury by a person authorized to sign the return, attached to the Form 1120F, and filed with the return.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f) of the 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. An initial regulatory flexibility analysis has been prepared as required for the collection of information in this notice of proposed rulemaking under 5 U.S.C. 603. The analysis is set forth in this preamble under the heading "Initial Regulatory Flexibility Analysis."

Initial Regulatory Flexibility Analysis

This initial analysis is prepared pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6). The objective of the proposed regulations is to provide guidance to foreign corporations engaged in the international operation of a ship or ships or aircraft. This guidance will enable the foreign corporation to determine if it is eligible to exclude its income from these activities from gross income for purposes of its United States Federal income tax. The legal basis for these requirements is section 883. The IRS and Treasury are not aware of any Federal rules that duplicate, overlap, or conflict with the proposed regulations.

The documentation and reporting requirements of the proposed regulations enable the IRS to identify those taxpayers that may or may not be eligible to claim a reciprocal exemption. In addition, analysis of the required shareholder documentation will enable the foreign corporation to correctly file its U.S. Federal income tax return.

There are approximately 1,400 foreign corporations that operate a ship or ships or aircraft on voyages or flights to or from the United States annually. These foreign corporations all have an obligation to file a U.S. Federal income tax return, regardless of whether they are entitled to a reciprocal exemption. However, many of those corporations are organized in qualified foreign countries and may be eligible to exempt their income from the international operation of a ship or ships or aircraft from U.S. tax. Because it is impossible to determine at this time which of these foreign corporations satisfies the ownership requirements of the proposed rule, an estimate of the number of small entities that would be affected by these regulations is unavailable. A foreign corporation that complies with the documentation requirements of these proposed rules should have the information necessary to determine with certainty whether it is eligible for an equivalent exemption. This, in turn, is expected to create the additional benefits of increasing compliance with the filing requirements of the Internal Revenue Code and enabling the IRS to confirm whether the foreign corporation is entitled to an exemption.

None of the significant alternatives considered in drafting these regulations would have significantly altered the economic impact of the collections of information on small entities. In considering the significant alternatives that would be permissible under the Code and would enable the IRS to ensure compliance with the Code, the IRS and Treasury concluded that the alternatives generally would impose equal or greater burdens.

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. The IRS and Treasury request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be made available for public inspection and copying.

A public hearing has been scheduled for April 27, 2000, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Ave., NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to this hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 5, 2000. 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 proposed regulations is Patricia A. Bray of the Office of the 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 1.883–1 is also issued under 26 U.S.C. 883.

Section 1.883–2 is also issued under 26 U.S.C. 883.

Section 1.883–3 is also issued under 26 U.S.C. 883.

Section 1.883–4 is also issued under 26 U.S.C. 883.

Section 1.883–5 is also issued under 26 U.S.C. 883. * * *

Par. 2. Section 1.883–0 is added to read as follows:

§1.883–0 Outline of major topics.

This section lists the major paragraphs contained in §§1.883–1 through 1.883–5.

§1.883–0 Outline of major topics.

§1.883–1 Exclusion of income from the international operation of ships or aircraft.

(a) General rule.
(b) Qualified income.
(c) Qualified foreign corporation.
(1) General rule.
(2) Stock ownership tests.
(3) Substantiation and reporting requirements.
(i) General rule.
(ii) Further documentation.
(4) Commissioner's discretion to cure defects in documentation.
(d) Qualified foreign country.
(e) Operation of ships or aircraft.
(1) General rule.
(2) Activities not considered operation of ships or aircraft.
(3) Definitions.
(i) Full charter.
(ii) Time charter.
(iii) Voyage charter.
(iv) Wet lease.
(v) Bareboat charter.
(vi) Dry lease.
(vii) Space or slot charter.
(viii) Nonvessel operating common carrier (NVOCC).
(ix) Code sharing arrangements.
(f) International operation.
(1) General rule.
(2) Determining whether income is from international operation.
(i) International carriage of passengers.
(A) In general.
(B) Round trip travel on cruise ships.
(ii) International carriage of cargo.
(iii) Bareboat charter of ships or aircraft used in international operations.
(A) Ratio based on use.
(B) Ratio based on gross income.
(g) Activities incidental to the international operation of ships or aircraft.
(1) General rule.
(2) Activities not considered incidental to the international operation of ships or aircraft.
(h) Equivalent exemption.
(1) General rule.
(2) Determining equivalent exemptions for each category of income.
(3) Special rule with respect to income tax conventions.
(4) Exemptions not qualifying as equivalent exemptions. (i) General rule.
(ii) Reduced tax rate or time limited exemption.
(iii) Inbound or outbound freight tax.
(iv) Exemptions for limited types of cargo.
(v) Territorial tax systems.
(vi) Countries that tax on a residence basis.
(vii) Exemptions within categories of income.
(i) Treatment of possessions.
(j) Expenses related to exempt income not deductible from non-exempt income.

§1.883–2 Treatment of publicly-traded corporations.

(a) General rule.
(b) Established securities market.
(1) General rule.
(2) Exchanges with multiple tiers.
(3) Computation of dollar value of stock traded.
(4) Over-the-counter market.
(5) Discretion to determine that an exchange does not qualify as an established securities market.
(c) Primarily traded.
(d) Regularly traded.
(1) General rule.
(2) Classes of stock traded on a domestic established securities market treated as meeting trading requirements.
(3) Closely-held classes of stock not treated as meeting trading requirements.
(i) General rule.
(ii) Exception.
(iii) Treatment of related persons.
(4) Anti-abuse rule.
(5) Example.
(e) Substantiation that a foreign corporation is publicly-traded.
(i) In general.

(ii) Availability and retention of documents for inspection.
(f) Reporting requirements.

§1.883–3 Treatment of controlled foreign corporations.

(a) General rule.
(b) Special rule for CFC's with certain entity shareholders.
(1) Income inclusion test.
(2) Examples.
(c) Substantiating CFC stock ownership.
(1) In general.
(2) Documentation from certain U.S. shareholders.
(3) Availability and retention of documents for inspection.
(d) Reporting requirements.

§1.883–4 Qualified shareholder stock ownership test.

(a) General rule.
(b) Qualified shareholder.
(1) General rule.
(2) Residence of individual shareholders.
(i) General rule.
(ii) Tax home.
(3) Certain income tax convention restrictions applied to shareholders.
(i) Application of restrictions.
(ii) Examples.
(4) Not-for-profit organizations.
(5) Pension funds.
(i) Pension fund defined.
(ii) Government pension funds.
(iii) Non-government pension funds.
(iv) Beneficiary of a pension fund.
(c) Rules for determining constructive ownership.
(1) General rules for attribution.
(2) Partnerships.
(i)General rule.
(ii) Partners resident in same country.
(iii) Examples.
(3) Trusts and estates.
(i) Beneficiaries.
(ii) Grantor trusts.
(4) Corporations that issue stock.
(5) Mutual insurance companies and similar entities.
(6) Computation of beneficial interests in non-government pension funds.
(d) Substantiation of stock ownership.
(1) General rule.
(2) Application of general rule.
(i) Ownership statements.
(ii) Three-year period of validity.
(3) Special rules.
(i) Determining residence of certain shareholders.
(ii) Special rule for registered shareholders owning less than one percent of widely-held corporations.
(iii) Special rules for beneficiaries of pension funds.
(A) Government pension fund.
(B) Non-government pension fund.
(iv) Special rule for stock owned by publicly-traded corporations.
(v) Special rule for not-for-profit organizations.
(4) Ownership statements from shareholders.
(i) Ownership statements from individuals.
(ii) Ownership statements from foreign governments.
(iii) Ownership statements from publicly-traded corporate shareholders.
(iv) Ownership statements from not-for-profit organizations.
(v) Ownership statements from intermediaries.
(A) General rule.
(B) Ownership statements from widely-held intermediaries with registered shareholders owning less than one percent of such widely-held intermediary.
(C) Ownership statements from pension funds.
(*1*) Ownership statements from government pension funds.
(*2*) Ownership statements from non-government pension funds.
(*3*) Time for making determinations.
(5) Availability and retention of documents for inspection.
(e) Reporting requirements.

§1.883–5 Effective date.

(a) General rule.
(b) Election for retroactive application.
(c) Transition rule.

Par. 3. Section 1.883–1 is revised to read as follows:

§1.883–1 Exclusion of income from the international operation of ships or aircraft.

(a) *General rule*. A foreign corporation shall exclude from its gross income for U.S. tax purposes any income it derives from the international operation of ships or aircraft if such income is qualified income under paragraph (b) of this section and if the corporation is a qualified foreign corporation under paragraph (c) of this section. See paragraph (e) of this section for the definition of the term *operation of ships or aircraft* and see paragraph (f) of this section for the definition of the term *international operation*.

(b) *Qualified income*. Qualified income is income from the international operation of ships or aircraft that—

(1) Is properly includible in any of the income categories described in paragraph (h)(2) of this section; and

(2) Is the subject of an equivalent exemption, as described in paragraph (h) of this section, granted by the qualified foreign country in which the foreign corporation seeking qualified foreign corporation status is organized. See paragraph (d) of this section for the definition of the term *qualified foreign country*.

(c) *Qualified foreign corporation*—(1) *General rule*. A qualified foreign corporation is a corporation, as defined in §§301.7701–2(b) and 301.7701–3 of this chapter, that is engaged in the international operation of ships or aircraft and that is organized in a qualified foreign country. To be a qualified foreign corporation the corporation must also satisfy one of the three stock ownership tests described in paragraph (c)(2) of this section and satisfy the substantiation and reporting requirements described in paragraph (c)(3) of this section. A corporation may be a qualified foreign corporation with respect to one category of qualified income but may not be with respect to another category of income. See paragraph (h)(2) of this section for a discussion of categories of qualified income.

(2) *Stock ownership tests*. To be a qualified foreign corporation the foreign corporation generally must demonstrate and document that more than fifty percent of the value of its stock is owned by qualified shareholders, as determined in §1.883–4 (qualified shareholder stock ownership test). However, a foreign corporation will not be required to demonstrate that it satisfies the qualified shareholder stock ownership test if it can demonstrate either that its stock is primarily and regularly traded on an established securities market in a qualified foreign country or in the United States, as determined under §1.883–2 (publicly-traded test), or that it is a controlled foreign corporation as determined under §1.883–3 (CFC test).

(3) *Substantiation and reporting requirements*—(i) *General rule*. To be a

qualified foreign corporation, a foreign corporation must include the following information in its Form ll20F, "U.S. Income Tax Return of a Foreign Corporation," in the manner that the Form 1120F and its accompanying instructions prescribes—

(A) The corporation's name and address (including mailing code);

(B) The corporation's U.S. taxpayer identification number;

(C) The foreign country in which the corporation is organized;

(D) The applicable authority for an equivalent exemption, (e.g., a citation to either a statute in the country where the corporation is organized or a diplomatic note between the foreign country where the corporation was organized and the United States that provides an equivalent exemption, or to Rev. Rul. 97–31 (1997–1 C.B. 703) (see §601.601(d)(2) of this chapter), if the foreign country is included in Part II or III of the Table of countries that currently provide an equivalent exemption);

(E) The category or categories of qualified income for which an exemption is being claimed;

(F) A reasonable estimate of the amount of each category of U.S. source qualified income for which the exemption is claimed;

(G) Any other information required under §1.883–2(f), 1.883–3(d), or 1.883–4(e); and

(H) Any other specified information.

(ii) *Further documentation*. If the Commissioner requests in writing that the foreign corporation substantiate representations made under paragraph (c)(3)(i) of this section, or under §1.883–2(f), 1.882–3(d) or 1.883–4(e), the foreign corporation must provide the supporting documentation or substantiation within 60 days following the written request. If the foreign corporation does not provide all of the information requested within the 60 day period but demonstrates that the failure was due to reasonable cause and not willful neglect, the Commissioner may grant the foreign corporation a 30-day extension to provide the supporting documentation or substantiation. Whether a failure to obtain the documentation or substantiation in a timely manner was due to reasonable cause shall be determined by the Commissioner after considering all the facts and circumstances.

(4) *Commissioner's discretion to cure defects in documentation*. The Commissioner retains the discretion to cure any defects in the documentation where the Commissioner is satisfied that the foreign corporation would otherwise be a qualified foreign corporation.

(d) *Qualified foreign country*. A qualified foreign country is a foreign country that grants to corporations organized in the United States an equivalent exemption, as described in paragraph (h) of this section, for the category of qualified income earned by the foreign corporation seeking qualified foreign corporation status. A foreign country may be a qualified foreign country with respect to one category of income but not with respect to another category of income, as described in paragraph (h)(2) of this section.

(e) *Operation of ships or aircraft*—(1) *General rule*. Only a corporation that is an owner, lessor or lessee of an entire ship or aircraft used to carry cargo or passengers for hire can be considered engaged in the operation of ships or aircraft. The term *operation of ships or aircraft*, which includes the operation of a single ship or aircraft, means—

(i) Carriage of passengers or cargo for hire;

(ii) Time or voyage charter of a ship, or wet lease of an aircraft (full charter), as defined in paragraph (e)(3) of this section;

(iii) Bareboat charter of a ship, or dry lease of an aircraft, as defined in paragraph (e)(3) of this section; or

(iv) Active participation by a foreign corporation that is otherwise engaged in the operation of ships or aircraft in a pool, partnership, strategic alliance, joint operating agreement, code sharing or other joint venture, that is itself engaged in the operation of ships or aircraft.

(2) *Activities not considered operation of ships or aircraft*. A corporation that is not engaged in any of the activities described in paragraph (e)(1) of this section shall not be considered engaged in the operation of ships or aircraft. Examples of activities that do not constitute activities described in (e)(1) include—

(i) The activities of a nonvessel-operating common carrier (NVOCC), as defined in paragraph (e)(3)(viii) of this section;

(ii) Space or slot charter, as defined in paragraph (e)(3)(vii) of this section;

(iii) Ship management;

(iv) Obtaining crews for ships or aircraft not operated by the corporation;

(v) The activities of a ship's agent;

(vi) Ship or aircraft brokering;

(vii) Freight forwarding;

(viii) The activities of travel agents and tour operators;

(ix) Rental by a container leasing company of containers and related equipment for inland transportation;

(x) Passive investment in an enterprise, including a pool, partnership, strategic alliance, joint operating agreement, or other joint venture, engaged in the international operation of ships or aircraft; or

(xi) The activities of a concessionaire.

(3) *Definitions*—(i) *Full charter*. Full charter (or full rental) means a time charter or a voyage charter of a ship or a wet lease of an aircraft.

(ii) *Time charter*. A time charter is a contract for the use of a ship or aircraft for a specific period of time during which the owner/lessor of the ship or aircraft retains control of the navigation and management of the ship or aircraft (e.g., the owner/lessor continues to be responsible for the crew, supplies, repairs and maintenance, fees and insurance, charges, commissions and other expenses connected with the use of the ship or aircraft).

(iii) *Voyage charter*. A voyage charter is a contract similar to a time charter except that the ship or aircraft is chartered for a specific voyage or flight rather than for a specific period of time.

(iv) *Wet lease*. When a time charter or voyage charter involves an aircraft, it is referred to, in both cases, as a wet lease.

(v) *Bareboat charter*. A bareboat charter is a contract for the use of aircraft whereby the charterer/lessee is in complete possession, control, and command of the ship or aircraft and performs functions normally performed by the owner/lessor of the ship or aircraft. For example, the charterer/lessee is responsible for the navigation and management of the ship or aircraft, the crew, supplies, repairs and maintenance, fees, insurance, charges, commissions and other expenses connected with the use of the ship or aircraft. The owner/lessor of the ship bears none of the expense or responsibility of operation of the ship or aircraft.

(vi) *Dry lease*. When a bareboat char-

ter involves an aircraft, it is referred to as a dry lease.

(vii) *Space or slot charter*. A space or slot charter is a contract for use of a certain amount of space (but less than all of the space) on a ship or aircraft, and may be on a time or voyage basis. When used in connection with passenger aircraft this may be referred to as the sale of block seats.

(viii) *Nonvessel operating common carrier (NVOCC)*. A nonvessel operating common carrier is an entity that holds itself out to the public as providing transportation for hire, assumes responsibility or has liability by law for safe transportation of shipments and arranges in its own name with underlying carriers for the performance of such transportation. An NVOCC is distinguishable from a charterer/lessee in that a charterer/lessee hires and has control of all or part of a vessel. An NVOCC is merely a customer of the ocean common carrier. Where an NVOCC consolidates shipments and holds itself out to the public as providing transportation for hire, its services and liabilities are comparable to that of a freight forwarder.

(ix) *Code-sharing arrangements*. Code sharing is an arrangement in which one air carrier puts its identification code on the flight of another carrier. This allows the first carrier to hold itself out as providing service in markets where it does not operate or where it operates infrequently. Code sharing can range from a very limited agreement involving only one market, to alliances between international carriers involving agreements on joint marketing, baggage handling, one-stop check-in service and sharing of frequent flyer awards.

(f) *International operation*—(1) *General rule*. The term *international operation* means operation of ships or aircraft, as defined in paragraph (e) of this section, on voyages or flights that begin or end in the United States, as determined in paragraph (f)(2) of this section, and correspondingly end or begin in a foreign country. The term does not include a voyage or flight that begins and ends in the United States even if the voyage or flight contains a segment extending beyond the territorial limits of the United States with no stop in a foreign country. Operation of ships or aircraft beyond the territorial limits of the United States does not, in itself, constitute international operation of ships or aircraft.

(2) *Determining whether income is from international operation*. Whether income is derived from the international operation of ships or aircraft is determined on a passenger-by-passenger basis (as provided in paragraph (f)(2)(i) of this section) and item of cargo-by-item of cargo basis (as provided in paragraph (f)(2)(ii) of this section). In the case of the bareboat charter of a ship or the dry lease of an aircraft, whether the charter income is derived from international operation is determined by reference to the use of the ship or aircraft by the lowest-tier operator in the chain of lessees (as provided in paragraph (f)(2)(iii) of this section).

(i) *International carriage of passengers*—(A) *In general*. Except in the case of a round trip cruise, income from the carriage of a passenger will be income from the international operation of ships or aircraft if the passenger is carried between a beginning point in the United States and an ending point in a foreign country and vice versa. Carriage of a passenger will be treated as ending at the passenger's final destination even if, en route to the passenger's final destination, a stop is made at an intermediate point for refueling, maintenance, or other business reasons, provided the passenger does not change aircraft or ships at the intermediate point. Similarly, carriage of a passenger will be treated as beginning at the passenger's point of origin even if, en route to the passenger's final destination, a stop is made at an intermediate point and the passenger does not change aircraft or ships at the intermediate point. Carriage of a passenger will be treated as beginning or ending at a U.S. or foreign intermediate point if the passenger changes aircraft or ships at that intermediate point.

(B) *Round trip travel on cruise ships*. In the case of the carriage of a passenger on a round trip cruise that begins in the United States, stops at a foreign intermediate port for shore excursions, refueling, maintenance, or other business reasons, and returns to the same or another U.S. port, the carriage of such passenger on the round trip cruise will be treated as international operation of a ship under paragraph (f)(2)(i)(A) of this section. Such a round trip cruise may also include one or more intermediate stops at a U.S. port or ports for similar purposes.

(ii) *International carriage of cargo*. Income from the carriage of cargo will be income from the international operation of ships or aircraft if the cargo is carried between a beginning point in the United States and an ending point in a foreign country or vice versa. Carriage of cargo will be treated as ending at the final destination of the cargo even if, en route to that final destination, a stop is made at a U.S. intermediate point, provided that the cargo is transported to its ultimate destination on the same ship or aircraft. If the cargo is transferred to another ship or aircraft, the carriage of the cargo may nevertheless be treated as ending at its final destination if the same taxpayer transports the cargo to and from the U.S. intermediate point and the cargo does not pass through customs at the U.S. intermediate point. Similarly, carriage of cargo will be treated as beginning at the cargo's point of origin, even if en route to its final destination, a stop is made at a U.S. intermediate point, provided that the cargo is transported to its ultimate destination on the same ship or aircraft. If the cargo is transferred to another ship or aircraft, the carriage of the cargo may nevertheless be treated as beginning at the point of origin if the same taxpayer transports the cargo to and from the U.S. intermediate point and the cargo does not pass through customs at the U.S. intermediate point. Repackaging, recontainerization, or any other activity involving the unloading of the cargo at the U.S. intermediate point will not change these results if the same taxpayer transports the cargo to and from the U.S. intermediate point and the cargo does not pass through customs at the U.S. intermediate point.

(iii) *Bareboat charter of ships or aircraft used in international operations*. If a qualified foreign corporation bareboat charters a ship or dry leases an aircraft to a lessee and the lowest tier lessee-operator in the chain of ownership uses such ship or aircraft for the international carriage of passengers or cargo for hire, as described in paragraphs (f)(2)(i) and (ii) of this section, the qualified foreign corporation may exclude the proportion of the bareboat charter income attributable to such international operation of the ship

or aircraft. The foreign corporation must use a reasonable method for determining the proportion of the charter income that is attributable to such international operation. Two reasonable methods for determining the amount of charter income attributable to the international operation of the ship or aircraft are the following:

(A) *Ratio based on use*. Multiply the annual charter amount attributable to use of the ship or aircraft by a lessee by a ratio, the numerator of which is the total number of days of uninterrupted travel on voyages or flights of such ship or aircraft between the United States and the farthest point or points where cargo or passengers are loaded en route to, or discharged en route from, the United States, and the denominator of which is the total number of days in the smaller of the taxable year or the particular charter period. For this purpose, the number of days during which the ship or aircraft is not generating transportation income, within the meaning of section 863(c)(2), for example while the ship or aircraft is out of service while being repaired or maintained, should not be included in the numerator of the ratio.

(B) *Ratio based on gross income*. Multiply the annual charter amount attributable to the use of the ship or aircraft by the lessee by a ratio, the numerator of which is the U.S. source gross transportation income (USSGTI as that term is defined in section 887(b)) earned from the operation of the vessel or aircraft by the lowest tier lessee-operator, and the denominator of which is the total gross income of such lessee-operator from the operation of the ship or aircraft during the smaller of the taxable year or the term of the charter, if such information is available. An allocation based on the net income of such lessee-operator will not be considered reasonable for this purpose.

(g) *Activities incidental to the international operation of ships or aircraft*—(1) *General rule*. Certain activities of an operator of ships or aircraft are so closely related to the primary activity of operation of ships or aircraft that they are considered incidental to such operations. Income from these incidental activities is eligible for the reciprocal exemption under this section. Examples of activities of a foreign corporation engaged in the international operation of ships or aircraft that may be considered incidental to such operation include—

(i) Contracting for the international carriage of cargo or passengers, as defined in paragraph (f) of this section, using a space or slot charter, alliance, code sharing or similar arrangement, on ships or aircraft operated by another carrier;

(ii) Temporary investment of working capital funds;

(iii) Sale of tickets for an international voyage by a ship operator for another ship operator;

(iv) Sale of tickets for an international flight by an air carrier for another air carrier;

(v) Rental of containers in connection with the international carriage of goods by sea by the operator of a ship or by air by the operator of an aircraft;

(vi) Contracting with concessionaires for performance of services onboard during the international operation of the operator's ship or aircraft as the case may be; or

(vii) Bareboat charter of ships or aircraft normally used by the operator in international operation but currently not needed, if the ship or aircraft is used by the lessee for international voyages or flights.

(2) *Activities not considered incidental to the international operation of ships or aircraft*. Examples of activities that are not considered to be incidental to the international operation of ships or aircraft by an operator include—

(i) The sale of or arranging for train travel, bus transfers, land tour packages, or port city hotel accommodations within the United States or a foreign country, or the sale of airline tickets by a cruise ship operator or cruise tickets by an air carrier;

(ii) The sale or rental of real property;

(iii) Treasury activities involving the investment of excess funds or funds awaiting repatriation generated by the operation of ships or aircraft;

(iv) Rental of containers for a domestic leg of transportation in connection with international carriage of cargo;

(v) Passive investment in an enterprise engaged in the international operation of ships or aircraft;

(vi) Services performed for parties other than passengers, consignors or consignees, such as ground services at ports or airports or ship or aircraft maintenance; or

(vii) The carriage of passengers or cargo on ships or aircraft on domestic legs, not treated as international operation under paragraph (f) of this section, either by the foreign operator or by a U.S. operator that is a member with the foreign operator in a pool, partnership, strategic alliance, joint operating agreement, code sharing or other joint venture, that is itself engaged in the operation of ships or aircraft.

(h) *Equivalent exemption*—(1) *General rule*. A foreign country grants an equivalent exemption when it exempts from taxation income from the international operation of ships or aircraft derived by corporations organized in the United States. Whether a foreign country provides an equivalent exemption must be determined separately with respect to each category of income, as provided in paragraph (h)(2) of this section. However, an equivalent exemption may be available for income derived from the international operation of ships even though income derived from the international operation of aircraft may not be exempt, and vice versa. For rules regarding shareholders resident in a foreign country that offers an exemption under an income tax convention, see §1.883–4(b)(3). An equivalent exemption may exist where the foreign country—

(i) Generally imposes no tax on income, including income from the international operation of ships or aircraft;

(ii) Specifically provides a domestic law tax exemption for income derived from the international operation of ships or aircraft, either by statute, decree, or otherwise; or

(iii) Exchanges diplomatic notes with the United States, or enters into an agreement with the United States, that provides for a reciprocal exemption under section 883.

(2) *Determining equivalent exemptions for each category of income*. Whether a foreign country grants an equivalent exemption is determined separately with respect to each category of income listed in paragraphs (h)(2)(i) through (vii) of this section and is determined separately with respect to income from the operation of ships and income from the operation of aircraft. Where an exemption is unavailable in the foreign country for a particular category of income, a foreign corporation

organized in that country shall not be permitted to exempt that category of income from U.S. tax under this section, even though the foreign country may grant an equivalent exemption for other categories of income. An equivalent exemption may be available for income derived from the international operation of ships even though income derived from the international operation of aircraft may not be exempt, and vice versa. A separate determination of whether a foreign country grants an equivalent exemption must be made for each of the following categories of income—

(i) Income from the carriage of cargo and passengers (operating income);

(ii) Time or voyage (full) charter income (or full rental);

(iii) Bareboat charter income (or bareboat rental);

(iv) Incidental bareboat charter income (or incidental bareboat rental);

(v) Incidental container-related income;

(vi) Income incidental to the operation of ships or aircraft other than incidental income described in paragraphs (h)(2)(iv) and (v) of this section; and

(vii) Capital gains of the operator from the sale, exchange or other disposition of a ship, aircraft, container or related equipment or other moveable property used by that operator in the international operation of ships or aircraft.

(3) *Special rule with respect to income tax conventions*. If a corporation is organized in a foreign country that provides an equivalent exemption only through an income tax convention with the United States, the foreign corporation must satisfy the terms of that convention before it can receive a benefit under the convention and the foreign corporation may not claim an exemption under section 883. If, however, the corporation is organized in a foreign country that offers an equivalent exemption under an income tax convention and also by some other means, such as by diplomatic note or domestic law, the foreign corporation may choose annually whether it will claim benefits under section 894 and the income tax convention or an exemption under section 883. This choice will apply with respect to all income of the corporation from the international operation of ships or aircraft and the choice cannot be made separately with respect to different categories of such income. If a foreign corporation bases its claim for an exemption on section 883 rather than the income tax convention, the foreign corporation must satisfy all of the requirements under this regulation to qualify for an exemption from U.S. income tax. See §1.883–4(b)(3) for rules regarding shareholders resident in a foreign country that offers an equivalent exemption under a treaty.

(4) *Exemptions not qualifying as equivalent exemptions*—(i) *General rule*. Exemptions provided to corporations organized in the United States by certain foreign countries may not satisfy the equivalent exemption requirements of this section.

(ii) *Reduced tax rate or time limited exemption*. The exemption granted by the foreign country's law or income tax convention must be a complete exemption. The exemption may not constitute merely a reduction to a non-zero rate of tax levied against corporations organized in the United States engaged in the international operation of ships or aircraft or a temporary reduction to a zero rate of tax for only a limited period of time, such as in the case of a tax holiday.

(iii) *Inbound or outbound freight tax*. With respect to the carriage of cargo, the foreign country must provide an exemption from tax for income from transporting freight both inbound and outbound before it will be considered to grant an equivalent exemption. A foreign country that imposes tax only on outbound freight will not be treated as granting an equivalent exemption for income from transporting freight inbound into that country.

(iv) *Exemptions for limited types of cargo*. A foreign country must provide an exemption from tax for income from transporting all categories of cargo before it will be considered to grant an equivalent exemption. For example, if a foreign country were generally to impose tax on income from the international carriage of cargo but to provide a statutory exemption for income from transporting agricultural products, the foreign country would not be considered to grant an equivalent exemption with respect to income from the international carriage of cargo and passengers and would not be a qualified foreign country with respect to that type of income.

(v) *Territorial tax systems*. A foreign country with a territorial tax system will be treated as granting an equivalent exemption if it treats income from the international operation of ships or aircraft derived by a U.S. corporation as 100 percent foreign source and thereby not subject to tax, even if the income is derived from a voyage or flight that begins or ends in that foreign country.

(vi) *Countries that tax on a residence basis*. A foreign country that generally provides an equivalent exemption to corporations organized in the United States but also imposes a residence-based tax on certain corporations organized in the United States, may nevertheless be considered to grant an equivalent exemption if the residence-based tax is imposed only on a corporation organized in the United States that maintains its center of management and control or other comparable attributes in that foreign country. If the residence-based tax is imposed on corporations organized in the United States and engaged in the international operation of ships or aircraft that are not managed and controlled in that foreign country, the foreign country shall not be treated as a qualified foreign country and shall not be considered to grant an equivalent exemption for purposes of this section.

(vii) *Exemptions within categories of income*. A foreign country must provide an exemption from tax for all income in a category of income, as defined in paragraph (h)(2) of this section. For example, a country that exempts income from the bareboat charter of passenger aircraft but not the bareboat charter of cargo aircraft does not provide an equivalent exemption. However, an equivalent exemption may be available for income derived from the international operation of ships even though income derived from the international operation of aircraft may not be exempt, and vice versa.

(i) *Treatment of possessions*. A possession of the United States will be considered to grant an equivalent exemption and will be treated as a qualified foreign country if it is on a mirror system. The term *mirror system* refers to the general applicability in the possession of the Internal Revenue Code of 1986, as amended, with the name of the possession substituted for "United States" where appropriate. If a

possession does not use a mirror system, the possession may nevertheless be a qualified foreign country if, for example, it provides for an equivalent exemption through its internal law.

(j) *Expenses related to exempt income not deductible from non-exempt income*. If a qualified foreign corporation derives income from the international operation of ships or aircraft as well as from a non-exempt activity, and that income is effectively connected with the conduct of a trade or business within the United States, the foreign corporation may not deduct from income derived from a non-exempt activity, any amount otherwise allowable as a deduction from qualified shipping or aircraft income if that income is excluded under this proposed rule. See section 265(a)(1).

Par. 4. Sections 1.883–2 through 1.883–5 are added to read as follows:

§1.883–2 Treatment of publicly-traded corporations.

(a) *General rule*. A foreign corporation shall satisfy the stock ownership test of §1.883–1(c)(2) if it is considered a publicly-traded corporation and satisfies the substantiation and reporting requirements of paragraphs (e) and (f) of this section. To be considered a publicly-traded corporation, the stock of the foreign corporation must be primarily traded and regularly traded on one or more established securities markets, as those terms are defined in paragraphs (b), (c), and (d) of this section, in the United States or any qualified foreign country.

(b) *Established securities market*—(1) *General rule*. For purposes of this section, the term *established securities market* means, for any taxable year—

(i) A foreign securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority of the country in which the market is located, and has an annual value of shares traded on the exchange exceeding $1 billion during each of the three calendar years immediately preceding the beginning of the taxable year;

(ii) A national securities exchange that is registered under section 6 of the Securities Act of 1934 (15 U.S.C. 78f);

(iii) A United States over-the-counter market, as defined in paragraph (b)(4) of this section;

(iv) Any exchange designated under a Limitation On Benefits article in a United States income tax convention; and

(v) Any other exchange that the Secretary may designate by regulation or otherwise.

(2) *Exchanges with multiple tiers*. If an exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier shall be treated as a separate exchange.

(3) *Computation of dollar value of stock traded*. For purposes of paragraph (b)(1)(i) of this section, the value in U.S. dollars of shares traded during a calendar year shall be determined on the basis of the dollar value of such shares traded as reported by the International Federation of Stock Exchanges located in Paris, or, if not so reported, then by converting into U.S. dollars the aggregate value in local currency of the shares traded using an exchange rate equal to the average of the spot rates on the last day of each month of the calendar year.

(4) *Over-the-counter market*. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of such broker or dealer.

(5) *Discretion to determine that an exchange does not qualify as an established securities market*. The Commissioner may determine that a securities exchange that otherwise meets the requirements of this paragraph (b) of this section does not qualify as an established securities market, if—

(i) The exchange does not have adequate listing, financial disclosure, or trading requirements (or does not adequately enforce such requirements); or

(ii) There is not clear and convincing evidence that the exchange ensures the active trading of listed stocks.

(c) *Primarily traded*. For purposes of this section, stock of a corporation is primarily traded on one or more established securities markets, as defined in paragraph (b) of this section, if, with respect to each class of stock described in paragraph (d)(1)(i) of this section (relating to classes of stock relied on to meet the regularly traded test)—

(1) The number of shares in each such class that are traded during the taxable year on all established securities markets in that country exceeds

(2) The number of shares in each such class that are traded during that year on established securities markets in any other single foreign country.

(d) *Regularly traded*—(1) *General rule*. For purposes of this section, stock of a corporation is regularly traded on one or more established securities markets, as defined in paragraph (b) of this section, if—

(i) One or more classes of stock of the corporation that, in the aggregate, represent 80 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation are listed on such market or markets during the taxable year; and

(ii) With respect to each class relied on to meet the 80 percent requirement of paragraph (d)(1)(i) of this section—

(A) Trades in each such class are effected, other than in de minimis quantities, on such market or markets on at least 60 days during the taxable year (or 1/6 of the number of days in a short taxable year); and

(B) The aggregate number of shares in each such class that are traded on such market or markets during the taxable year are at least 10 percent of the average number of shares outstanding in that class during the taxable year (or, in the case of a short taxable year, a percentage that equals at least 10 percent of the average number of shares outstanding in that class during the taxable year multiplied by the number of days in the short taxable year, divided by 365).

(2) *Classes of stock traded on a domestic established securities market treated as meeting trading requirements*. A class of stock that is traded during the taxable year on an established securities market located in the United States shall be considered to meet the trading requirements of paragraph (d)(1)(ii) of this section if the stock is regularly quoted by dealers making a market in the stock. A dealer makes a market in a stock only if the

dealer regularly and actively offers to, and in fact does, purchase the stock from, and sell the stock to, customers who are not related persons (as defined in section 954(d)(3)) with respect to the dealer in the ordinary course of a trade or business.

(3) *Closely-held classes of stock not treated as meeting trading requirement*—(i) *General rule*. Except as provided in paragraph (d)(3)(ii) of this section, a class of stock of a foreign corporation listed on an established securities market or markets and otherwise meeting the trading requirements of paragraph (d)(1)(ii) of this section shall not be treated as meeting the trading requirements of paragraph (d)(1)(ii) of this section (or the requirements of paragraph (d)(2) of this section) for a taxable year if, at any time during the taxable year, one or more persons who own at least 5 percent of the value of the outstanding shares of the class of stock (5 percent shareholders as determined under paragraph (d)(3)(iii) of this section) own, in the aggregate, 50 percent or more of the value of the shares.

(ii) *Exception*. Notwithstanding the general rule of paragraph (d)(3)(i) of this section, a closely-held class of stock that otherwise satisfies the trading requirements of paragraph (d)(1)(ii) of this section may be treated as meeting such trading requirements if the foreign corporation can establish that more than 50 percent of the value of the outstanding shares of the class of stock is owned, or treated as owned under §1.883–4(c), by persons who are qualified shareholders, within the meaning of §1.883–4(b), for more than half the number of days during the taxable year. In addition, such persons may not own their interests in the foreign corporation either directly or by applying the attribution rules of §1.883–4(c) through bearer shares. Further, the foreign corporation must obtain from such persons the relevant documentation described in §1.883–4(d).

(iii) *Treatment of related persons*. Solely for purposes of determining whether a person is a 5 percent shareholder, persons related within the meaning of section 267(b) shall be treated as one person. In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). Further, in determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(4) *Anti-abuse rule*. Trades between related persons described in section 267(b), as modified by paragraph (d)(3)(iii) of this section, and trades conducted in order to meet the requirements of paragraph (d)(1) of this section (the trading rule) shall be disregarded. A class of stock shall not be treated as meeting the trading requirements of paragraph (d)(1) of this section if there is a pattern of trades conducted to meet the requirements of paragraph (d)(1) of this section. For example, trades between two persons that occur several times during the taxable year may be treated as an arrangement or a pattern of trades conducted to meet the trading requirements of paragraph (d)(1)(ii) of this section.

(5) *Example*. The closely-held class of stock rule in paragraph (d)(3) is illustrated by the following example:

Example. Closely-held exception—(i) *Facts*. X is a corporation organized in a qualified foreign country. X has one class of stock that is listed and primarily traded on an established securities market in the qualified foreign country. The class of stock of X also meets the trading requirements of paragraph (d)(1)(ii) of this section. However, the founding family owns 60 percent of that class of stock through Hold Co. The remaining 40 percent is not owned by any 5 percent shareholder. Some of the family members are U.S. residents, while the remaining family members are residents of the qualified foreign country. Individuals A and B are members of the founding family and each owns 10 percent of the stock of Hold Co.

(ii) *Analysis*. Because Hold Co owns 60 percent of the class of stock, Hold Co is a 5 percent shareholder and the class of stock will not be regularly traded unless X can prove, applying the attribution rules of §1.883–4(c), that more than 50 percent of the stock of X is owned, or treated as owned under §1.883–4(c), by residents of a qualified foreign country. If X can demonstrate that more than 50 percent of the stock held by Hold Co is owned by qualified shareholders, X can meet this burden and the stock of X will be regularly traded because the exception in paragraph (d)(3)(ii) of this section would apply.

(e) *Substantiation that a foreign corporation is publicly traded*—(1) *In general*. A foreign corporation that relies on the publicly traded test of this section to establish that it is a qualified foreign corporation for purposes of §1.883–1(c)(2) must substantiate that the stock of the foreign corporation is primarily and regularly traded on an established securities market. If one of the classes of stock on which the foreign corporation relies to meet this test is closely-held within the meaning of paragraph (d)(3)(i) of this section, the foreign corporation must obtain an ownership statement described in §1.883–4(d) from each qualified shareholder and intermediary that it relies upon to satisfy the exception to the closely-held class of stock rule, but only to the extent such statement would be required if the foreign corporation were relying on the qualified shareholder test of §1.883–4 with respect to those shares of stock. The foreign corporation must also maintain and provide to the Commissioner upon request a list of its shareholders of record and any other relevant information known to the foreign corporation.

(2) *Availability and retention of documents for inspection*. The documentation described in paragraph (e)(1) of this section must be retained by the corporation seeking qualified foreign corporation status (the foreign corporation) until the expiration of the statute of limitations for the taxable year of the foreign corporation to which the documentation relates. Such documentation must be made available for inspection by the Commissioner at such time and such place as the Commissioner may request in writing.

(f) *Reporting requirements*. A foreign corporation relying on this section to satisfy the stock ownership requirements of §1.883–1(c)(2) must provide the following information that is current as of the end of the corporation's taxable year, in addition to the information required in §1.883–1(c)(3) to be included in its Form 1120F for the taxable year—

(1) The name of the country in which the stock is primarily traded;

(2) The name of the established securities market or markets on which that the stock is listed;

(3) A description of each class of stock relied upon to meet the requirements of paragraph (d) of this section, including the number of shares issued and outstanding as of the close of the taxable year;

(4) For each class of stock relied upon to meet the requirements of paragraph (d) of this section, if one or more 5 percent

shareholders, as defined in paragraph (d)(3)(i) of this section, own in the aggregate 50 percent or more of the value of the outstanding shares of that class of stock at any time during the taxable year, state—

(i) The name and address of each 5 percent shareholder of that class of stock and each related person whose stock is treated as owned by the 5 percent shareholder;

(ii) For each qualified shareholder of the closely-held class of stock upon whom the corporation intends to rely to satisfy the exception to the closely-held class of stock rule of paragraph (d)(3)(ii) of this section—

(A) The name of each such shareholder;

(B) The percentage of the total value of the stock held by each such shareholder;

(C) The address of record of each such shareholder;

(D) The country of residence of each such shareholder, determined under §1.883–4(b)(2)(residence of individual shareholders) or §1.883–4(d)(3)(special rules for residence of certain shareholders);

(E) The portion of the taxable year of the foreign corporation during which the requisite ownership in the closely-held block of stock by qualified shareholders was satisfied;

(5) The percentage of the value of the class of stock represented by the widely-held block of stock; and

(6) Any other specified information.

§1.883–3 Treatment of controlled foreign corporations—(a) *General rule*. A foreign corporation that is a controlled foreign corporation (CFC), as defined in section 954(a), satisfies the stock ownership test of §1.883–1(c)(2) if it meets the income inclusion test in paragraph (b)(1) of this section and satisfies the substantiation and reporting requirements of paragraphs (c) and (d) of this section, respectively (the CFC test). A CFC that fails the income inclusion test of paragraph (b)(1) of this section may not satisfy the stock ownership test of §1.883–1(c)(2) unless the CFC demonstrates that it meets either the publicly traded test of §1.883–2 or the qualified shareholder test of §1.883–4.

(b) *Special rule for CFCs with certain entity shareholders*— (1) *Income inclusion test.* For purposes of these proposed rules, a CFC will not be considered to satisfy the requirements of paragraph (a) of this section unless—

(i) Such corporation would be a CFC as defined in section 957(a) if such section were applied without regard to section 318(a)(4); and

(ii) More than 50 percent of the CFC's subpart F income (as defined in section 952) derived from the international operation of ships or aircraft is includible, pursuant to section 951, in the gross income of one or more U.S. citizens, individual residents of the United States or domestic corporations for the taxable years of such persons in which the taxable year of the CFC ends.

(2) *Examples*. The income inclusion test of this paragraph (b) is illustrated in the following examples:

Example 1. CFC earns U.S. source income from the international operation of aircraft that is not effectively connected with the conduct of a U.S. trade or business. CFC is organized in a qualified foreign country. CFC is not a publicly traded corporation and all of its U.S. shareholders, as defined in section 951(b), are domestic partnerships. All of the partners in those domestic partnerships are citizens and residents of foreign countries. Thus, the CFC fails the income inclusion test of paragraph (b)(1) of this section because no amount of the CFC's relevant subpart F income is includible in the gross income of one or more U.S. citizens, individual residents of the United States or domestic corporations. Therefore the CFC must satisfy the rules of §1.883–4, regarding the qualified shareholder stock ownership test, in order to satisfy the stock ownership test of §1.883–1(c)(2) and be considered a qualified foreign corporation.

Example 2. Ship Co is a CFC organized in a qualified foreign country and is not a publicly traded corporation. Corp A, a domestic corporation, owns 50 percent of the value of the stock of Ship Co. X, a domestic partnership, owns the remaining 50 percent of the value of the stock of Ship Co. A U.S. citizen is a partner owning a 20 percent interest in X. Individual partners owning 80 percent of X are citizens and residents of foreign countries. There are no special allocations of partnership income. Ship Co satisfies the income inclusion test of paragraph (b)(1) of this section because 60 percent (50% + (20% x 50%))of the subpart F income would be includible in the gross income of U.S. citizens or individual residents of the United States or domestic corporations. If Ship Co satisfies the substantiation and reporting requirements of paragraphs (c) and (d) of this section, respectively and the reporting requirements of §1.883–1(c)(3), it will be a qualified foreign corporation.

(c) *Substantiating CFC stock ownership*—(1) *In general.* A CFC relying on this section to satisfy the stock ownership test of §1.883–1(c)(2) must establish all the facts necessary to satisfy the Commissioner that it qualifies under the CFC test. For purposes of the income inclusion test of paragraph (b)(1) of this section, if the CFC has one or more U.S. shareholders that are domestic partnerships, estates, or trusts, the proportionate interest of the subpart F income of the CFC will not be treated as includible in the gross income of any partner, beneficiary or other interest owner of such U.S. shareholder that is a U.S. citizen, resident of the United States or a domestic corporation unless the CFC obtains the documentation described in paragraph (c)(2) of this section.

(2) *Documentation from certain U.S. shareholders*—(i) *In general.* A CFC can only meet the documentation requirements of paragraph (c)(1) of this section if the CFC obtains the following documentation from each U.S. shareholder that is a partnership, estate or trust, with respect to the taxable year of the entity which ends with or within the taxable year of the CFC—

(A) A copy of the Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations," if required to be filed with the U.S. shareholder's return and with the Internal Revenue Service Center, Philadelphia PA 19255;

(B) A written statement, signed under penalties of perjury by a person authorized to sign the U.S. Federal tax return of the U.S. shareholder, providing the following information with respect to each U.S. citizen, individual resident of the United States or domestic corporation that is a partner, beneficiary or other interest owner of each such U.S. shareholder and upon whom the CFC intends to rely to satisfy the income inclusion test of paragraph (b)(1) of this section—

(*1*) The name, address (if not a non-residential address, such as a post office box or in care of a financial intermediary or stock transfer agent), and taxpayer identification number;

(*2*) The interest owner's proportionate interest in the U.S. shareholder that reflects that owner's share of subpart F income required to be included in income on such interest owner's U.S. Federal income tax return;

(*3*) The percentage of the vote and the percentage of the value of shares of the CFC owned by each such interest owner; and

(C) Any other specified information.

(ii) *Availability and retention of documents for inspection.* The documentation described in paragraph (c)(2)(i) of this

section must be retained by the corporation seeking qualified foreign corporation status (the CFC) until the expiration of the statute of limitations for the taxable year of the CFC to which the documentation relates. Such documentation must be made available for inspection by the Commissioner at such place as the Commissioner may request in writing.

(d) *Reporting requirements*. A foreign corporation that relies on the CFC test of this section to satisfy the stock ownership test of §1.883–1(c)(2), must provide the following information in addition to the information required in §1.883–1(c)(3) to be included in its Form 1120F for the taxable year. The information must be current as of the end of the corporation's taxable year and must include the following—

(1) The name, address in the corporate records (if that address is not a non-residential address such as a post office box or in care of a financial intermediary or stock transfer agent) and taxpayer identification number of each U.S. shareholder of the CFC;

(2) The percentage of the value of the shares of the CFC that is owned by each U.S. shareholder, as defined in section 957(a) if such section were applied without regard to section 318(a)(4);

(3) If one or more of the U.S. shareholders is a domestic partnership, estate or trust, the name, address, taxpayer identification number and percentage of the vote and the percentage of the value of shares of the CFC owned by each interest owner of each such U.S. shareholder that is a U.S. citizen, individual resident of the United States or a domestic corporation; and

(4) Any other specified information.

§1.883–4 Qualified shareholder stock ownership test .

(a) *General rule*. A foreign corporation shall satisfy the stock ownership test of §1.883–1(c)(2) if more than 50 percent of its stock (by value) is owned, or treated as owned by applying the attribution rules of paragraph (c) of this section, for at least half of the number of days in the foreign corporation's taxable year by one or more qualified shareholders. In addition, a foreign corporation must meet the substantiation and reporting requirements of paragraphs (d) and (e) of this section.

(b) *Qualified shareholder*—(1) *General rule*. A shareholder is a qualified shareholder only if the shareholder—

(i) Is a resident of a country that offers an equivalent exemption for the same type of income (as described in §1.883–1(h)(2)), as that earned by the foreign corporation and for which the foreign corporation is seeking an exemption;

(ii) Does not own its interest in the foreign corporation through bearer shares either directly or by applying the attribution rules of paragraph (c) of this section;

(iii) Provides to the foreign corporation the documentation required in paragraph (d) of this section and the foreign corporation meets the reporting requirements of paragraph (e) of this section with respect to such shareholder; and

(iv) Is described in one of the following categories of qualified shareholders—

(A) An individual not described in paragraph (b)(1)(iv)(E) of this section (whose residency is determined under paragraph (b)(2) of this section);

(B) The government of a qualified foreign country (or a political subdivision or local authority of such country);

(C) A foreign corporation that is organized in a qualified foreign country and meets the publicly traded rules of §1.883–2;

(D) A not-for-profit organization described in paragraph (b)(4) of this section that is not a pension fund as defined in paragraph (b)(5) of this section and that is organized in a qualified foreign country; or

(E) A beneficiary of a pension fund (as defined in paragraph (b)(5)(iv) of this section) administered in or by a qualified foreign country (whose residency is determined under paragraph (d)(3)(iii) of this section).

(2) *Residence of individual shareholders*—(i) *General rule*. An individual not described in paragraph (b)(1)(iv)(E) of this section is a resident of a qualified foreign country only if the individual is fully liable to tax as a resident in such country (e.g., an individual who is liable to tax on a remittance basis in a foreign country will not be treated as a resident of that country) and, in addition—

(A) The individual's tax home, within the meaning of paragraph (b)(2)(ii) of this section, is within that qualified foreign country for 183 days or more of the taxable year; or

(B) The individual is treated as a resident of a qualified foreign country based on special rules pursuant to paragraph (d)(3) of this section.

(ii) *Tax home*. For purposes of this section, an individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of his business (or lack of a business), then the individual's tax home is located at his regular place of abode in a real and substantial sense. If an individual has no regular or principal place of business and no regular place of abode in a real and substantial sense in a qualified foreign country for 183 days or more of the taxable year, that individual does not have a tax home for purposes of this section.

(3) *Certain income tax convention restrictions applied to shareholders*—(i) *Application of restrictions*. A shareholder otherwise described in paragraph (b)(1) of this section may be a resident of a foreign country that provides an equivalent exemption for the category of income at issue through an income tax convention with the United States. If the shareholder relies on the convention to demonstrate that the country of residence provides an equivalent exemption and the convention has a requirement in the shipping and air transport article other than residence, such as place of registration or documentation of the ship or aircraft, or in the limitation on benefits (LOB) article, such as a percentage of resident ownership, the shareholder is not a qualified shareholder unless the corporation seeking qualified foreign corporation status would satisfy any such additional requirement if it were organized in such foreign country.

(ii) *Examples*. The rules of this paragraph (b)(3) are illustrated by the following examples:

Example 1. LOB article requiring additional Country B ownership. Ship Co is organized in Country A. Country A provides an equivalent exemption through a diplomatic note. Eighty percent of the value of the shares of Ship Co is owned by a resident of Country B. Country B provides an equivalent exemption only through an income tax convention with the United States. The limitation on benefits article in the income tax convention between the United States and Country B requires that more than 75 percent of the value of the shares of a Country B corporation must be owned by residents of Country B before such corporation could receive benefits under the income tax convention. In accordance with paragraph (b)(3) of this section, in order for the Country B resident to be a qualified share-

holder, Ship Co must meet the LOB requirements of the United States/Country B income tax convention applied as if Ship Co were a Country B corporation. Because 80 percent of the value of the shares of Ship Co is owned by a resident of Country B, this requirement is satisfied and the Country B shareholder may be a qualified shareholder.

Example 2. Income tax convention requiring registration of ship. Ship Co is organized in Country X and owned entirely by residents of Country Y. Country X's domestic law grants an equivalent exemption to shipping corporations organized in the United States. Country Y grants an equivalent exemption for shipping income through an income tax convention between the United States and Country Y. Article 8 of the income tax convention provides that the exemption will apply only if the ships are registered in the contracting state of the taxpayer's country of residence. Ship Co owns a ship registered in Country Y and a ship registered in Country Z. In accordance with paragraph (b)(3) of this section, in order for the Country Y resident to be a qualified shareholder, Ship Co must meet the flagging requirements of the United States/Country Y income tax convention applied as if Ship Co were a Country Y corporation. Thus, the Country Y shareholders may be qualified shareholders with respect to income earned by the ship registered in Country Y but not with respect to the income earned by the ship registered in Country Z. Thus, if Ship Co otherwise satisfies the requirements of this proposed rule, Ship Co may exclude its income derived from the international operation of the ship registered in Country Y from gross income for purposes of its United States income tax, but may not exclude its income from the international operation of the ship registered in Country Z.

(4) *Not-for-profit organizations.* A not-for-profit organization is a qualified shareholder if it meets the following requirements—

(i) It is a corporation, association taxable as a corporation, trust, fund, foundation, league or other entity operated exclusively for religious, charitable, educational, or recreational purposes, and not organized for profit;

(ii) It is generally exempt from tax in its country of organization by virtue of its not-for-profit status; and

(iii) Either—

(A) More than 50 percent of its annual support is expended on behalf of persons described in paragraph (b)(1)(i) of this section (see paragraph (d)(3)(v) of this section for rules regarding the residence of individual beneficiaries); or

(B) More than 50 percent of its annual support is derived from persons described in paragraph (b)(1)(i) of this section (see paragraph (d)(3)(v) of this section for rules regarding the residence of individual supporters).

(5) *Pension funds*—(i) *Pension fund defined.* The term *pension fund* shall mean a government pension fund or a non- government pension fund, as those terms are defined, respectively, in paragraph (b)(5)(ii) and paragraph (b)(5)(iii) of this section, that is a trust, fund, foundation, or other entity that is established exclusively for the benefit of employees or former employees of one or more employers, the principal purpose of which is to provide retirement, disability, and death benefits to beneficiaries of such entity and persons designated by such beneficiaries in consideration for prior services rendered.

(ii) *Government pension funds.* A government pension fund is a pension fund that is a controlled entity of a foreign sovereign within the principles of §1.892–2T(c)(1) (relating to pension funds established for the benefit of employees or former employees of a foreign government).

(iii) *Non-government pension funds.* A non-government pension fund is a pension fund that—

(A) Is administered in a foreign country and is subject to supervision or regulation by a governmental authority (or other authority delegated to perform such supervision or regulation by a governmental authority) in such country;

(B) Is generally exempt from income taxation in its country of administration;

(C) Has 100 or more beneficiaries; and

(D) The trustees, directors or other administrators of which pension fund provide the documentation required in paragraph (d) of this section.

(iv) *Beneficiary of a pension fund.* The term *beneficiary of a pension fund* shall mean any person who has made contributions to a pension fund, as that term is defined in paragraph (b)(5)(i) of this section, or on whose behalf contributions have been made, and who is currently receiving retirement, disability, or death benefits from the pension fund or can reasonably be expected to receive such benefits in the future, whether or not the person's right to receive benefits from the fund has vested. See paragraph (c)(6) of this section for rules regarding the computation of stock ownership through non-government pension funds.

(c) *Rules for determining constructive ownership*—(1) *General rules for attribution.* For purposes of applying the exception to the closely-held test of §1.883–2(d)(3)(ii) and paragraph (a) of this section, stock owned by or for a corporation, partnership, trust, estate, or mutual insurance company or similar entity shall be treated as owned proportionately by its shareholders, partners, beneficiaries, grantors, or other interest holders as provided in paragraphs (c)(2)through (6) of this section. The proportionate interest rules of this paragraph (c) shall apply successively upward through a chain of ownership, and a person's proportionate interest shall be computed for the relevant days or period that is taken into account in determining whether a foreign corporation satisfies the requirements of paragraph (a) of this section. Stock treated as owned by a person by reason of this paragraph (c) shall be treated as actually owned by such person for purposes of this section. An owner of an interest in an association taxable as a corporation shall be treated as a shareholder of such association for purposes of this paragraph (c).

(2) *Partnerships*—(i) *General rule.* A partner shall be treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the least of—

(A) The partner's percentage distributive share of the partnership's dividend income from the stock;

(B) The partner's percentage distributive share of gain from disposition of the stock by the partnership; or

(C) The partner's percentage distributive share of the stock (or proceeds from the disposition of the stock) upon liquidation of the partnership.

(ii) *Partners resident in the same country.* For purposes of this paragraph, all qualified shareholders that are partners in a partnership and that are residents of, or organized in, the same qualified foreign country shall be treated as one partner. Thus, the percentage distributive shares of dividend income, gain and liquidation rights of all qualified shareholders that are partners in a partnership and that are residents of, or organized in, the same qualified foreign country are aggregated prior to determining the least of the three percentages set out in paragraph (c)(2)(i) of this section. For the meaning of the term *resident*, see paragraph (b)(2) of this section.

(iii) *Examples.* The rules of paragraph (c)(2)(ii) of this section are illustrated by the following examples:

Example 1. Stock held solely by qualified shareholders through a partnership. Country X grants an equivalent exemption. A and B are individual residents of Country X and are qualified shareholders within the meaning of paragraph (b)(1) of this section. A and B are the sole partners of Partnership P. P's only asset is the stock of Corporation Z, a Country X corporation seeking a reciprocal exemption under this section. A's distributive share of P's income and gain on the disposition of P's assets is 80 percent, but A's distributive share of P's assets (or the proceeds therefrom) on P's liquidation is 20 percent. B's distributive share of P's income and gain is 20 percent and B is entitled to 80 percent of the assets (or proceeds therefrom) on P's liquidation. Under the attribution rules of paragraph (c)(2)(ii) of this section, A and B will be treated as a single partner owning in the aggregate 100 percent of the stock of Z owned by P.

Example 2. Stock held by both qualified and non-qualified shareholders through a partnership. Assume the same facts as in *Example 1* except that C, an individual who is not a resident of a qualified foreign country, is also a partner in P and that C's distributive share of P's income is 60 percent. The distributive shares of A and B are the same as in *Example 1* except that A's distributive share of income is 20 percent. Under the attribution rules of paragraph (c)(2)(ii) of this section, qualified shareholders A and B will be treated as a single partner owning in the aggregate 40 percent of the stock of Z owned by P (i.e., the lowest aggregate percentage of A and B's distributive shares of dividend income (40 percent), gain (100 percent), and liquidation rights (100 percent) with respect to the Z stock). Thus, Z fails to satisfy the ownership requirements of paragraph (a) of this section.

Example 3. Stock held through tiered partnerships. Country X grants an equivalent exemption. A and B are individual residents of Country X and are qualified shareholders within the meaning of paragraph (b)(1) of this section. A and B are the sole partners of Partnership P. P is a partner in Partnership P1, which owns the stock of Corporation Z, a Country X corporation seeking a reciprocal exemption under this section. Assume that P's distributive share of the dividend income, gain and liquidation rights with respect to the Z stock held by P1 is 40 percent. Assume that of the remaining partners of P1 only D is a qualified shareholder. D's distributive share of P1's dividend income and gain is 15 percent; D's distributive share of P1's assets on liquidation is 25 percent. Under the attribution rules of paragraph (c)(2)(ii) of this section, A and B, treated as a single partner, will own 40 percent of the Z stock owned by P1 (100 percent X 40 percent) and D will be treated as owning 15 percent of the Z stock owned by P1 (the least of D's dividend income (15 percent), gain (15 percent), and liquidation rights (25 percent) with respect to the Z stock). Thus, 55 percent of the Z stock owned by P1 is treated as owned by qualified shareholders.

(3) *Trusts and estates*—(i) *Beneficiaries*. In general, an individual shall be treated as having an interest in stock of a foreign corporation owned by a trust or estate in proportion to the individual's actuarial interest in the trust or estate, as provided in section 318(a)(2)(B)(i), except that an income beneficiary's actuarial interest in the trust will be determined as if the trust's only asset were the stock. The interest of a remainder beneficiary in stock will be equal to 100 percent minus the sum of the percentages of any interest in the stock held by income beneficiaries. The ownership of an interest in stock owned by a trust shall not be attributed to any beneficiary whose interest cannot be determined under the preceding sentence, and any such interest, to the extent not attributed by reason of this paragraph (c)(3)(i), shall not be considered owned by a beneficiary unless all potential beneficiaries with respect to the stock are qualified shareholders. In addition, a beneficiary's actuarial interest will be treated as zero to the extent that someone other than the beneficiaries is treated as owning the stock under paragraph (c)(3)(ii) of this section. A substantially separate and independent share of a trust, within the meaning of section 663(c), shall be treated as a separate trust for purposes of this paragraph (c)(3)(i), provided that payment of income, accumulated income or corpus of a share of one beneficiary (or group of beneficiaries) cannot affect the proportionate share of income, accumulated income or corpus of another beneficiary (or group of beneficiaries).

(ii) *Grantor trusts*. A person is treated as the owner of stock of a foreign corporation owned by a trust to the extent that the stock is included in the portion of the trust that is treated as owned by the person under sections 671 through 679 (relating to grantors and others treated as substantial owners).

(4) *Corporations that issue stock*. A shareholder of a corporation that issues stock shall be treated as owning stock of a foreign corporation that is owned by such corporation on any day in a proportion that equals the value of the stock owned by such shareholder to the value of all stock of such corporation. If, however, there is an agreement, express or implied, that a shareholder of a corporation will not receive distributions from the earnings of stock owned by the corporation, the shareholder will not be treated as owning that stock owned by the corporation.

(5) *Mutual insurance companies and similar entities*. Stock held by a mutual insurance company, mutual savings bank, or similar entity (including an association taxable as a corporation that does not issue stock interests) shall be considered owned proportionately by the policy holders, depositors, or other owners in the same proportion that such persons share in the surplus of such entity upon liquidation or dissolution.

(6) *Computation of beneficial interests in non-government pension funds*. Stock held by a pension fund shall be considered owned by the beneficiaries of the fund equally on a pro-rata basis if—

(i) The pension fund meets the requirements of paragraph (b)(5)(iii) of this section;

(ii) The trustees, directors or other administrators of the pension fund have no knowledge, and no reason to know, that a pro-rata allocation of interests of the fund to all beneficiaries would differ significantly from an actuarial allocation of interests in the fund (or, if the beneficiaries' actuarial interest in the stock held directly or indirectly by the pension fund differs from the beneficiaries's actuarial interest in the pension fund, the actuarial interests computed by reference to the beneficiaries' actuarial interest in the stock);

(iii) Either—

(A) Any overfunding of the pension fund would be payable, pursuant to the governing instrument or the laws of the foreign country in which the pension fund is administered, only to, or for the benefit of, one or more corporations that are organized in the country in which the pension fund is administered, individual beneficiaries of the pension fund or their designated beneficiaries, or social or charitable causes (the reduction of the obligation of the sponsoring company or companies to make future contributions to the pension fund by reason of overfunding shall not itself result in such overfunding being deemed to be payable to or for the benefit of such company or companies); or

(B) The foreign country in which the pension fund is administered has laws that are designed to prevent overfunding of a pension fund and the funding of the pension fund is within the guidelines of such laws; or

(C) The pension fund is maintained to provide benefits to employees in a particular industry, profession, or group of industries or professions and employees of at least 10 companies (other than compa-

nies that are owned or controlled, directly or indirectly, by the same interests) contribute to the pension fund or receive benefits from the pension fund; and

(iv) The trustees, directors or other administrators provide the relevant documentation as required in paragraph (d) of this section.

(d) *Substantiation of stock ownership*—(1) *General rule*. A foreign corporation that relies on this section to satisfy the ownership requirements of §1.883–1(c)(2), must establish all the facts necessary to satisfy the Commissioner that more than 50 percent of the value of its shares is owned, or treated as owned applying paragraph (c) of this section, by qualified shareholders. A foreign corporation cannot meet this requirement with respect to any stock that is issued in bearer form. A shareholder that holds shares in the foreign corporation either directly or indirectly in bearer form cannot be a qualified shareholder.

(2) *Application of general rule*—(i) *Ownership statements*. Except as provided in paragraph (d)(3) of this section, a person shall only be treated as a qualified shareholder of a foreign corporation if—

(A) For the relevant period, the person completes an ownership statement described in paragraph (d)(4) of this section or has a valid ownership statement in effect under paragraph (d)(2)(ii) of this section;

(B) In the case of a person owning stock in the foreign corporation indirectly through one or more intermediaries (including mere legal owners or recordholders acting as nominees), each intermediary in the chain of ownership between that person and the foreign corporation seeking qualified foreign corporation status completes an intermediary ownership statement described in paragraph (d)(4)(v) of this section or has a valid intermediary ownership statement in effect under paragraph (d)(2)(ii) of this section; and

(C) The foreign corporation seeking qualified foreign corporation status obtains the statements described in paragraphs (d)(2)(i)(A) and (B) of this section.

(ii) *Three-year period of validity*. The ownership statements required in paragraph (d)(2)(i) of this section shall remain valid until the earlier of the last day of the third calendar year following the year in which the ownership statement is signed, or the day that a change of circumstance occurs that makes any information on the ownership statement incorrect. For example, an ownership statement signed on September 30, 2000, remains valid through December 31, 2003, unless circumstances change that make the information of the statement no longer correct.

(3) *Special rules*—(i) *Determining residence of certain shareholders*. A foreign corporation seeking qualified foreign corporation status or an intermediary that is a direct or indirect shareholder of such foreign corporation may determine the residence of certain shareholders, for purposes of paragraph (b)(2)(i)(B) of this section, under one of the following special rules, in lieu of obtaining the ownership statements required in paragraph (d)(2)(i) of this section from such shareholders.

(ii) *Special rule for registered shareholders owning less than one percent of widely-held corporations*. A foreign corporation with at least 250 registered individual shareholders, that is not a publicly-traded corporation, as described in §1.883–2, (a widely-held corporation), may not be required to obtain an ownership statement from an individual shareholder owning less than one percent of the widely-held corporation at all times during the taxable year. If such widely-held foreign corporation is the foreign corporation seeking qualified foreign corporation status, or an intermediary that meets the documentation requirements of paragraphs (d)(4)(v)(A) and (B) of this section, the widely-held foreign corporation may treat the address of record in its ownership records as the residence of any less than one percent individual shareholder if—

(A) The individual's address of record is not a non-residential address, such as a post office box or in care of a financial intermediary or stock transfer agent; and

(B) The officers and directors of the widely-held corporation neither know nor have reason to know that the individual does not reside at that address.

(iii) *Special rule for beneficiaries of pension funds*—(A) *Government pension fund*. An individual who is a beneficiary of a government pension fund, as defined in paragraph (b)(5)(ii) of this section, shall be treated as a resident of the country in which the pension fund is administered if the pension fund satisfies the documentation requirements of paragraphs (d)(4)(v)(A) and (C)(1) of this section.

(B) *Non-government pension fund*. An individual who is a beneficiary of a non-government pension fund, as described in paragraph (b)(5)(iii) of this section, shall be treated as a resident of the country of the beneficiary's address as it appears on the records of the fund, provided it is not a nonresidential address, such as a post office box or an address in care of a financial intermediary, and provided none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not an individual resident of such foreign country. The rules of this paragraph (d)(3)(iii)(B) shall apply only if the non-government pension fund satisfies the documentation requirements of paragraphs (d)(4)(v)(A) and (C)(2) of this section.

(iv) *Special rule for stock owned by publicly-traded corporations*. Any stock in a foreign corporation seeking qualified foreign corporation status that is owned by a publicly- traded corporation will be treated as owned by an individual resident in the country where the publicly-traded corporation is organized if the foreign corporation receives the statement described in paragraph (d)(4)(iii) of this section from the publicly-traded intermediary and copies of any relevant ownership statements from shareholders of the publicly traded corporation relied on to satisfy the exception to the closely-held class of stock rule of §1.883–2(d)(3)(ii) as required in paragraph (d)(2)(i) of this section.

(v) *Special rule for not-for-profit organizations*. For purposes of meeting the ownership requirements of paragraph (a) of this section, a not-for-profit organization may rely on the addresses of record of its individual beneficiaries and supporters to determine the residence of an individual beneficiary or supporter, within the meaning of paragraph (b)(2)(i)(B) of this section, to the extent required under paragraph (b)(4) of this section, provided that—

(A) The addresses of record are not nonresidential addresses such as a post office box or in care of a financial interme-

diary;

(B) The officers, directors or administrators or the organization do not know or have reason to know that the individual beneficiaries or supporters do not reside at that address; and

(C) The foreign corporation seeking qualified foreign corporation status receives the statement required in paragraph (d)(4)(iv) of this section from the not-for-profit organization.

(4) *Ownership statements from shareholders*—(i) *Ownership statements from individuals*. An ownership statement from an individual is a written statement signed by the individual under penalties of perjury stating—

(A) The individual's name, permanent address, and country where the individual is fully liable to tax as a resident, if any;

(B) If the individual was not a resident of the country for the entire taxable year of the foreign corporation seeking qualified foreign corporation status, state each of the foreign countries in which the individual resided and the dates of such residence during the taxable year of such foreign corporation;

(C) If the individual directly owns stock in the corporation seeking qualified foreign corporation status, the name of the corporation, the number of shares in each class of stock of the corporation that are so owned, and the period of time during the taxable year of the foreign corporation during which the individual owned the stock;

(D) If the individual directly owns an interest in a corporation, partnership, trust, estate or other intermediary that directly or indirectly owns stock in the corporation seeking qualified foreign corporation status, the name of the intermediary, the number and class of shares or amount and nature of the interest of the individual in such intermediary, and the period of time during the taxable year of the corporation seeking qualified foreign corporation status during which the individual held such interest;

(E) To the extent known by the individual, a description of the chain of ownership through which the individual owns stock in the corporation seeking qualified foreign corporation status, including the name and address of each intermediary standing between the intermediary described in paragraph (d)(4)(i)(D) of this section and the foreign corporation and whether this interest is owned either directly or indirectly through bearer shares; and

(F) Any other specified information.

(ii) *Ownership statements from foreign governments*. An ownership statement from a government that is a qualified shareholder is a written statement—

(A) Signed by either—

(*1*) An official of the governmental authority, agency or office who has supervisory authority with respect to the government's ownership interest and who is authorized to sign such a statement on behalf of the authority, agency or office; or

(*2*) The competent authority of the foreign country (as defined in the income tax convention between the United States and the foreign country);

(B) That provides—

(*1*) The title of the official signing the statement;

(*2*) The name and address of the government authority, agency or office that has supervisory authority;

(*3*) The information described in paragraphs (d)(4)(i)(C) through (F) of this section (substituting "government" for "individual") with respect to the government's direct or indirect ownership of stock in the corporation seeking qualified resident status; and

(C) Any other specified information.

(iii) *Ownership statements from publicly-traded corporate shareholders*. An ownership statement from a publicly-traded corporation that is a direct or indirect owner of the corporation seeking qualified foreign corporation status is a written statement, signed under penalties of perjury by a person that would be authorized to sign a tax return on behalf of the shareholder corporation containing the following information—

(A) The name of the country in which the stock is primarily traded;

(B) The name of the established securities market or markets on which that the stock is listed;

(C) A description of each class of stock relied upon to meet the requirements of §1.883–2(d)(1), including the number of shares issued and outstanding as of the close of the taxable year;

(D) For each class of stock relied upon to meet the requirements of §1.883–2(d)(1), if one or more 5 percent shareholders, as defined in §1.883–2(d)(3)(i), own in the aggregate 50 percent or more of the value of the outstanding shares of that class of stock at any time during the taxable year, state—

(*1*) The name and address of each 5 percent shareholder and of each related person whose stock is treated as owned by the 5 percent shareholder;

(*2*) For each qualified shareholder upon whom the corporation intends to rely to satisfy the exception to the closely-held class of stock rule of §1.883–2(d)(3)(ii)—

(*i*) The name of each such shareholder;

(*ii*) The percentage of the total outstanding shares of that class owned by such shareholder;

(*iii*) The address of record of such shareholder;

(*iv*) The country of residence of such shareholder, determined under paragraph (b)(2) or (d)(3) of this section; and

(E) The information described in paragraphs (d)(4)(i)(C) through (F) of this section (substituting "publicly-traded corporation" for "individual") with respect to the publicly-traded corporation's direct or indirect ownership of stock in the corporation seeking qualified resident status; and

(F) Any other specified information.

(iv) *Ownership statements from not-for-profit organizations*. An ownership statement from a not-for-profit organization (other than a pension fund as defined in paragraph (b)(5) of this section) is a written statement signed by a person authorized to sign a tax return on behalf of the organization under penalties of perjury stating—

(A) The name, permanent address, and principal location of the activities of the organization (if different from its permanent address);

(B) The information described in paragraphs (d)(4)(i)(C) through (F) of this section (substituting "not-for-profit organization" for "individual");

(C) A representation that the not-for-profit organization satisfies the requirements of paragraph (b)(4) of this section; and

(D) Any other specified information.

(v) *Ownership statements from intermediaries*—(A) *General rule*. The foreign corporation seeking qualified foreign corporation status under the shareholder stock ownership test must obtain an inter-

mediary ownership statement from each intermediary standing in the chain of ownership between it and the qualified shareholders on whom it relies to meet this test. An intermediary ownership statement is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or a person who would be authorized to sign a tax return on behalf of the intermediary (if the intermediary is not an individual) containing the following information—

(*1*) The name, address, country of residence, and principal place of business (in the case of a corporation or partnership) of the intermediary and, if the intermediary is a trust or estate, the name and permanent address of all trustees or executors (or equivalent under foreign law), or the name and permanent address of place of administration of the intermediary (if a pension fund);

(*2*) The information described in paragraphs (d)(4)(i)(C) through (F) (substituting "intermediary" for "individual");

(*3*) If the intermediary is a nominee for a shareholder or another intermediary, the name and permanent address of the shareholder, or the name and principal place of business of such other intermediary;

(*4*) If the intermediary is not a nominee for a shareholder or another intermediary, the name and country of residence (within the meaning of paragraph (b)(2) of this section) and the proportionate interest in the intermediary of each direct shareholder, partner, beneficiary, grantor, or other interest holder (or if the direct holder is a nominee, of its beneficial shareholder, partner, beneficiary, grantor, or other interest holder) which the foreign corporation seeking qualified foreign corporation status intends to rely on to satisfy the requirements of paragraph (a) of this section, as well as an ownership statement from such person and the period of time during the taxable year for which the interest in the intermediary was owned by the shareholder, partner, beneficiary, grantor or other interest holder. For purposes of this paragraph (d)(4)(v)(A), the proportionate interest of a person in an intermediary is the percentage interest (by value) held by such person, determined using the principles for attributing ownership in paragraph (c) of this section;

(*5*) If the intermediary is a widely-held corporation with registered shareholders owning less than one percent of the stock of such widely-held corporation, the statement set out in paragraph (d)(4)(v)(B) of this section, relating to ownership statements from widely-held intermediaries with registered shareholders owning less than one percent of such widely-held intermediaries;

(*6*) If the intermediary is a pension fund, within the meaning of paragraph (b)(5) of this section, the statement set out in paragraph (d)(4)(v)(C) of this section, relating to ownership statements from pension funds; and

(*7*) Any other specified information.

(B) *Ownership statements from widely-held intermediaries with registered shareholders owning less than one percent of such widely-held intermediary*. An ownership statement from an intermediary that is a corporation with at least 250 individual shareholders, but that is not a publicly-traded corporation within the meaning of §1.883–2, and that relies on paragraph (d)(3)(ii) of this section, relating to the special rule for registered shareholders owning less than one percent of widely-held corporations, must provide the following information in addition to the information required in paragraph (d)(4)(v)(A) of this section—

(*1*) The aggregate proportionate interest by country of residence in the widely-held corporation of such registered shareholders or other interest holders whose address of record is not a non-residential address, such as a post office box or in care of a financial intermediary or stock transfer agent; and

(*2*) A representation that the officers and directors of the widely-held intermediary neither know nor have reason to know that the individual shareholder does not reside at his or her address of record in the corporate records; and

(*3*) Any other specified information.

(C) *Ownership statements from pension funds*—(*1*) *Ownership statements from government pension funds*. A government pension fund (as defined in paragraph (b)(5)(ii) of this section) that relies on paragraph (d)(3)(iii) of this section, relating to the special rules for pension funds, generally must provide the documentation required in paragraph (d)(4)(v)(A) of this section and, in addition, the government pension fund must also provide the following information—

(*i*) The name of the country in which the plan is administered;

(*ii*) A representation that the fund is established exclusively for the benefit of employees or former employees of a foreign government, or employees or former employees of a foreign government and non-governmental employees or former employees that perform or performed governmental or social services;

(*iii*) A representation that the funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government;

(*iv*) A representation that the trust forming part of the pension plan provides for retirement, disability, or death benefits in consideration for prior services rendered;

(*v*) A representation that the income of the trust satisfies the obligations of the foreign government to the participants under the plan, rather than inuring to the benefit of a private person; and

(*vi*) Any other specified information.

(*2*) *Ownership statement from non-government pension funds*. The trustees, directors, or other administrators of the non-government pension fund, as defined in paragraph (b)(5)(iii) of this section, that rely on paragraph (d)(3)(iii) of this section, relating to the special rules for pension funds, generally must provide the pension fund's intermediary ownership statement described in paragraphs (d)(4)(v)(A) of this section, and, in addition, the non-government pension fund must also provide the following information—

(*i*) The name of the country in which the pension fund is administered;

(*ii*) A representation that the pension fund is subject to supervision or regulation by a governmental authority (or other authority delegated to perform such supervision or regulation by a governmental authority) in such country, and, if so, the name of the governmental authority (or other authority delegated to perform such supervision or regulation);

(*iii*) A representation that the pension fund is generally exempt from income taxation in its country of administration;

(*iv*) The number of beneficiaries in the pension plan;

(*v*) The aggregate percentage interest of beneficiaries by country of residence based on addresses shown on the books

and records of the fund, provided the addresses are not nonresidential addresses, such as a post office box or an address in care of a financial intermediary, and provided none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not a resident of such foreign country;

(*vi*); A representation that the pension fund meets the requirements of paragraph (b)(5)(iii) of this section;

(*vii*) A representation that the trustees, directors or other administrators of the pension fund have no knowledge, and no reason to know, that a pro-rata allocation of interests of the fund to all beneficiaries would differ significantly from an actuarial allocation of interests in the fund (or, if the beneficiaries' actuarial interest in the stock held directly or indirectly by the pension fund differs from the beneficiaries's actuarial interest in the pension fund, the actuarial interests computed by reference to the beneficiaries' actuarial interest in the stock);

(*viii*) Either—

(*A*) Any overfunding of the pension fund would be payable, pursuant to the governing instrument or the laws of the foreign country in which the pension fund is administered, only to, or for the benefit of, one or more corporations that are organized in the country in which the pension fund is administered, individual beneficiaries of the pension fund or their designated beneficiaries, or social or charitable causes (the reduction of the obligation of the sponsoring company or companies to make future contributions to the pension fund by reason of overfunding shall not itself result in such overfunding being deemed to be payable to or for the benefit of such company or companies); or

(*B*) The foreign country in which the pension fund is administered has laws that are designed to prevent overfunding of a pension fund and the funding of the pension fund is within the guidelines of such laws; or

(*C*) The pension fund is maintained to provide benefits to employees in a particular industry, profession, or group of industries or professions and employees of at least 10 companies (other than companies that are owned or controlled, directly or indirectly, by the same interests) contribute to the pension fund or receive benefits from the pension fund; and

(*ix*) Any other specified information.

(*3*) *Time for making determinations*. The determinations required to be made under this paragraph (d)(4)(v)(C) shall be made using information shown on the records of the pension fund for a date during the foreign corporation's taxable year to which the determination is relevant.

(5) *Availability and retention of documents for inspection*. The documentation described in paragraphs (d)(3) and (4) of this section must be retained by the corporation seeking qualified foreign corporation status (the foreign corporation) until the expiration of the statute of limitations for the taxable year of the foreign corporation to which the documentation relates. Such documentation must be made available for inspection by the Commissioner at such time and place as the Commissioner may request in writing.

(e) *Reporting requirements*. A foreign corporation relying on the qualified shareholder test of this section to demonstrate that it is a qualified foreign corporation for purposes of §1.883–1(c)(2) must provide the following information in addition to the information required in §1.883–1(c)(3) to be included in its Form 1120F for each taxable year. The information should be current as of the end of the corporation's taxable year. The information must include the following—

(1) A representation that more than 50 percent of the value of the outstanding shares of the corporation is owned (or treated as owned by reason of paragraph (c) of this section) by qualified shareholders for the category of income for which the exemption is claimed;

(2) With respect to each individual qualified shareholder owning 5 percent or more of the foreign corporation, applying the attribution rules of paragraph (c) of this section, and relied upon to meet the 50 percent ownership test of paragraph (a) of this section, the name and address, as represented on each such individual's ownership statement;

(3) With respect to all qualified shareholders relied upon to satisfy the 50 percent ownership test of paragraph (a) of this section, the total percentage of the value of the outstanding shares owned, applying the attribution rules of paragraph (c) of this section, by all qualified shareholders resident in a qualified foreign country, by country; and

(4) Any other required documentation.

§1.883–5 Effective date.

(a) *General rule*. Sections 1.883–1 through 1.883–4 apply to taxable years of the foreign corporation ending 30 days or more after the date these regulations are published as final regulations in the **Federal Register**.

(b) *Election for retroactive application*. When §§1.883–1 through 1.883–4 become generally applicable, taxpayers may rely on all the provisions of §§1.883–1 through 1.883–4 for guidance and may elect to apply all such substantive provisions for any open taxable year of the foreign corporation beginning after December 31, 1986, and ending less than 30 days after the date these regulations are published as final regulations in the **Federal Register**. However, such election is not required to be applied with respect to §1.883–1(c)(3) (relating to the substantiation and reporting required to be treated as a qualified foreign corporation) or §§1.883–2(f), 1.883–3(d) and 1.883–4(e) (relating to additional information to be included in the return to demonstrate whether the foreign corporation satisfies one of three stock ownership tests). Such election will be applicable for the year of the election and for all subsequent taxable years.

(c) *Transition rule*. For taxable years of the foreign corporation ending 30 days or more after the date these regulations are published as final regulations in the **Federal Register,** and until such time as the Form 1120F and its instructions are revised to conform to §§1.883–1 through 1.883–4, the information required in §1.883–1(c)(3) and §1.883–2(f), 1.883–3(d) or 1.883–4(e), as applicable, must be included on a written statement signed under penalties of perjury by a person authorized to sign the return, attached to the Form 1120F, and filed with the return.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on February 7, 2000, 8:45 a.m., and published in the issue of the Federal Register for February 8, 2000, 65 F.R. 6065)

Notice of Proposed Rulemaking and Notice of Public Hearing

Certain Asset Transfers to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)

REG–209135–88

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In T.D. 8872 on page 639, the IRS is issuing temporary regulations which apply with respect to the net built-in gain of C corporation assets that become assets of a Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT) by the qualification of a C corporation as a RIC or REIT or by the transfer of assets of a C corporation to a RIC or REIT in a carryover basis transaction. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of topics to be discussed at the public hearing scheduled for May 10, 2000, at 10 a.m. in the IRS Auditorium, must be received by April 19, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209135–88), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–209135–88), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the Home Page or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing has been scheduled for May 10, 2000, at 10 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Christopher W. Schoen, (202) 622-7750, concerning submissions and the hearing, LaNita Van Dyke (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 for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. section 3507(d)).

Comments on the collection of information should be sent 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, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by April 7, 2000. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the collection will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.337(d)–5. This information is necessary for the Service to determine whether liquidation treatment or section 1374 treatment is appropriate for the entity for which the regulation applies. The collection of information is required to obtain a benefit, i.e., to elect to be subject to section 1374 in lieu of liquidation treatment. The likely respondents are Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs).

The regulation provides that a section 1374 election is made by filing a statement, signed by an official authorized to sign the income tax return of the RIC or REIT and attached to the RIC's or REIT's Federal income tax return. The burden for the collection of information in §1.337(d)–5T(b)(3) is as follows:

Estimated total annual reporting burden: 50 hours

Estimated average annual burden per respondent: 30 minutes

Estimated number of respondents: 100

Estimated annual frequency of responses: Once

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

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. section 6103.

Background

Temporary regulations in T.D. 8872, page 639, amend the Income Tax Regulations (26 CFR part 1) relating to section 337(d). The temporary regulations provide rules that when a C corporation (1) qualifies to be taxed as a RIC or REIT, or (2) transfers assets to a RIC or REIT in a carryover basis transaction, the C corporation is treated as if it sold all of its assets at their respective fair market values and immediately liquidated, unless the RIC or REIT elects to be subject to tax under section 1374 of the Code. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Ad-

ministrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted to the IRS. The IRS and Treasury request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be made available for public inspection and copying.

A public hearing has been scheduled for May 10, 2000, 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 at the hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed (signed original and eight (8) copies) by [Insert date].

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of 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 Christopher W. Schoen of the Office of Assistant Chief Counsel (Corporate). Other personnel from the IRS and Treasury participated in their development.

* * * * *

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 26 CFR part 1 is amended by adding an entry in numerical order to read as follows:

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

Section 1.337(d)–5 also issued under 26 U.S.C. 337. * * *

Par. 2. Section 1.337(d)–5 is added to read as follows:

§1.337(d)–5 Tax on C assets becoming RIC or REIT assets.

[The text of proposed §1.337(d)–5 of this section is the same as the text of §1.337(d)–5T published in T.D. 8872.]

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 4, 2000, 8:45 a.m., and published in the issue of the Federal Register for February 7, 2000, 65 F.R. 5805)

Notice of Proposed Rulemaking and Notice of Public Hearing

Financial Asset Securitization Investment Trusts; Real Estate Mortgage Investment Conduits

REG–100276–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to financial asset securitization investment trusts (FASITs). This action is necessary because of changes to the applicable tax law made by the Small Business Job Protection Act of 1996. The proposed regulations affect FASITs and their investors. This document also contains proposed regulations relating to real estate mortgage investment conduits (REMICs). This document provides notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by May 8, 2000. Outlines of topics to be discussed at the public hearing scheduled for May 15, 2000 at 10 a.m., must be received by April 24, 2000.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–100276–97 and REG–122450–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–100276–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments via the Internet by selecting the "Tax Regs" option of the IRS Home Page or by submitting them directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslist.html. The public hearing will be held in Room 2615, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations other than issues relating specifically to cross border transactions, David L. Meyer at (202) 622-3960 (not a toll-free number) and for issues relating specifically to cross border transactions, Rebecca Rosenberg or Milton Cahn at (202) 622-3870 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor at (202) 622-7180 (not a toll-free number).

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 for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent 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, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of informa-

tion should be received by April 7, 2000. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the collection will have a practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or startup costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information is in §1.860H–1(b)(2) and §1.860H–6(e). This information is required to permit qualified entities to elect to become a Financial Asset Securitization Investment Trust and to ensure the holder of the ownership interest in a FASIT properly reports the FASIT's items of income, gain, deduction, loss, and credit. This information will be used to properly administer the provisions of part V of subchapter M of the Code. The collection of information is mandatory. The likely respondents are business or other for-profit institutions.

Estimated total annual reporting and/or record keeping burden: 750 hours.

Estimated average annual burden hours per respondent and/or record-keeper: 5 hours.

Estimated number of respondents and/or record-keepers: 150.

Estimated annual frequency of responses: one annually.

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.

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 information are confidential, as required by 26 U.S.C. 6103.

Background

Section 1621(a) of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1755 (August 20, 1996) (the Act) amended the Internal Revenue Code (Code) by adding part V (sections 860H through 860L) (the FASIT provisions) to subchapter M of chapter 1. Part V, which is effective September 1, 1997, authorizes a securitization vehicle called a Financial Asset Securitization Investment Trust (FASIT). FASITs are meant to facilitate the securitization of debt instruments, including non-mortgage and mortgage debt instruments.

A solicitation for comments (SPR–247516–96) was published in the **Federal Register** for November 4, 1996 (61 FR 56647). The comments received both raised and helped resolve significant issues. The IRS and Treasury request comments on these proposed regulations generally, and specifically request suggestions on how they may be revised to be more easily understood.

Explanation of Provisions

In General

A FASIT is a qualified arrangement that elects FASIT treatment and meets certain requirements concerning the composition of its assets and the interests it issues to investors. A qualified arrangement can be a corporation (other than a regulated investment company (RIC) as defined in section 851(a)), partnership, trust, or segregated pool of assets.

A FASIT may issue one or more classes of regular interests, which are treated as debt for all purposes of the Code. In addition, each FASIT must have a single ownership interest, which must be held entirely by a non-exempt domestic C corporation (other than a RIC, real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), or subchapter T cooperative).

A FASIT is not subject to income tax. Instead, the tax items of the FASIT are included in the taxable income of the holder of the ownership interest (the Owner). The Owner, (and in some circumstances a person related to the Owner) must recognize gain (if any) when property is either transferred to the FASIT or supports the regular interests.

Congress enacted the FASIT provisions to facilitate the securitization of revolving, non-mortgage debt obligations. An anti-abuse rule incorporated in these proposed regulations is designed to ensure that FASITs are used in a manner that is consistent with this intent and not to create opportunities for tax planning that would not exist but for the enactment of the FASIT provisions and these proposed regulations.

RULES APPLICABLE TO THE FASIT

Administrative Provisions

1. Background

The administrative provisions have three objectives: (1) ensuring accurate and timely reporting of the FASIT's tax items, (2) ensuring compliance by the FASIT with the operating and qualification rules, and (3) reducing administrative burdens on FASIT interest holders and the IRS.

2. FASIT Election

The proposed regulations provide that a FASIT election is made by attaching a statement to the Owner's Federal income tax return for the taxable year that includes the startup day. No particular form is presently required, but the statement must be specified as a FASIT election, and must identify the arrangement for which the election is made. The IRS and Treasury want to ensure that the persons most affected by a FASIT election have agreed to make the election. Therefore, if the electing arrangement is an entity, the election statement must be signed by the person who would sign the entity's return in the absence of the FASIT election. If the electing arrangement is a segregated pool of assets, the election statement must be signed by each person that owns the assets in the pool for Federal income tax purposes immediately before the startup day.

3. Treatment of FASIT Under Subtitle F

None of the FASIT provisions addresses how a FASIT is treated under subtitle F (Procedure and Administration), which governs matters such as returns, penalties, tax payments, and assessments. One rule considered was to make a FASIT's subtitle F treatment depend on the classification of the electing arrangement. Thus, for example, if a partnership makes a FASIT election, the FASIT is a partnership for purposes of subtitle F. Rather than adopt this approach, which

leads to several different administrative regimes for FASITs, the proposed regulations treat each FASIT as a branch or division of its Owner for purposes of subtitle F. Because an Owner must always be a domestic C corporation, this solution results in uniform treatment.

The proposed regulations also make the Owner responsible for reporting interest income with respect to the regular interests which are treated for reporting purposes as collateralized debt obligations (CDOs).

Relationship of a FASIT to the Owner

The FASIT provisions do not provide a general rule defining the relationship between a FASIT and its Owner for non-FASIT Federal income tax purposes. The nature of this relationship may be relevant in determining the Federal income tax consequences of a number of transactions entered into with a FASIT. For example, it is necessary to know the extent to which transactions with a FASIT are treated as transactions with the Owner in determining how the portfolio interest exception applies and whether a change in the Owner of the FASIT results in a realization event for holders of the FASIT regular interests.

The IRS and Treasury considered proposing a general rule to characterize the FASIT's relationship to its Owner for all non-FASIT Federal income tax purposes. Among the alternatives evaluated were (1) treating the FASIT as an entity separate from the Owner; (2) treating the FASIT as a branch of the Owner; and (3) treating the FASIT as an entity for some purposes and as a branch for others.

Each alternative has some underpinning in the statutory scheme. For example, in determining the Owner's taxable income, the FASIT provisions treat a FASIT's assets, liabilities, and tax items as the assets, liabilities, and tax items of the Owner. This supports treating a FASIT as a branch of the Owner. However, the restrictions on what kind of assets may be held and what type of investor interests may be issued apply to the FASIT alone and favor treating a FASIT as a separate entity.

The IRS and Treasury have decided it is better to resolve the nature of the FASIT's relationship with the Owner on an issue-by-issue basis rather than by adopting a single general rule. A few situations (for example, the treatment of a FASIT under subtitle F and the treatment of a FASIT under the portfolio interest rules) are addressed in these proposed regulations. The IRS and Treasury welcome additional comments on whether and how additional rules should detail the FASIT's relationship with the Owner for non-FASIT Federal income tax purposes.

Assets That May be Held by a FASIT (Permitted Assets)

1. Background

Except during a brief formation period, substantially all of a FASIT's assets must consist of permitted assets. Permitted assets include cash and cash equivalents, debt instruments (and rights to acquire debt instruments), foreclosure property, interest and currency hedges (and rights to acquire interest and currency hedges), guarantees (and rights to acquire guarantees), regular interests in other FASITs, and regular interests in REMICs. The FASIT provisions generally do not allow a FASIT to hold debt instruments issued by the Owner (or a related person).

Several commentators requested guidance on whether certain assets qualified as permitted assets. Other comments focused on the prohibition on Owner debt. In particular, the commentators requested guidance on the extent to which an Owner may guarantee assets or enter into a permitted hedge with the FASIT without violating the prohibition on Owner debt.

2. "Substantially All"

The FASIT provisions require *substantially all* of a FASIT's assets to be permitted assets. Under the proposed regulations, a FASIT meets this test if the aggregate adjusted basis of its assets other than permitted assets is less than one percent of the aggregate adjusted basis of all its assets.

The proposed rule is patterned after a safe harbor rule applicable to REMICs. The proposed regulations do not incorporate a provision in the REMIC safe harbor that allows a qualified entity that fails the REMIC safe harbor to otherwise demonstrate that it does not own more than a de minimis amount of non-qualified assets. This provision does not appear necessary because a FASIT, unlike a REMIC, can acquire additional permitted assets if it is in danger of failing the *substantially all* test.

3. Cash and Cash Equivalents

The FASIT provisions treat *cash and cash equivalents* as permitted assets. The proposed regulations generally define the phrase *cash and cash equivalents* to mean functional currency. Investment quality debt instruments that are close to maturity are also cash and cash equivalents because of their perceived liquidity.

In response to some commentators, the proposed regulations provide that cash and cash equivalents include shares in U.S.-dollar-denominated money market mutual funds. Although such shares are technically stock, money market mutual funds are practical investments for cash balances pending either distribution to regular interest holders or reinvestment in new debt instruments. The IRS and Treasury, therefore, believe it is appropriate to allow FASITs to hold these investments.

4. Debt Instruments in General

Under the FASIT provisions, a debt instrument must satisfy two criteria to be a permitted asset. First, it has to be a *debt instrument* as defined in section 1275(a)(1) of the Code, which means it has to be a bond, debenture, note or certificate, or other evidence of indebtedness. Second, interest payments (if any) must be made in the manner prescribed for REMIC regular interests. Interest payments on REMIC regular interests must be based on a fixed or variable rate (as allowed in regulations), or must consist of a specified portion of the interest payments on the underlying mortgages held by the REMIC. This means that under the FASIT provisions, interest payments on a debt instrument held by a FASIT must also be payable at a fixed or variable rate, or consist of a specified portion of the interest payments on some underlying debt instrument.

The proposed regulations enumerate the types of debt instruments that meet this standard and therefore qualify as permitted assets. In general, a FASIT may hold fixed-rate debt instruments, specified floating-rate debt instruments, inflation-indexed debt instruments, and credit card receivables. In response to comments received, the proposed regulations also clarify that a FASIT may generally hold beneficial interests in, or coupon and principal strips created from, these instruments.

One commentator requested that the proposed regulations specifically allow

FASITs to hold debt instruments that provide for prepayment penalties. The commentator's concern was that prepayment penalties might be viewed as contingent payments that are not fixed or variable interest payments within the meaning of the FASIT provisions. The proposed regulations accommodate this concern by including in the list of permitted debt instruments, debt instruments to which §1.1272–1(c) (relating to debt instruments that provide for alternate payment schedules) applies. These rules generally accommodate prepayment penalties.

To prevent a FASIT from indirectly holding equity-like or other non-debt interests, the proposed regulations disqualify any debt instrument that can be converted into, or the value of which is based on, anything other than a permitted debt instrument. Impermissible debt instruments include, for example, a debt instrument convertible into stock and a debt instrument the interest payments on which vary based on the spot price of oil. The proposed regulations also do not permit a FASIT to hold debt instruments that, when acquired by the FASIT, are in default due to any payment delinquency unless the Owner reasonably expects the obligor to cure the default (including the payment of any interest and penalties) within 90 days of the date the instrument is acquired by the FASIT. The concern is that a distressed debt instrument may take on the characteristics of equity because the FASIT (and in turn the regular interest holders): (1) may have to look to the obligor's general assets for payment of the instrument, (2) may not receive full payment of the instrument, and (3) may not receive any payment until the satisfaction of claims held by the obligor's other creditors.

5. Participation Interests

One commentator requested guidance on whether a participation interest in a pool of revolving loans would be considered a permitted asset. The commentator pointed out that a participation interest can be based either on a fixed percentage of assets in the pool or on a fixed dollar amount of assets in the pool.

The proposed regulations do not specifically address participation interests. It does not appear that guidance is needed concerning participation interests that are based on a fixed percentage of assets. If a FASIT owns a fixed-percentage participation interest, as the outstanding principal balance of the pool rises and falls, the FASIT may be required to pay additional amounts or entitled to receive distributions to maintain its fixed percentage ownership in the pool. As long as the distributions are paid in cash (or in the form of an otherwise permitted asset), the FASIT's fixed-percentage interest should be considered a fixed-percentage interest in each of the debt instruments in the pool. Thus, the FASIT's fixed-percentage participation interest should qualify as a permitted debt instrument to the extent the underlying debt instruments are themselves permitted assets.

The result under the FASIT provisions is less clear in cases where the participation interest is based on a fixed dollar amount of assets in a pool. In this case, each change in the outstanding balance of the pool would trigger a corresponding change in the FASIT's percentage ownership of the pool. When the size of the pool increases, the FASIT could be viewed as exchanging an interest in each asset in the old pool for a lower percentage interest in each asset in the new pool. This exchange might constitute an impermissible asset disposition. In some cases, this disposition could result in the imposition of the prohibited transaction tax.

While the problem with fixed-dollar participation interests might be resolved by treating a pool as a single asset, a rule specifically allowing a FASIT to hold participation interests may be used as a means of inappropriately avoiding other rules. The IRS and Treasury welcome additional comments on whether and how the need for a FASIT to hold fixed-dollar amount participation interests can be accommodated.

6. Debt Instruments Issued by the Owner

To ensure that the holders of the regular interests are looking primarily to the FASIT, and not the Owner, for payment, the FASIT provisions generally prohibit a FASIT from holding debt instruments issued either by the Owner or a person related to the Owner (collectively, Owner debt). An exception is made for cash equivalents and other instruments specified by regulation.

Under the proposed regulations, Owner debt means more than just debt instruments issued by the Owner. It includes an obligation of the Owner embedded in another instrument, a third party debt instrument the performance of which is contingent on the performance of Owner debt, and any partial interest in Owner debt such as a principal or coupon strip. Similarly, a debt instrument guaranteed by an Owner is treated as Owner debt, if at the time the FASIT acquires the debt instrument, the Owner is in substance the primary obligor of the debt instrument. See Rev. Rul. 97–3 (1997–1 C.B. 9).

Cash equivalents of the Owner, which are permitted under the FASIT provisions, are limited by the proposed regulations to short-term investment quality debt instruments that are acquired to temporarily invest cash pending either distribution to the FASIT interest holders or re-investment in other permitted assets.

One commentator noted that under the FASIT provisions, it is unclear whether the Owner of two or more FASITs may use regular interests from one FASIT to fund another of its FASITs. If regular interests are considered debt of the Owner, then, technically, the regular interests held by the second FASIT would be impermissible Owner debt. The commentator noted that this form of tiering arrangement is commonly used in REMICs and should be available for use with FASITs. In response to this comment, the proposed regulations allow this type of tiering arrangement. As discussed below, however, tiered FASITs may not be used to achieve benefits that could not be obtained without the FASIT provisions.

7. Foreclosure Property

The FASIT provisions allow a FASIT to hold an asset (foreclosure property) acquired upon the default or imminent default of a permitted debt instrument. The FASIT provisions generally allow a FASIT to retain foreclosure property for a designated grace period of approximately three to four years. After the grace period, a 100-percent tax is imposed on any net income derived from the foreclosure property, including income from its operation or disposition.

In some cases, the property acquired upon foreclosure may independently qualify as another type of permitted asset. Under the proposed regulations, the FASIT may retain this type of foreclosure property beyond the grace period. If the FASIT retains the property beyond the

grace period, the property loses its status as foreclosure property at the end of the grace period. At this point, the proposed regulations require the Owner to recognize gain, if any, on the property as if it had been contributed to the FASIT at the close of the grace period. In addition, after the grace period, the property can no longer qualify for the foreclosure exception to the prohibited transaction rules.

8. Contracts or Agreements in the Nature of a Line of Credit

A FASIT may generally hold as a permitted asset a contract or agreement in the nature of a line of credit as long as the FASIT does not originate the contract or agreement.

9. Guarantees and Hedges

Under the FASIT provisions, a contract may qualify as a permitted asset if it is a permitted hedge or guarantee. The FASIT provisions impose two requirements on permitted hedges and guarantees. First, the contract must be an interest rate or foreign currency notional principal contract, letter of credit, insurance, guarantee against defaults, or other similar instrument. Second, the contract must be reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor on the interests that the FASIT has issued. Several commentators asked for guidance on the scope of this rule.

The proposed regulations provide guidance as to what constitutes a permitted hedge or guarantee. Rather than focus on the type of contract, the proposed regulations focus on its intended function. Under the proposed regulations, a contract is a permitted hedge or guarantee if the contract is reasonably required to offset differences that specified risk factors may cause between the amount or timing of the cash flows on a FASIT's assets and the amount or timing of the cash flows on the FASIT's regular interests. The specified risk factors are (1) fluctuations in market interest rates, (2) fluctuations in currency exchange rates, (3) the credit quality of the FASIT's assets and regular interests, and (4) the receipt of payments on the FASIT's assets earlier or later than originally anticipated.

Several commentators requested that the proposed regulations list specific types of hedges and guarantees that qualify as permitted assets. Because the proposed regulations define permitted assets and guarantees in terms of their function, the proposed regulations do not include this type of list. Out of a concern that hedges could be used to effect the economic equivalent of a transfer of non-permitted assets to the FASIT, the proposed regulations prohibit a hedge or guarantee from referencing certain assets and indices. In particular, a hedge is not a permitted hedge if it references an asset other than a permitted asset or if it references an index, economic indicator or financial average that is not widely disseminated and designed to correlate closely with changes in one or more of the four specified risk factors.

One commentator requested that the proposed regulations permit the incidental hedging of assets allocable to ownership interests. The commentator suggested that, as a practical matter, an Owner may desire to hedge all of the FASIT's assets inside the FASIT even though the FASIT securitizes less than all of the assets. The proposed regulations accommodate this concern by allowing the FASIT to hedge assets held (or to be held) and liabilities issued (or to be issued). Thus, under the proposed regulations, an Owner can hedge assets inside a FASIT that currently relate to the ownership interest if the assets are being held inside the FASIT because the Owner intends for them to support FASIT regular interests in the future.

The proposed regulations provide special rules for hedges and guarantees entered into with the Owner or a related party. These rules generally allow a FASIT to enter into a hedge (other than a credit hedge) with the Owner (or a related party) if two conditions are met. First, the Owner (or related party) must be a dealer with respect to that type of hedging contract. Second, the Owner must maintain records establishing that the hedge contract was entered into at arm's length. In addition, the special rules provide that an Owner (or a related party) may issue a guarantee to a FASIT if the Owner can demonstrate that, immediately after the guarantee is issued, less than three percent of the value of the FASIT's assets are attributable to Owner guarantees.

Finally, the usefulness of a hedge is diminished if the tax character of the hedge (as an ordinary or capital asset) does not match the tax character of the hedged item. Absent a special rule, disposing of a FASIT hedge could generate capital loss even though the associated assets and liabilities of the FASIT generate ordinary income and deductions. To alleviate this character mismatch, the proposed regulations treat a permitted hedge as an ordinary asset.

Prohibited Transactions

1. Background

The FASIT provisions restrict the types of transactions in which a FASIT may engage through the imposition of a prohibited transactions tax. The tax is equal to 100 percent of the income a FASIT realizes from a prohibited transaction. The four categories of prohibited transactions set out in the FASIT provisions include the receipt of any income from a loan originated by the FASIT and the receipt of gains from the FASIT's disposition of its assets.

2. Loan Origination

Commentators expressed considerable concern over the lack of statutory guidance on determining whether a debt instrument held by a FASIT has been originated by the FASIT. Commentators noted that debt instruments originated through the Owner's business activities might be deemed to be originated by the FASIT thereby exposing the FASIT to liability for the prohibited transactions tax on any income realized on the instrument.

The proposed regulations contain five safe harbors to limit the scope of the prohibited transaction rules as they relate to loan origination. Under the first safe harbor, a FASIT is not considered to have originated a loan if the FASIT acquires the loan from an established securities market.

Under the second safe harbor, a FASIT is not considered to have originated a loan if the FASIT acquires the loan more than a year after the loan was created.

Under the third safe harbor, a FASIT is not considered to have originated a loan if the FASIT acquires the loan from a person that regularly originates similar loans in the ordinary course of its trade or business. Importantly, this third safe harbor extends to transactions entered into with the Owner (or a related party). As a result, a FASIT that acquires credit card receivables from its Owner (or a related party), or creates new receivables from issuances made on accounts held by the FASIT will not be

considered to have originated the receivables to the extent the Owner (or related party) originates similar loans in the ordinary course of its business.

The fourth safe harbor provides that the FASIT will not be treated as originating any new loan it may receive from the same obligor in exchange for the obligor's original loan in the context of a workout.

Finally, a FASIT will not be treated as having originated a debt instrument when it makes a loan pursuant to a contract or agreement in the nature of a line of credit the FASIT is permitted to hold.

3. Substitution or Distribution of Debt Instruments.

The FASIT provisions generally impose a prohibited transaction tax on the distribution of debt instruments to the Owner. An exception to this rule exists for distributions to the Owner so long as the principal purpose of the distribution is not the recognition of gain that is due to changes in market conditions while the FASIT held the debt instrument. This rule effectively allows an Owner to reduce over-collateralization so long as the reduction is not designed to obtain a character advantage. Absent this rule, in times of falling market interest rates, an Owner could inappropriately generate capital gain and economically offsetting ordinary loss by disposing of distributed appreciated debt instruments while having the FASIT dispose of related hedges. To clarify the application of the distribution rule, the proposed regulations deem a distribution of a debt instrument to be carried out principally to recognize gain if the Owner (or a related person) sells the substituted or distributed debt instrument at a gain within 180 days of the substitution or distribution. In this case, the distribution will be a prohibited transaction subject to the 100-percent tax.

Consequences of FASIT Cessation

Under the FASIT provisions, the Commissioner may consent to the intended cessation of a FASIT and may grant conditional relief in the case of an inadvertent cessation. There are, however, no comprehensive rules describing the consequences of a cessation. The proposed regulations, therefore, detail how a cessation affects the FASIT, the underlying arrangement that made the FASIT election, the Owner, and the regular interest holders. These rules apply unless a cessation is carried out with the Commissioner's consent, in which case the consent document controls.

Under the proposed regulations the Owner is treated as disposing of the FASIT's assets for their fair market value in a prohibited transaction. Gain, if any, on this deemed distribution is subject to the prohibited transactions tax. Any loss is disallowed. The Owner is also treated as satisfying the regular interests for an amount equal to the lesser of the adjusted issue price or fair market value of the regular interests. This deemed satisfaction will result in cancellation of indebtedness income in cases where the aggregate fair market value of the assets is less than the aggregate adjusted issue price of the regular interests. The underlying arrangement is no longer treated as a FASIT and generally is prohibited from making a new FASIT election. In addition, the underlying arrangement is treated as holding the assets of the terminated FASIT and is classified (for example, as a corporation or partnership) under general tax principles. Finally, the regular interest holders are treated as exchanging their FASIT regular interests for new interests in the underlying arrangement. These new interests are classified under general tax principles, and the deemed exchange of the regular interests for the new interests may require the regular interest holders to recognize gain or loss.

RULES APPLICABLE TO OWNER

Under the FASIT provisions, an Owner generally determines its taxable income by including the gains, losses, income and deductions of the FASIT and by treating the assets and liabilities of the FASIT as its own. In addition, the Owner must also follow special rules concerning the FASIT's tax-exempt income, prohibited transactions and method of accounting for debt instruments. Few comments were received concerning these provisions.

Under the special rule concerning the method of accounting for debt instruments, a FASIT must use the constant yield method in determining all interest, acquisition discount, original issue discount (OID), market discount, and premium deductions or adjustments. To ensure that the Owner uses a constant yield method for all interest and interest-like items, the proposed regulations require the Owner to compute the amount of interest income and premium offset accruing on debt instruments held in a FASIT under the methodology described in §1.1272–3(c).

One commentator noted that the FASIT provisions speak in terms of determining the Owner's *taxable income*, and that taxable income, which the Code defines as gross income minus deductions, makes no reference to credits. The proposed regulations, therefore, clarify the extent to which an Owner, in determining its tax, may claim the FASIT's credits. In general, the Owner may claim a credit for taxes paid or deemed paid by the FASIT in the same manner and to the same extent as if the FASIT were an unincorporated branch of the Owner. As discussed below, the allowance of a foreign tax credit is subject to the anti-abuse provisions of this regulation, and other relevant authorities including case law and the potential application of IRS Notice 98–5 (1998–3 I.R.B. 49).

Because the Owner includes the FASIT's tax items in determining its credits and taxable income, the proposed regulations make the Owner (rather than the FASIT) responsible for reporting those items on its Federal income tax return. The Owner is required to attach a separate statement to its income tax return detailing these items. No specific form is required.

Gain Recognition on Property Transferred to a FASIT

1. Background

The FASIT provisions require Owners (or, in some cases, related persons) to include in income gain (but not loss) realized on the transfer of assets to a FASIT. In general, the amount of gain (if any) that must be included is equal to the value of the transferred asset over its adjusted basis in the transferor's hands. In addition, the FASIT provisions require gain (if any) to be recognized on assets the Owner holds outside of the FASIT but which nonetheless support FASIT regular interests. Significant comments were received regarding the gain recognition rule. In particular, comments were received on the method of valuing property, the scope of the support rule, and the need for a gain deferral rule.

2. Related-person Gain Recognition Rule

The IRS and Treasury have determined that the gain recognition rule of the

FASIT provisions could be circumvented when a related person transfers property to a FASIT. Because the FASIT provisions do not require that the related person be a taxable C corporation (or even that the related person be subject to U.S. tax), the intended corporate-level tax on gain could be avoided by having non-corporate or foreign related persons make asset transfers. In this case, the FASIT provisions could be interpreted as allocating gain to the related person and the economically offsetting losses (usually in the form of premium offset) to the Owner. This misallocation of gain, if allowed, would frustrate the purpose of the gain recognition rule.

The IRS and Treasury considered two ways to address this issue in developing these proposed regulations. One approach would have required any contribution from a related party to the FASIT to be taxed as if it were a deemed sale to the Owner followed by a contribution to the FASIT. This rule would conform the treatment of related person contributions with the treatment of contributions from unrelated persons under section 860I(a)(2). This rule would also ensure that gain upon contribution would be allocated to the taxpayer entitled to the subsequently occurring offsetting economic loss, namely, the Owner. A second approach was to develop regulations that would limit related person treatment to taxable, domestic C corporations and ensure that the misallocation of gain (in the related person) and associated loss (in the Owner) would not produce unwarranted tax benefits.

The proposed regulations adopt the first approach. Under the proposed regulations, transactions between a related person and the FASIT are treated as transactions between the related person and the Owner followed by transactions between the Owner and the FASIT. This rule, however, does not apply in all cases. Transfers of publicly traded property by related persons are unlikely to be abusive. The rule in the proposed regulations, therefore, only applies if the related person transfers property not traded on an established securities market. Thus, for example, the rule applies to a transfer of consumer receivables, but not to a transfer of Treasury bills.

3. Determination of Value for Gain Recognition Purposes

a. *In general*

To determine value for purposes of applying the gain recognition rules, the FASIT provisions divide property into two categories: (1) debt instruments not traded on an established securities market, and (2) all other property. The value of debt instruments not traded on an established securities market is determined by a special statutory rule. The value of all other property (which includes debt instruments that *are* traded on an established securities market) is fair market value.

Under the special rule, the value of a debt instrument not traded on an established securities market is the sum of the reasonably expected cash flows on the instrument, discounted using semiannual compounding at a rate equal to 120 percent of the applicable federal rate (AFR). The intent behind the special valuation rule is uncertain. The legislative history of the FASIT provisions indicates the rule was meant to be a simple and mechanical formula that, by its nature, would not produce accurate results in every case. Specifically, the legislative history states that the value of an asset is determined by the special valuation rule even if a different value would be determined by applying a willing buyer/willing seller standard. See H.R. Rept.104-737, 104th Cong. 2d Sess., 327 (1996). At the same time, by applying a fair market value standard to all other assets (including market-traded debt), Congress showed a clear preference for using actual fair market value whenever it can be determined with reasonable accuracy.

Several commentators made suggestions on how to interpret the legislative intent behind the special valuation rule. In general, the commentators were concerned that implementing the rule without modification would in many cases generate tax gains far in excess of economic gains. Because the commentators viewed this overvaluation as a substantial impediment to the use of FASITs, they asked that the proposed regulations narrow as much as possible the debt instruments subject to the special valuation rule.

The proposed regulations attempt to reconcile the legislative intent and the commentators' concerns in a consistent and principled manner. The policy justification for the special valuation rule is strongest where it is difficult, if not impossible, to separate the value of a debt instrument from the value of the Owner's business relationship with the debtor. For example, the value of credit card receivables may be inferred if the receivables are placed in trust and used to create new debt instruments that are sold to the public at a disclosed price. In this case, however, the implied price necessarily includes both the value of the receivables and the value of the transferor's implicit or explicit promise to replace the receivables as they mature. Because there is no objective, easily administrable method for allocating the portion of the price allocable to the receivable (as opposed to the portion allocable to the transferor's ongoing business), the special valuation rule seems appropriate in this context.

By contrast, the policy justification for the special valuation rule is weakest in cases where the fair market value of the debt instrument can be easily established. For example, if a FASIT purchases a pool of non-market-traded securities for cash in a transaction where the FASIT maintains no continuing relationship with the seller, there appears to be no reason to distrust the value as determined by an actual arm's length bargaining.

Consistent with this understanding of the purpose behind the special valuation rule, the proposed regulations take a broad view of what constitutes an established securities market. In addition, the regulations clearly delineate whether property is subject to the special rule and provide a number of exceptions from the special rule.

b. *Traded on an established securities market*

The proposed regulations define the term *traded on an established securities market* by reference to §1.1273–2(f)(2) through (4) of the OID regulations. The proposed regulations also give the Commissioner the power to determine that debt instruments not meeting the standards of the OID regulations are nevertheless traded on an established securities market. Under the cross- reference to the OID regulations, debt is considered traded on an established securities market if (1) it is listed on certain specified securities exchanges or on certain interdealer quotation systems, (2) it is traded on a board of trade or interbank market, or (3)

it appears on a quotation medium that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent sales transactions.

The proposed regulations do not cross-reference §1.1273–2(f)(5) of the OID regulations. Consequently, debt is not considered *traded on an established securities market* if it is merely readily quotable within the meaning of §1.1273–2(f)(5). The IRS and Treasury do not expect this omission to have a significant impact because, under a special exception (the spot purchase rule, discussed below) the proposed regulations value non-publicly traded debt instruments at their cost if a FASIT acquires them in (or soon after) an arm's length cash purchase.

According to one commentator, bank loans and private placement loans, which are typically made to small and medium sized businesses, are readily quotable within the meaning of §1.1273–5(f)(5) but would not otherwise be considered as traded on an established securities market. The commentator stated there would be commercial interest in securitizing these loans through FASITs but for application of the special valuation rule. Although the proposed regulations do not adopt the readily quotable standard, the IRS and Treasury believe bank and private placement loans will be securitized in transactions qualifying for the spot purchase exception. Nevertheless, comments are requested on whether the readily quotable standard is still necessary.

c. *Exceptions for debt not traded on an established securities market*

The proposed regulations except from the special valuation rule certain beneficial and stripped interests. Under this exception, a certificate representing beneficial ownership of debt instruments constitutes beneficial ownership of debt instruments traded on an established securities market if either the certificate or all of the underlying debt instruments are traded on an established securities market. Similarly, a stripped bond or stripped coupon represents debt traded on an established securities market, if either the strip or the underlying debt instrument is traded on an established securities market. Because fair market value is easily determined in these circumstances, there appears to be little reason to apply the special valuation rule.

Finally, the proposed regulations provide an exception for certain debt instruments that are contemporaneously purchased and transferred to the FASIT (the spot purchase rule). Under this provision, the value of a debt instrument is its cost to the Owner if four conditions are met: (1) the debt instrument is purchased from an unrelated person in an arm's length transaction, (2) the debt instrument is acquired for cash, (3) the price of the debt instrument is fixed no more than 15 days before the date of the purchase, and (4) the debt instrument is transferred to the FASIT no more than 15 days after the date of the purchase.

d. *Debt instruments not traded on an established securities market*

As discussed above, the special valuation rule values a debt instrument by discounting the reasonably expected cash flows on the instrument. The proposed regulations require that the determination of reasonably expected cash flows be commercially reasonable. The proposed regulations also permit reasonable assumptions concerning credit risk, early repayments, and loan servicing costs to be taken into account. Additional rules discourage the use of assumptions known to be inaccurate.

One safeguard is a consistency test. Even though a debt instrument may not be traded on an established securities market, a person securitizing the debt instrument may make certain public representations about the debt instrument, such as in a prospectus or an offering memorandum. The consistency test prevents the use of one set of assumptions for tax purposes and the use of another set for different purposes. Specifically, all assumptions used in determining reasonably expected cash flows (for purposes of the FASIT valuation rule) must be no less favorable than the assumptions underlying the representations made to any of the following groups in the prescribed order: investors, rating agencies, or governmental agencies. For example, if one default rate is assumed to value debt instruments in a prospectus, a higher default rate cannot be assumed to value the debt instruments for purposes of the gain recognition provisions. Even if no representations concerning value are made to investors, rating agencies, or governmental agencies, the assumptions made for purposes of the gain recognition provisions must still be consistent with any applicable industry customs and standards. To encourage adherence to the consistency test, the Commissioner may determine reasonably expected cash flows without making any adjustment if the assumption made with respect to that adjustment (for example, assumed credit risks) fails the consistency test or is otherwise unreasonable.

In addition to the consistency test, the proposed regulations place a ceiling on projected loan servicing costs. Specifically, the amount of loan servicing costs projected may not exceed the lesser of (1) the amount the FASIT agrees to pay the Owner (or a related person) for servicing all, or a portion, of the loans held by the FASIT, or (2) the amount a third party would reasonably pay for the servicing of identical loans.

e. *Special valuation rule for guarantees*

Because a guarantee usually is not a debt instrument, any gain recognized on transferring a guarantee to a FASIT would be determined using the guarantee's fair market value absent a special rule. Nevertheless, if a guarantee relates solely to non-traded debt instruments, the proposed regulations allow taxpayers to value the guarantee and the debt instruments together. Under this rule, the reasonably expected payments on the guarantee are treated as part of the reasonably expected payments on the debt instruments to which the guarantee relates.

4. Property Held Outside a FASIT Supporting FASIT Regular Interests

An Owner (or a person related to the Owner) must recognize gain on any property the Owner or related person holds outside the FASIT that supports the regular interests. In addition, property held by the Owner or related person that supports regular interests is treated as held by the FASIT for all purposes of the FASIT provisions. By treating support property as transferred to and held by a FASIT, the support rules discourage taxpayers from trying to avoid the gain-on-transfer rules and ensure that FASIT income includes the income from all FASIT property.

Commentators asked for a clear and narrow definition of support property. They suggested limiting the support rule to situations in which the arrangement

with the regular interest holders indicates that assets held outside the FASIT would have been transferred to the FASIT but for the gain recognition rules. Under this view, support property includes: (1) subordinated interests in debt instruments contributed to the FASIT, (2) property securing an Owner's guarantee, and (3) contribution agreements that allow the FASIT to purchase a debt instrument for an amount significantly below its fair market value. Several commentators argued that unless a narrow view of support is adopted, the support rule threatens to subject to the gain recognition rule all property held by an Owner whenever the Owner guarantees a regular interest or has any kind of continuing relationship with the FASIT.

Consistent with the comments received, the proposed regulations narrowly define support property. Under the proposed regulations, property generally is *support property* if the Owner (or a related person): (1) identifies the property as providing security for a regular interest, (2) sets aside the property for transfer to the FASIT under a contribution agreement, or (3) holds an interest in the property that is subordinate to the FASIT's interest in the property. This last situation can arise, for example, if the Owner holds the junior interests in a pool of debt instruments while the FASIT holds the senior interests.

5. Deferral of Gain Recognition

Although gain must ordinarily be recognized as soon as property is transferred, the FASIT provisions authorize regulations under which gain on transferred property is deferred until the transferred property supports regular interests. Several commentators specifically requested a gain deferral system and one explained in detail how a gain deferral system could be applied to a constantly revolving pool of assets.

The proposed regulations do not provide a general gain deferral system. After carefully considering the issues involved, the IRS and Treasury have determined that gain deferral rules must build on rules for accounting for pooled debt instruments. The IRS and Treasury anticipate providing rules for pooled debt instrument in future guidance, and at that time expect to revisit the FASIT gain deferral rules.

Although the proposed regulations do not provide rules for gain deferral generally, rules permitting gain deferral for pre-effective date FASITs have been developed consistent with the requirements of the Act. The IRS and the Treasury request comments on whether and how the gain deferral system for pre-effective date FASITs may be modified to accommodate a general gain deferral system.

Ownership Interests and Consolidated Groups

By statute, to qualify as a FASIT, an arrangement must have one (and only one) ownership interest, and that ownership interest must be held by one (and only one) eligible corporation. Congress, however, anticipated that Treasury would "issue guidance on how the ownership rule would apply to cases in which the entity that owns the FASIT joins in the filing of a consolidated return with other members of the group that wish to hold an ownership interest in the FASIT." See H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 329 (1996).

Commentators urged the IRS and Treasury to issue guidance that would change the statutory rule and permit members of a consolidated group to jointly hold a FASIT ownership interest. In studying the issue, however, the IRS and Treasury became concerned about how such guidance would continue to satisfy those general principles of the consolidated return regulations that preclude the shifting of stock basis, income, or loss. The IRS and Treasury considered different models that would permit members of a consolidated group to jointly hold (or enjoy the benefits of jointly holding) a FASIT ownership interest, but none of these were found to adequately address the government's concerns without adding administrative complexity for both the IRS and taxpayers. Moreover, the IRS and Treasury are not convinced the level of potential attribute shifting should be disregarded or addressed through an anti-abuse rule or would be so minor that disregarding it would be appropriate. Therefore, the proposed regulations do not provide rules permitting members of a consolidated group to jointly hold ownership interests in a FASIT. The IRS and Treasury invite the submission of additional comments that would address these concerns.

Transfers of Ownership Interests

The proposed regulations ignore the transfer of an ownership interest if the transfer is accomplished to impede the assessment or collection of tax. A transfer is accomplished to impede the assessment or collection of tax if the transferor knows, or should know, that the transferee would be unwilling or unable to pay some or all of the tax arising from holding the ownership interest. A safe harbor, incorporated through a cross-reference to comparable rules regarding transfers of REMIC residual interests, is available to Owner-transferors who conduct a reasonable investigation of the transferee's financial condition. As explained under the caption PROPOSED AMENDMENT TO REMIC REGULATIONS in this preamble, the REMIC safe harbor incorporated by the FASIT rules has been modified.

RULES APPLICABLE TO REGULAR INTEREST HOLDERS

The FASIT provisions treat a regular interest as a debt instrument for all purposes of the Code and require the holder to account for gross income with respect to the regular interest under an accrual method.

Few comments were made with respect to FASIT regular interests. One commentator suggested a rule that would prevent the holder of a debt instrument from recognizing a loss on, or changing the tax consequences of, the debt instrument by transferring it to a FASIT in exchange for an identical or similar FASIT regular interest. No such rule is adopted by the proposed regulations because the IRS and Treasury believe this type of transaction is adequately addressed by the wash sales rules of the Code and the FASIT anti-abuse rule described later. Similarly, the proposed regulations have adopted no special rules concerning the consequences of modifying regular interests, because the IRS and Treasury believe these issues are adequately addressed under existing principles of Federal tax law.

SPECIAL RULES

Anti-Abuse Rule

The proposed regulations contain an anti-abuse rule patterned after the anti-abuse rule in the partnership regulations issued under subchapter K. The FASIT

anti-abuse rule evaluates transactions against the underlying purpose of the FASIT provisions, which is to promote the spreading of credit risk on debt instruments by facilitating the securitization of debt instruments. If a FASIT is formed or used to achieve a tax result inconsistent with this purpose, the Commissioner may take remedial action, including disregarding the FASIT election, reallocating items of income, deductions and credits, recharacterizing regular interests, and redesignating the holder of the ownership interest. Whether a FASIT is formed or used to achieve a tax result that is inconsistent with the FASIT provisions is a question of fact. In addition to applying the specific anti-abuse rule included in these proposed regulations, the IRS and Treasury will also continue to apply other statutory, administrative, and judicial anti-abuse provisions, such as the judicial doctrines of economic substance and substance over form, to transactions and structures involving FASITs. For example, see the principles of Notice 98–5 (1998–3 I.R.B. 49), regarding foreign tax credits.

Although regular interests in a FASIT may be held in a tiered FASIT structure and treated by each FASIT as permitted assets, the tiering of FASITs may not be used for double or multiple counting of the FASIT gross income or gross assets for other purposes of the Code in a manner that would be inconsistent with the intent of the FASIT provisions. In this regard, the IRS and Treasury consider the recognition of interest expense paid and the corresponding interest income received by the same Owner to be inconsistent with the intent of the provisions. Accordingly, such Owner-created attributes must be disregarded because a taxpayer may not enter into a transaction with itself. For example, the gross income and gross assets from the tiering of FASITs may not be taken into account more than once for purposes of testing whether an Owner is an 80/20 company under section 861, or for purposes of determining the relative domestic and foreign source gross assets of the Owner or the Owner's affiliated group in applying the interest expense allocation rules proposed here under section 864(e).

INTERNATIONAL PROVISIONS

Prohibition of Foreign FASITS and Segregated Pools Subject to Foreign Tax

It appears that taxpayers may attempt to exploit differences in the characterization of a FASIT or the interests in a FASIT under U.S. law and relevant foreign law to produce inappropriate tax avoidance (including by producing a non-economic allocation of foreign taxes to the holder of the FASIT ownership interest). To minimize this possibility, the proposed regulations provide that a foreign entity (including but not limited to a foreign corporation or a foreign partnership) may not be a qualified arrangement. In addition, a qualified arrangement may not be a domestic entity or a segregated pool of identified assets any of the income of which is subject to tax on a net basis by a foreign country. The IRS and Treasury intend that the imposition of foreign tax on a net basis with respect to the assets and liabilities of a FASIT will disqualify a FASIT election without regard to whether the segregated pool of assets is actually held through a U.S. or foreign office or fixed place of business. In addition, a preexisting qualified FASIT may cease to be a FASIT prospectively by being subjected to foreign net taxation for the first time in a later year as a result of newly conducted foreign activities. It is not necessary that actual foreign tax be imposed for an arrangement to be considered subject to foreign net taxation.

The IRS and Treasury request comments regarding whether there may be circumstances in which legitimate (non-tax) business reasons justify allowing a FASIT election to be made by a foreign entity, or an entity the income of which is subject to net foreign taxation, or on behalf of a segregated pool which may be subject to net foreign taxation.

Prohibition on Foreign FASITs and Segregated Pools Subject to Foreign Tax

The IRS and Treasury are also concerned that taxpayers may attempt to use FASITs to produce non-economic allocations of foreign withholding taxes to the holder of the FASIT ownership interest. The IRS and Treasury believe that such transactions may be facilitated by the ease with which an Owner can acquire publicly-traded debt that is subject to foreign withholding tax. In addition, prohibiting a FASIT from holding publicly-traded debt subject to a foreign withholding tax should not unduly interfere with legitimate securitizations of debt held by an Owner. Accordingly, the proposed regulations provide that the definition of permitted debt instruments does not include debt instruments traded on an established securities market if such debt instruments are subject to foreign withholding tax. The IRS and Treasury request comments concerning whether the scope of this rule is adequate to address potentially abusive transactions and whether legitimate (non-tax) business reasons may justify the use of a FASIT to hold foreign debt that is traded on an established securities market and is subject to a foreign withholding tax.

Avoidance of U.S. Withholding Tax

The IRS and Treasury are also concerned that FASITs may be used by foreign resident taxpayers to avoid U.S. withholding taxes that would otherwise be imposed on direct cross-border financing to a foreign person's U.S. subsidiary. In particular, the IRS and Treasury are aware that foreign taxpayers may attempt to use FASITs to convert interest that would be disqualified from the portfolio interest exemption under sections 871(h)(3), 881(c)(3)(B), and 881(c)(3)(C) (concerning interest paid to a 10 percent shareholder and interest paid to a controlled foreign corporation from a related person) into interest that qualifies as portfolio interest. To prevent such avoidance, the proposed regulations provide that interest paid or accrued to a foreign holder of a FASIT regular interest will not qualify as portfolio interest under sections 871(h)(3) and 881(c)(3) to the extent that the FASIT receives or accrues interest from an obligor who is a U.S. resident taxpayer (the related obligor) if (1) the foreign holder is a 10 percent shareholder (within the meaning of Section 871(h)(3)) of the related obligor or (2) the foreign holder is a controlled foreign corporation and the related obligor is a *related person* (within the meaning of section 864(d)(4)) with respect to the foreign holder. For these purposes, the related obligor is defined as a *conduit debtor* who is treated as paying interest directly to the 10 percent shareholder or the controlled foreign corporation for purposes of sections 871, 881, 1441 and 1442. This rule characterizes all interest of the foreign regular interest holder as non-portfolio interest if

the FASIT receives or accrues an equal or greater amount of interest from the related obligor.

Further, the IRS and Treasury request comments concerning whether FASIT regular interests, REMIC regular interests, and pass through certificates should be treated in a consistent manner for purposes of applying U.S. withholding tax rules.

The IRS and Treasury intend to issue regulations that will provide that the FASIT and its Owner are withholding agents in respect of payments made to foreign regular interest holders. The IRS and Treasury solicit comments with respect to circumstances in which the FASIT and its Owner may be unaware of a possible relationship between foreign regular interest holders and the related obligors of the debt instruments held by the FASIT or other circumstances under which it would be inappropriate to treat payments to a regular interest holder as payments directly from a conduit debtor. It is anticipated that these regulations will provide that the FASIT and its Owner will not be responsible for withholding amounts paid to the foreign regular interest holders in the above circumstances unless the FASIT or its Owner knows, or has reason to know, that the foreign regular interest holder is a 10 percent shareholder of the related obligor or is a controlled foreign corporation considered to be receiving interest from a related person. It is expected that these regulations will further provide that the FASIT and its Owner shall be presumed to know that these circumstances exist if the foreign regular interest holder owns 10 percent or more of the total value of the FASIT's regular interests and the debt of the related obligor accounts for 10 percent or more of the total value of the FASIT's assets.

Earnings Stripping and Original Issue Discount

The IRS and Treasury are also aware that regular interests in FASITs may be used by foreign residents to avoid other consequences that might apply to cross-border related-party payments. The IRS and Treasury are concerned that taxpayers may attempt to use FASITs to avoid the deferrals on deductibility imposed by sections 163(e)(3) on OID owing to related foreign persons and 163(j) on net interest expense that is otherwise treated as disqualified under the earnings stripping rules.

Similar to the rules adopted for portfolio indebtedness purposes, the proposed regulations treat a U.S. resident taxpayer who is an obligor to a FASIT as a conduit debtor to the extent a related person (within the meaning of section 267(b) or 707(b)(1)) who would not be subject to tax on a direct payment by the U.S. obligor receives interest with respect to a regular interest in the FASIT. In such circumstances, the earnings stripping provisions will apply to treat interest paid by a U.S. corporation or a U.S. trade or business of a foreign corporation on an obligation held by a FASIT as disqualified interest for purposes of section 163(j). Similarly, the conduit debtor rule also operates to treat OID accrued to a FASIT by a domestic party as deferred to the extent a related foreign person (as defined in section 163(e)(3)(B)) receives interest with respect to a regular interest of the FASIT. These rules apply to payments and accruals made during the same period the regular interest in the FASIT is held by the 10 percent shareholder or foreign related party.

No Correlative Adjustments to FASIT

The FASIT and its Owner are not entitled to any correlative adjustments for amounts that are treated as directly paid by a conduit debtor and treated as directly received by or accrued to a related party. Accordingly, all interest paid or accrued by the conduit debtor to the FASIT must be taken into account by the Owner in determining its own taxable income. This treatment is consistent with Treasury's general approach, already adopted in conduit financing regulations, to preventing withholding tax avoidance. TD 8611, 1995–2 C.B. 286, 293.

Interest Expense Allocation

For purposes of applying the interest expense allocation rules to the Owner under section 864(e) and the regulations thereunder, new proposed regulations provide that all interest expense from all FASITs that is treated as incurred by any Owner or by any other Owner that is a member of the same affiliated group of which the Owner is a member is directly allocated solely to all income from all FASITs of such Owners. The directly allocated interest expense is treated as directly related to all activities and assets of all the Owner's FASITs and is apportioned between domestic and foreign source FASIT gross income by applying the general asset method to the FASIT's assets. The proposed interest allocation rules also extend the existing asset adjustment rules under the asset method in §1.861–9T(g), which reduce assets to reflect the principal amount of indebtedness outstanding relating to the interest which is directly allocated. The rules of §1.861–10T(d)(2) are also made applicable. In addition, the new proposed interest allocation rules are the exclusive method for the direct allocation of FASIT interest expense. The IRS and Treasury are not aware of any situations in which the direct allocation rules of the existing temporary regulations would apply to any items of FASIT income and interest expense. Comments are solicited in this regard.

The rules apply to interest expense with respect to any FASIT as of that FASIT's startup day and throughout the entire period that the arrangement continues to qualify as a FASIT. The rules provide the Commissioner with discretion to continue to directly allocate interest expense with respect to a ceased FASIT to FASIT income if the Commissioner determines that a principle purpose for terminating the FASIT was to affect the interest allocation.

The IRS and Treasury believe that directly allocating FASIT interest expense solely to FASIT gross income is an administrable and appropriate way to limit distortions (favorable or unfavorable as the case may be) to a taxpayer's overall allocation of interest expense for foreign tax credit purposes. It is recognized, however, that the new proposed direct allocation rules may enable certain interest expense allocation planning that may create distortions that would not occur under existing interest allocation rules. To address these concerns, the IRS and Treasury are considering whether to adopt rules in final regulations that limit the extent to which the direct allocation rules may apply, including rules regarding the amount of variance between the direct allocation and combined asset allocation rules that is appropriate. Comments are solicited on this issue.

PRE-EFFECTIVE DATE FASITs

Section 1691(e) of the Small Business Job Protection Act of 1996 (the Act) provides special transition rules for securitization entities in existence on August 31, 1997. Under these rules, the Owner of a pre-effective date FASIT may defer the recognition of FASIT gain on assets attributable to pre-FASIT interests. For purposes of this rule, a *pre-effective date FASIT* is a FASIT the underlying arrangement of which was in existence on August 31, 1997. A *pre-FASIT interest* is an interest in the underlying arrangement that was outstanding on the FASIT startup date and that is considered debt under general tax principles.

The proposed regulations provide a safe-harbor method of accounting that allows the separation of FASIT gain attributable to pre-FASIT interests, and other FASIT gain. Basically, the safe-harbor method has three steps. Under the first step, the Owner groups the assets of the FASIT into pools. To ensure that each pool can be marked to market using a valuation methodology appropriate for its constituent assets, the proposed regulations provide that no pool may contain assets of more than one of the following three types: (1) assets that are valued under the special valuation rule and that have FASIT gain on the first day they are held by the FASIT, (2) assets that are valued under general fair market value principles and that have FASIT gain on the first day they are held by the FASIT, and (3) assets that do not have FASIT gain on the first day they are held by the FASIT.

Under the second step, the Owner periodically computes for each pool the difference between the income determined under a mark-to-market system (using the appropriate FASIT valuation methodology) and the income determined under an accrual system. This difference is referred to as FASIT gain (or loss) and is essentially a measure of the gain (or loss) from the pool that is attributable to the operation of the FASIT gain recognition rules. These rules require gain to be determined at the pool level when assets are contributed to a FASIT, and implicitly allow this gain to be reversed out (as deductions in the nature of premium offset) as the assets in the pool mature. In periods in which net contributions are made to the pool, the calculation generally will produce FASIT gain. In periods in which the pool decreases in size or duration, the calculation generally will produce FASIT loss. This FASIT loss is, in effect, a recapture of previously determined FASIT gain. Over the entire life of a pool, the aggregate FASIT gain (or loss) will be zero; the FASIT valuation rules do not create lifetime net income.

Under the third step, the Owner determines the proper amount of FASIT gain (or loss) to recognize during the current period. To determine this amount, the Owner first calculates the total amount of FASIT gain as of the last day of the current period. The Owner then reduces this amount to exclude the percentage of the FASIT gain that is attributable to pre-FASIT interests outstanding on the last day of the period. This reduced amount represents the cumulative amount of FASIT gain the Owner should recognize by the end of the current period. Finally, to adjust for amounts recognized in previous periods, the Owner subtracts from this amount the cumulative amount of FASIT gain that the Owner had recognized at the end of the previous period. The difference is the amount of FASIT gain (or loss) to be recognized in the current period.

Owners of pre-effective date FASITs that presently use a gain deferral methodology that differs from the safe harbor method described above may adopt the safe-harbor method. The IRS and Treasury request comments on whether guidance is needed on how this change of method may be accomplished.

PROPOSED AMENDMENT TO REMIC REGULATIONS

Final regulations governing REMICs, issued in 1992, contain rules governing the transfer of noneconomic REMIC residual interests. In general, a transfer of a noneconomic residual interest is disregarded for all tax purposes if a significant purpose of the transfer is to enable the transferor to impede the assessment or collection of tax. A purpose to impede the assessment or collection of tax (a wrongful purpose) exists if the transferor, at the time of the transfer, either knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of the REMIC's taxable income.

Under a safe harbor, the transferor of a REMIC residual interest is presumed not to have a wrongful purpose if two requirements are satisfied. First, the transferor must conduct a reasonable investigation of the transferee's financial condition. Second, the transferor must secure a representation from the transferee to the effect that the transferee understands the tax obligations associated with holding a residual interest and intends to pay those taxes.

The IRS and Treasury are concerned that some transferors of residual interests claim they satisfy the safe harbor even in situations where the economics of the transfer clearly indicate the transferee is unwilling or unable to pay the tax associated with holding the interest. The proposed regulations, therefore, would clarify the safe harbor. The proposal explains that the safe harbor is unavailable unless the present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of: (1) the present value of any consideration given to the transferee to acquire the interest; (2) the present value of the expected future distributions on the interest; and (3) the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses. No inference is intended regarding whether any existing transactions satisfy the substantive requirements of this safe harbor before the clarification made by this amendment.

Proposed Effective Date

In general, the proposed regulations including the proposed amendments to the interest expense allocation regulations are proposed to apply on the date final regulations are filed with the **Federal Register**. The portion of the proposed regulations containing the anti-abuse rule and the portion of the proposed regulations allowing the deferral of gain on assets held by a pre-effective date FASIT are proposed to apply on February 4, 2000. The proposed amendment to the REMIC regulations is proposed to apply to all transfers occurring after the date final regulations concerning the amendment are published in the **Federal Register**.

Special Analyses

It is hereby certified that these proposed regulations will not have a significant economic impact on a substantial

number of small entities. This certification is based on the fact that it is unlikely that a substantial number of small entities will hold FASIT ownership interests. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (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 May 15, 2000, beginning at 10 a.m. in Room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble. The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 24, 2000. 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 proposed regulations is David L. Meyer, Office of Assistant Chief Counsel (Financial Institutions and Products), IRS. 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 parts 1 and 602 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for 1.861–10(e) and adding entries in numerical order to read as follows:

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

Section 1.860H–1 also issued under 26 U.S.C. 860L(h).

Section 1.860H–2 also issued under 26 U.S.C. 860L(h).

Section 1.860H–3 also issued under 26 U.S.C. 860L(h) and 860L(f).

Section 1.860H–4 also issued under 26 U.S.C. 860L(h).

Section 1.860H–5 also issued under 26 U.S.C. 860L(h) and 7701(l).

Section 1.860I–1 also issued under 26 U.S.C. 860L(h) and 860I(c).

Section 1.860I–2 also issued under 26 U.S.C. 860L(h).

Section 1.860J–1 also issued under 26 U.S.C. 860L(h).

Section 1.860K–1 also issued under 26 U.S.C. 860L(h).

Section 1.860L–1 also issued under 26 U.S.C. 860L(h).

Section 1.860L–2 also issued under 26 U.S.C. 860L(h).

Section 1.860L–3 also issued under 26 U.S.C. 860L(h).

Section 1.860L–4 also issued under 26 U.S.C. 860L(h). * * *

Section 1.861–9 also issued under 26 U.S.C. 864(e)(7).

Section 1.861–10 also issued under 26 U.S.C 863(a), 26 U.S.C. 864(e)(7), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). * * *

Par. 2. Section 1.860E–1 is amended by:

1. Revising paragraph (c)(4).

2. Adding paragraphs (c)(5) and (c)(6).

The addition and revision read as follows:

§1.860E–1 Treatment of taxable income of a residual interest holder in excess of daily accruals.

* * * * *

(c) * * *

(4) *Safe harbor for establishing lack of improper knowledge*. A transferor is presumed not to have improper knowledge if—

(i) The transferor conducted, at the time of the transfer, a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, the transferor found that the transferee had historically paid its debts as they came due and found no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future;

(ii) The transferee represents to the transferor that it understands that, as the holder of the noneconomic residual interest, the transferee may incur tax liabilities in excess of any cash flows generated by the interest and that the transferee intends to pay taxes associated with holding residual interest as they become due; and

(iii) The present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of—

(A) The present value of any consideration given to the transferee to acquire the interest;

(B) The present value of the expected future distributions on the interest; and

(C) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(5) *Computational assumptions*. The following rules apply for purposes of paragraph (c)(4)(iii) of this section:

(i) The transferee is assumed to pay tax at a rate equal to the highest rate of tax specified in section 11(b)(1); and

(ii) Present values are computed using a discount rate equal to the applicable Federal rate prescribed by section 1274(d) compounded semiannually (a lower discount rate may be used if the transferee can demonstrate that it regularly borrows, in the course of its trade or business, substantial funds at such lower rate from un-

related third parties).

(6) *Effective date*. Paragraphs (c)(4) and (5) of this section are applicable on February 4, 2000.

Par. 3. Sections 1.860H–0 through 1.860L–4 are added to read as follows:

§1.860H–0 Table of contents.

This section lists captions that appear in §§1.860H–1 through 1.860L–4.

§1.860H–1 FASIT defined, FASIT election, other definitions.

(a) FASIT defined.
(b) FASIT election.
(1) Person that makes the election.
(2) Form of election.
(3) Time for filing election.
(4) Contents of election.
(5) Required signatures.
(6) Special rules regarding startup day.
(c) General definitions.
(1) Owner.
(2) Transfer.

§1.860H–2 Assets permitted to be held by a FASIT.

(a) Substantially all.
(b) Permitted debt instrument.
(1) In general.
(2) Special rules for short-term debt instruments issued by the Owner or related person.
(3) Exceptions.
(c) Cash and cash equivalents.
(d) Hedges and guarantees.
(1) In general.
(2) Referencing other than permitted assets.
(3) Association with particular assets or regular interests.
(4) Creating an investment prohibited.
(e) Hedges and guarantees issued by Owner (or related person).
(1) Hedges.
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§1.860H–3 Cessation of a FASIT.

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§1.860H–4 Regular interests in general.

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(1) Pre-effective date FASIT defined.
(2) Pre-FASIT interest defined.
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(b) Election to defer gain.
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(d) Example
(e) Election to apply gain deferral retroactively
(f) Effective date.

§1.860L–4 Effective date.

§1.860H–1 FASIT defined, FASIT election, other definitions.

(a) *FASIT defined.* (1) A *FASIT* is a qualified arrangement (as defined in paragraph (a)(2) of this section) that meets the requirements of section 860L(a)(1) and the FASIT regulations (as defined in paragraph (c) of this section). A qualified arrangement fails to meet the requirements of section 860L(a)(1) unless it has one and only one ownership interest and that ownership interest is held by one and only one eligible corporation (as defined in section 860L(a)(2)).

(2) Except as provided in paragraph (a)(3) of this section, a qualified arrangement is an arrangement that is either—

(i) An entity (other than a regulated investment company as defined in section 851(a)); or

(ii) A segregated pool of assets if—

(A) The initial assets of the pool are clearly identified, such as through an indenture; and

(B) Changes in the assets of the pool are clearly identified, such as through instruments of conveyance or release.

(3) Notwithstanding paragraph (a)(2) of this section, a qualified arrangement does not include—

(i) An entity created or organized under the law of a foreign country or a possession of the United States;

(ii) An entity any of the income of which is or ever has been subject to net tax by a foreign country or a possession of the United States; or

(iii) A segregated pool of assets any of the income of which at any time is subject to net tax by a foreign country or a possession of the United States.

(b) *FASIT election*—(1) *Person that makes the election*. For a qualified arrangement to be a FASIT an eligible corporation (as defined in section 860L(a)(2)) must make the election required under section 860L(a)(1)(A).

(i) If the qualified arrangement is an entity described in paragraph (a)(2)(i) of this section, the eligible corporation making the election must hold one or more interests in the entity, and one of those interests must be the interest designated as the FASIT's ownership interest.

(ii) If the qualified arrangement is a segregated pool of assets described in paragraph (a)(2)(ii) of this section, the eligible corporation making the election must be the first taxpayer to be treated as the Owner of the resulting FASIT.

(2) *Form of election*. Unless the Commissioner prescribes otherwise, a FASIT election is made by means of a statement attached to the Federal income tax return of the eligible corporation making the election.

(3) *Time for filing election.* The statement referred to in paragraph (b)(2) of this section must be attached to a timely filed (including extensions) original Federal income tax return for the eligible corporation's taxable year in which the FASIT's startup day occurs. An election may not be made on an amended return.

(4) *Contents of election*. The statement referred to in paragraph (b)(2) of this section must include—

(i) For other than a segregated pool of assets, the name, address, and taxpayer identification number of the arrangement (if one was issued prior to the making of the election);

(ii) For a segregated pool of assets, the following information—

(A) The name, address, and taxpayer identification number of the person or persons holding legal title to the pool of assets;

(B) The name, address, and taxpayer identification number of the person or persons that, immediately before the startup day, are considered to own the pool for Federal income tax purposes; and

(C) Information describing the origin of the pool (including the caption and date of execution of any instruments of indenture or similar documents that govern the pool);

(iii) The startup day; and

(iv) The name and title of all persons signing the statement.

(5) *Required signatures.* The statement referred to in paragraph (b)(2) of this section must be signed by the authorized person, described in this paragraph (b)(5).

(i) For other than a segregated pool of assets, the authorized person is any person authorized to sign the qualified arrangement's Federal income tax return in the absence of a FASIT election. For example, if a qualified arrangement is a corporation or trust under applicable state law, an authorized person is a corporate officer or trustee, respectively.

(ii) For a segregated pool of assets, the authorized person is each person who, for Federal income tax purposes, owns the assets of the pool immediately before the earlier of the date on which—

(A) An outstanding interest in the pool is designated as a regular or ownership interest in a FASIT; or

(B) The pool issues an interest designated at the time of issuance as a regular or ownership interest in a FASIT.

(6) *Special rule regarding startup day*. The startup day must be a day on which the eligible corporation making the election is described in paragraph (b)(1)(i) or (ii) of this section.

(c) *General definitions*. For purposes of the regulations issued under part V of subchapter M of chapter 1 of subtitle A of the Internal Revenue Code (the FASIT regulations)—

(1) *Owner* means the eligible corporation that holds the interest described in section 860L(b)(2);

(2) *Transfer* includes a sale, contribution, endorsement, or other conveyance of a legal or beneficial interest in property.

§1.860H–2 Assets permitted to be held by a FASIT.

(a) *Substantially all*. For purposes of section 860L(a)(1)(D), substantially all of the assets held by a FASIT consist of permitted assets if the total adjusted bases of the permitted assets is more than 99 percent of the total adjusted bases of all the assets held by the FASIT, including those assets deemed to be held under section 860I(b)(2).

(b) *Permitted debt instrument*—(1) *In general*. Except as otherwise provided, a debt instrument is described in section 860L(c)(1)(B) only if it is a permitted debt instrument. For purposes of the FASIT regulations, a permitted debt instrument is—

(i) A fixed rate debt instrument, including a debt instrument having more than one payment schedule for which a single yield can be determined under §1.1272–1(c) or (d);

(ii) A variable rate debt instrument within the meaning of §1.1275–5 if the debt instrument provides for interest at a qualified floating rate within the meaning of §1.1275–5(b);

(iii) A REMIC regular interest;

(iv) A FASIT regular interest (includ-

ing a FASIT regular interest issued by another FASIT in which the Owner (or a related person) holds an ownership interest);

(v) An inflation-indexed debt instrument as defined in §1.1275–7;

(vi) Any receivable generated through an extension of credit under a revolving credit agreement (such as a credit card account);

(vii) A stripped bond or stripped coupon (as defined in section 1286(e)(2) and (3)), if the debt instrument from which the stripped bond or stripped coupon is created is described in paragraphs (b)(1)(i) through (vi) of this section; and

(viii) A certificate of trust representing a beneficial ownership interest in a debt instrument described in paragraphs (b)(1)(i) through (vii) of this section.

(2) *Special rules for short-term debt instruments issued by the Owner or related person.* Notwithstanding section 860L(c)(2) and paragraph (b)(3)(iii) of this section, a debt instrument issued by the Owner (or a related person) is a permitted debt instrument if it—

(i) Is described in paragraph (b)(1)(i) or (ii) of this section;

(ii) Has an original stated maturity of 270 days or less;

(iii) Is rated at least investment quality by a nationally recognized statistical rating organization that is not a related person of the issuer; and

(iv) Is acquired to temporarily invest cash awaiting either reinvestment in permitted assets not described in this paragraph (b)(2), or distribution to the Owner or holders of one or more FASIT regular interests.

(3) *Exceptions.* Notwithstanding paragraph (b)(1) of this section, the following debt instruments are not permitted assets.

(i) *Equity-linked debt instrument.* A debt instrument is not a permitted asset if the debt instrument contains a provision that permits the instrument to be converted into, or exchanged for, any legal or beneficial ownership interest in any asset other than a permitted debt instrument (such as a debt instrument that is exchangeable for an interest in a partnership). Similarly, a debt instrument is not a permitted asset if the debt instrument contains a provision under which one or more payments on the instrument are determined by reference to, or are contingent upon, the value of any asset other than a permitted debt instrument (such as a debt instrument containing a provision under which one or more payments on the instrument are determined by reference to, or are contingent upon, the value of stock).

(ii) *Defaulted debt instrument.* A debt instrument is not a permitted asset if, on the date the debt instrument is acquired by the FASIT, the debt instrument is in default due to the debtor's failure to have timely made one or more of the payments owed on the debt instrument and the Owner has no reasonable expectation that all delinquent payments on the debt instrument, including any interest and penalties thereon, will be fully paid on or before the date that is 90 days after the date the instrument is first held by the FASIT.

(iii) *Owner debt.* A debt instrument is not a permitted asset if the debt instrument is issued by the Owner (or a related person) and the debt instrument does not qualify as a permitted debt instrument under paragraphs (b)(1)(iv) or (2) of this section.

(iv) *Certain Owner-guaranteed debt.* A debt instrument is not a permitted asset if the debt instrument is guaranteed by the Owner (or a related person) and, based on all of the facts and circumstances existing at the time the guarantee is given, or at the time the FASIT acquires the guaranteed debt instrument the Owner (or a related person) is, in substance, the primary obligor on the debt instrument. For this purpose, a guarantee includes any promise to pay in the case of the default or imminent default of any debt instrument.

(v) *Debt instrument linked to the Owner's credit.* A debt instrument that is issued by a person other than the Owner (or a related person) is not a permitted asset if the timing or amount of payments on the instrument are determined by reference to, or are contingent on, the timing or amount of payments made on a debt instrument issued by the Owner (or a related person).

(vi) *Partial interests in non-permitted debt instruments.* A debt instrument is not a permitted asset if the debt instrument is a partial interest such a stripped bond or stripped coupon (as defined in section 1286(e)) in a debt instrument described in paragraphs (b)(3)(i) through (v) of this section.

(vii) *Certain Foreign Debt Subject to Withholding Tax.* A debt instrument is not a permitted asset if the debt instrument is traded on an established securities market (within the meaning of §1.860I–2) and interest on the debt instrument is subject to any tax determined on a gross basis (such as a withholding tax) other than a tax which is in the nature of a prepayment of a tax imposed on a net basis.

(c) *Cash and cash equivalents.* For purposes of section 860L(c)(1)(A) and the FASIT regulations, the term *cash and cash equivalents* means—

(1) The United States dollar;

(2) A currency other than the United States dollar if the currency is received as payment on a permitted asset described in §1.860H–2, or the currency is required by the FASIT to make a payment on a regular interest issued by the FASIT according to the terms of the regular interest;

(3) A debt instrument if it—

(i) Is described—

(A) In paragraphs (b)(1)(i), (ii), or (v) of this section, or

(B) In paragraph (b)(vii) of this section if it is created from an instrument described in paragraphs (b)(1)(i), (ii), or (v) of this section;

(ii) Has a remaining maturity of 270 days or less; and

(iii) Is rated at least investment quality by a nationally recognized statistical rating organization that is not a related person to the issuer; and

(4) Shares in a U.S.-dollar-denominated money market fund (as defined in 17 CFR 270.2a-7).

(d) *Hedges and guarantees*—(1) *In general.* Subject to the rules in paragraphs (d)(2) through (4) of this section, a hedge or guarantee contract is described in section 860L(c)(1)(D) (a *permitted hedge*) only if the hedge or guarantee contract is reasonably required to offset any differences that any risk factor may cause between the amount or timing of the receipts on assets the FASIT holds (or expects to hold) and the amount or timing of the payments on the regular interests the FASIT has issued (or expects to issue). For purposes of this paragraph (d), the risk factors are—

(i) Fluctuations in market interest rates;

(ii) Fluctuations in currency exchange rates;

(iii) The credit quality of, or default on, the FASIT's assets or debt instruments underlying the FASIT's assets; and

(iv) The receipt of payments on the FASIT's assets earlier or later than originally anticipated.

(2) *Referencing other than permitted assets*. A hedge or guarantee contract is not a permitted hedge if it references an asset other than a permitted asset or if it references an index, economic indicator, or financial average, that is not both widely disseminated and designed to correlate closely with changes in one or more of the risk factors described in paragraphs (d)(1)(i) through (iv) of this section.

(3) *Association with particular assets or regular interests*. A hedge or guarantee contract need not be associated with any of the FASIT's assets or regular interests, or any group of its assets or regular interests, if the hedge or guarantee contract offsets the differences described in paragraph (d)(1) of this section.

(4) *Creating an investment prohibited*. A hedge or guarantee contract is not a permitted hedge if at the time the hedge or guarantee is entered into, it in substance creates an investment in the FASIT.

(e) *Hedges and guarantees issued by Owner (or related person)*—(1) *Hedges*. A hedge contract issued by the Owner (or a related person) is a permitted asset only if—

(i) The contract is a permitted hedge other than a guarantee contract;

(ii) The Owner (or the related person) regularly provides, offers, or sells substantially similar contracts in the ordinary course of its trade or business;

(iii) On the date the contract is acquired by the FASIT (and on any later date that it is substantially modified) its terms are consistent with the terms that would apply in the case of an arm's length transaction between unrelated parties; and

(iv) The Owner maintains records that—

(A) Show the terms of the contract are consistent with the terms that would apply in the case of an arm's length transaction between unrelated parties; and

(B) Explain how the Owner (or related person) determined the consideration for the contract.

(2) *Guarantees*. A guarantee contract issued by the Owner (or a related person) is a permitted asset only if—

(i) The contract is a permitted hedge and satisfies paragraphs (e)(1)(iii) and (iv) of this section;

(ii) The contract is a credit enhancement contract under §1.860G–2(c); and

(iii) Immediately after the contract is acquired by the FASIT (and on any later date that it is substantially modified), the value (determined under section 860I and §1.860I–2) of all the FASIT's guarantee contracts issued by the Owner (and related persons) is less than 3 percent of the value (determined under section 860I and §1.860I–2) of all the FASIT's assets.

(f) *Foreclosure property*. Property acquired in connection with the default or imminent default of a debt instrument held by a FASIT may qualify both as foreclosure property under section 860L(c)(1)(C) and as another type of permitted asset under section 860L(c)(1). If foreclosure property qualifies as another type of permitted asset, the FASIT may hold the property beyond the grace period prescribed for foreclosure property under section 860L(c)(3). In this case, immediately after the grace period ends, the taxpayer must recognize gain, if any, as if the property had been contributed by the Owner to the FASIT on that date. See §1.860I–1(a)(1)(iii). In addition, after the close of the grace period, disposition of the property is subject to the prohibited transactions tax imposed under section 860L(e) without the benefit of the exception for foreclosure property.

(g) *Special rule for contracts or agreements in the nature of a line of credit*. For purposes of section 860L(c)(1), the term *permitted asset* includes a lender's position in a contract or agreement in the nature of a line of credit (other than a contract or agreement that is originated by the FASIT). Such a contract or agreement is not subject to the rules of section 860I(a) at the time the contract or agreement is transferred to the FASIT. Extensions of credit under the contract or agreement are subject to the rules of section 860I(a) at the time the extension is made. See section 860I(d)(2). To determine whether a contract or agreement is originated by a FASIT, see §1.860L–1.

(h) *Contracts to acquire hedges or debt instruments*. A contract is not described in section 860L(c)(1)(E) if it is an agreement under which the Owner (or a related person) agrees to transfer permitted hedges or permitted debt instruments to a FASIT for less than —

(1) Fair market value, in the case of hedges or debt instruments traded on an established securities market (as defined in §1.860I–2); or

(2) Ninety percent of their value, as determined under section 860I(d)(1)(A) and the FASIT regulations, in the case of debt instruments not traded on an established securities market.

§1.860H–3 Cessation of a FASIT.

(a) *In general*. An arrangement ceases to be a FASIT if it revokes its election with the consent of the Commissioner or if it fails to qualify as a FASIT and the Commissioner does not determine the failure to be inadvertent.

(b) *Time of cessation*. An arrangement ceases to be a FASIT at the close of the day designated by the Commissioner in the consent to revoke, or if there is no consent to revoke or determination of inadvertence, at the close of the day on which the arrangement initially fails to qualify as a FASIT.

(c) *Consequences of cessation*. Except as otherwise determined by the Commissioner, the consequences of cessation are as follows:

(1) *The FASIT and the underlying arrangement*. The arrangement that made the FASIT election (the underlying arrangement) is no longer a FASIT and cannot re-elect FASIT treatment without the Commissioner's approval. Immediately after the cessation, the arrangement's classification (for example, as a partnership or corporation) is determined under general principles of Federal income tax law. Immediately after the cessation, the arrangement holds the FASIT's assets with a fair market value basis. Any election the Owner made (other than the FASIT election), and any method of accounting the Owner adopted with respect to those assets, binds the underlying arrangement as if the underlying arrangement itself had made the election or adopted the method of accounting. If the underlying arrangement is a segregated pool of assets, the person holding legal title to the pool is responsible for complying with any tax filing or reporting requirements arising from the pool's operation.

(2) *The Owner*. (i) The Owner is treated as exchanging the assets of the FASIT for an amount equal to their value (as determined under §1.860I–2). Gain realized on the exchange is treated as gain from a prohibited transaction and the Owner is subject to the tax imposed by 860L without exception. Loss, if any, is disallowed. The determination of gain or loss on assets for purposes of this paragraph is made on an asset-by-asset basis.

(ii) The Owner must recognize cancellation of indebtedness income in an amount equal to the adjusted issue price of the regular interests outstanding immediately before the cessation over the fair market value of those interests immediately before the cessation. This determination is made on a regular interest by regular interest basis. The Owner cannot take any deduction for acquisition premium.

(iii) If, after the cessation, the Owner has a continuing economic interest in the assets, the characterization of this economic interest (for example, as stock or a partnership interest) is determined under general principles of Federal income tax law. If the Owner has a continuing economic interest in the assets immediately after cessation, the Owner holds the interest with a fair market value basis.

(3) *The regular interest holders*. Holders of the regular interests are treated as exchanging their regular interests for interests in the underlying arrangement. Interests in the underlying arrangement are classified (for example, as debt or equity) under general principles of Federal income tax law. Gain must be recognized if a regular interest is exchanged either for an interest not classified as debt or for an interest classified as debt that differs materially either in kind or extent. No loss may be recognized on the exchange. The basis of an interest in the underlying arrangement equals the basis in the regular interest exchanged for it, increased by any gain recognized on the exchange under this paragraph (c)(3).

(d) *Disregarding inadvertent failures to remain qualified*—(1) If a qualified arrangement that ceases to be a FASIT meets the requirements of paragraph (d)(2) of this section, then the Commissioner may either—

(i) Deem the qualified arrangement as continuing to be a FASIT notwithstanding the cessation; or

(ii) Allow the qualified arrangement to re-elect FASIT status after cessation notwithstanding the prohibition in section 860L(a)(4) .

(2) The requirements of this paragraph are satisfied if —

(i) The Commissioner determines that the cessation was inadvertent;

(ii) No later than a reasonable time after the discovery of the event resulting in the cessation, steps are taken so that all of the requirements for a FASIT are satisfied; and

(iii) The qualified arrangement and each person holding an interest in the qualified arrangement at any time during the period the qualified arrangement failed to qualify as a FASIT agree to make such adjustments (consistent with the treatment of the qualified arrangement as a FASIT or the treatment of the Owner as a C corporation) as the Commissioner may require with respect to such period.

§1.860H–4 Regular interests in general.

(a) *Issue price of regular interests*—(1) *Regular interests not issued for property*. The issue price of a FASIT regular interest not issued for property is determined under section 1273(b).

(2) *Regular interests issued for property.* Notwithstanding sections 1273 and 1274 and the regulations thereunder, the issue price of a FASIT regular interest issued for property is the fair market value of the regular interest determined as of the issue date.

(b) *Special rules for high-yield regular interests*—(1) *High-yield interests held by a securities dealer*—(i) *Due date of tax imposed on securities dealer under section 860K(d)*. The excise tax imposed under section 860K(d) (treatment of high-yield interest held by a securities dealer that is not an eligible corporation) must be paid on or before the due date of the securities dealer's Federal income tax return for the earlier of the taxable year in which the securities dealer—

(A) Ceases to be a dealer in securities; or

(B) Commences holding the high-yield interest for investment.

(ii) [Reserved]

(2) *High-yield interests held by a pass-thru*—(i) *Nature and due date of tax imposed under section 860K(e).* The tax imposed under section 860K(e) (treatment of high-yield interest held by a pass-thru entity) is an excise tax which must be paid on or before the due date of the pass-thru entity's Federal income tax return for the taxable year in which the pass-thru entity issues the debt or equity interest described in section 860K(e).

(ii) *Pass-thru entity includes REMIC*. For purposes of section 860K(e), a pass-thru entity includes a real estate mortgage investment conduit (REMIC) as defined in section 860D.

§1.860H–5 Foreign resident holders of regular interests.

(a) *Look-through to underlying FASIT debt*. If, during the same period, a foreign resident holds (either directly or through a vehicle which itself is not subject to the Federal income tax such as a partnership or trust) a regular interest in a FASIT and a conduit debtor (as defined in paragraph (b) of this section) pays or accrues interest on a debt instrument held by the FASIT, then any interest received or accrued by the foreign resident with respect to the regular interest during that period is treated as received or accrued from the conduit debtor. This rule applies to both the foreign resident holder of the FASIT regular interest and the conduit debtor for all purposes of subtitle A and the regulations thereunder.

(b) *Conduit debtor.* A debtor is a conduit debtor if the debtor is a U.S. resident taxpayer or a foreign resident taxpayer to which interest expense paid or accrued with respect to the debt held by the FASIT is treated as paid or accrued by a U.S. trade or business of the foreign taxpayer under section 884(f)(1)(A), and the foreign resident holder described in paragraph (a) of this section—

(1) Is a 10-percent shareholder of the debtor (within the meaning of section 871(h)(3)(B));

(2) Is a controlled foreign corporation, but only if the debtor is a related person (within the meaning of section 864(d)(4)) with respect to the controlled foreign corporation; or

(3) Is related to the debtor (within the meaning of section 267(b) or 707(b)(1)).

(c) *Limitation*. The amount of income treated under paragraph (a) of this section as received from a conduit debtor is the lesser of—

(1) The income received or accrued by the foreign resident holder with respect to

the FASIT regular interest; or

(2) The amount paid or accrued by the conduit debtor with respect to the debt instrument held by the FASIT.

(d) *Cross references*. For the treatment of related-party interest accrued to foreign related persons, see sections 163(e)(3), 163(j), 871(h)(3), 881(c)(3)(B), and 881(c)(3)(C).

§1.860H–6 Taxation of Owner, Owner's reporting requirements, transfers of ownership interest.

(a) *In general*. For purposes of determining an Owner's credits and taxable income, all assets, liabilities, and items of income, gain, deduction, loss, and credit of the FASIT are treated as assets, liabilities, and such items of the Owner.

(b) *Constant yield method to apply.* The income from each debt instrument a FASIT holds is determined by applying the constant yield method (including the rules of section 1272(a)(6)) described in §1.1272–3(c).

(c) *Method of accounting for, and character of, hedges*. The method of accounting used for a permitted hedge (as described in §1.860H–2(e)) must clearly reflect income and otherwise comply with the rules of §1.446–4 (whether or not the permitted hedge instrument is part of a hedging transaction as defined in §1.1221–2(b)). The character of any gain or loss realized on a permitted hedge (as described in §1.860H–2(e)) is ordinary.

(d) *Coordination with mark-to market provisions*—(1) *No mark to market accounting*. Mark to market accounting does not apply to any asset (other than a non-permitted asset) while it is held, or deemed held, by a FASIT.

(2) *Transfer of a mark to market asset to a FASIT*. If an Owner transfers a permitted asset to a FASIT and the asset would have been marked to market if the taxable year had ended immediately before the transfer (for example, an asset accounted for under section 475(a)), then immediately before the transfer, the Owner must mark the asset to market and take gain or loss into account as if the taxable year had ended at that point. See §1.475(b)–1(b)(4). If the asset is a debt instrument that is valued under the special valuation rule of §1.860I–2(a), then immediately after the asset is marked to market under this paragraph (d)(2), the asset is also valued under §1.860I–2(a), and any additional gain is taken into account under section 860I. The latter gain, but not any mark to market gain, is subject to section 860J.

(e) *Owner's annual reporting requirements*. Unless the Commissioner otherwise prescribes, specified information regarding the FASIT must be reported by means of a separate statement, attached by the Owner to its income tax return for the taxable year that includes the reporting period. The reporting period is the period in the Owner's taxable year during which the Owner holds the ownership interest in the FASIT. Unless the Commissioner otherwise requires, the statement must set forth—

(1) The name, address, and taxpayer identification number (if any) of the FASIT and any other information necessary to establish the identity of the FASIT for which the statement is being filed;

(2) If the ownership interest was acquired from another person during the Owner's taxable year, the date on which it was acquired, and the name and address of the person from which it was acquired;

(3) If the ownership interest was transferred by the Owner during the Owner's taxable year, the date on which it was transferred, the name and address of the person to which it was transferred, and whether such person is described in section 860L(a)(2);

(4) If any regular interests are issued during the reporting period, a description of the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6) and any regulations thereunder, including a statement supporting the selection of the prepayment assumption;

(5) The FASIT's items (taken into account during the reporting period) of income, gain, loss, deduction and credit from permitted transactions, and separately stated, the FASIT's items (taken into account during the reporting period) of income, gain, loss, deduction and credit from prohibited transactions;

(6) Information detailing the extent to which the items described in paragraph (f)(5) of this section consist of interest accrued that, but for section 860H(b)(4), is exempt from the taxes imposed under subtitle A of 26 U.S.C.; and

(7) If a qualified arrangement ceases to be a FASIT during a reporting period (including at the close of a reporting period), information disclosing—

(i) The effective date of the cessation;

(ii) A description of how the cessation occurred; and

(iii) A statement regarding whether the arrangement will continue after cessation and, if so, the continuing arrangement's name, address, and taxpayer identification number.

(f) *Treatment of FASIT under subtitle F of Title 26 U.S.C.* For purposes of subtitle F (Procedure and Administration)—

(1) A FASIT is treated as a branch or division of the Owner;

(2) The Owner is treated as the issuer of the regular interests; and

(3) The regular interests are treated as collateralized debt obligations as defined in §1.6049–7(d)(2).

(g) *Transfer of ownership interest*—(1) *In general*. If, at the time of any transfer of the ownership interest, the Owner knew or should have known that the transferee would be unwilling or unable to pay some or all of the tax arising from the application of section 860H(b), then the transfer is disregarded for all Federal tax purposes.

(2) *Safe harbor for establishing lack of improper knowledge*. A transfer will not be disregarded under paragraph (g)(1) of this section if the rules of §1.860E–1(c)(4) (safe harbor for establishing lack of improper knowledge on the transfer of a non-economic REMIC residual interest) are satisfied with respect to the FASIT ownership interest.

§1.860I–1 Gain recognition on property transferred to FASIT or supporting FASIT regular interests.

(a) *In general*—(1) Except as provided in paragraphs (a)(2) and (d) of this section, the Owner of a FASIT (or a related person) must recognize gain (if any) on—

(i) Property the Owner (or the related person) transfers either to the FASIT or its regular interest holders;

(ii) Support property; and

(iii) Property acquired by the FASIT as foreclosure property and held beyond the grace period allowed for foreclosure property.

(2) An Owner (or a related person) does not have to recognize gain under section 860I or paragraph (a)(1) of this section on a transfer or pledge of property to a regu-

lar interest holder, if the Owner (or the related person) makes the transfer or pledge in a capacity other than as Owner (or related person), and the regular interest holder receives the transfer or pledge in a capacity other than regular interest holder.

(b) *Support property defined*. Property is *support property* if the Owner (or a related person)—

(1) Pledges the property, directly or indirectly, to pay a FASIT regular interest, or otherwise identifies the property as providing security for the payment of a FASIT regular interest;

(2) Sets aside the property for transfer to a FASIT under any agreement or understanding; or

(3) Holds an interest in the property that is subordinate to the FASIT=s interest in the property (for example, the Owner holds subordinate interests in a pool of mortgages and the FASIT holds senior interests in the same pool).

(c) *Timing of gain determination and recognition*. Gain is determined and recognized under paragraph (a)(1) of this section immediately before the property is transferred to the FASIT or becomes support property, or in the case of foreclosure property, on the day immediately following the termination of the grace period allowed for foreclosure property.

(d) *Gain deferral election*. [Reserved]

(e) *Amount of gain*. Except as provided in paragraph (f) of this section, the amount of gain recognized under paragraph (a)(1) of this section is the same as if the Owner (or the related person) had sold the property for its value as determined under §1.860I–2.

(f) *Record keeping requirements*. The Owner is required to maintain such books and records as may be necessary or appropriate to demonstrate that the requirements of this section are satisfied.

(g) *Special rule applicable to property of related persons*. Except in the case of property traded on an established securities market (as defined in §1.860I–2(b)), if a related person holds property that becomes support property, or if a related person transfers property to a FASIT or its regular interest holders, then for purposes of applying the gain recognition provisions of this section—

(1) The related person is treated as transferring the property to the Owner for the property's fair market value as determined under general tax principles; and

(2) The Owner is treated as transferring the property to the FASIT for the property's value as determined under §1.860I–2.

§1.860I–2 Value of property.

(a) *Special valuation rule*. For purposes of section 860I(d)(1)(A), except as provided in paragraph (c) of this section, the value of a debt instrument not traded on an established securities market is the present value of the reasonably expected payments on the instrument determined—

(1) As of the date the instrument is to be valued (as described in §1.860I–1(c)); and

(2) By using a discount rate equal to 120 percent of the applicable federal rate, compounded semi-annually, for instruments having the same term as the weighted average maturity of the reasonably expected payments on the instrument. For this purpose, the applicable federal rate is the rate prescribed under section 1274(d) for the period that includes the date the instrument is valued (as described in §1.860I–1(c)).

(b) *Traded on an established securities market*. For purposes of section 860I(d)(1)(A), a debt instrument is traded on an established securities market if it is traded on a market described in §1.1273–2(f)(2), (3), or (4).

(c) *Reasonably expected payments*—(1) *In general*. Reasonably expected payments on an instrument must be determined in a commercially reasonable manner and, except as otherwise provided in this section (c), may take into account reasonable assumptions concerning early repayments, late payments, non-payments, and loan servicing costs. No other assumptions may be considered.

(2) *Consistency requirements*. Except as provided in paragraph (c)(3) of this section, any assumption used in determining the reasonably expected payments on an instrument must be consistent with (and no less favorable than) the first of the following categories that applies—

(i) Representations made in connection with the offering of a regular interest in the FASIT;

(ii) Representations made to any nationally recognized statistical rating organizations;

(iii) Representations made in any filings or registrations with any governmental agency with respect to the FASIT; and

(iv) Industry customs or standards (as defined in paragraph (e) of this section).

(3) *Servicing costs*. Notwithstanding paragraph (c)(2) of this section, the amount of loan servicing costs assumed may not exceed the lesser of—

(i) The amount the FASIT agrees to pay the Owner for servicing the loans held by the FASIT if the Owner is providing the servicing; or

(ii) The amount a third party would reasonably pay for servicing identical loans.

(4) *Nonconforming or unreasonable assumptions*. If a taxpayer, in determining the expected payments on an instrument, takes into account an assumption that either fails to meet the requirements of paragraph (c)(2) or (3) of this section or is unreasonable, the Commissioner may determine the reasonably expected payments on the instrument without the assumption. Thus, for example, if a taxpayer makes an unreasonable assumption concerning non-payments, the Commissioner may compute expected payments without any adjustment for non-payments.

(d) *Special rules*—(1) *Beneficial ownership interests*. A certificate representing beneficial ownership of a debt instrument, is deemed to represent beneficial ownership of a debt instrument traded on an established securities market, if either —

(i) The certificate is traded on an established securities market; or

(ii) The certificate represents ownership in a pool of assets composed solely of debt instruments all of which are traded on established securities markets.

(2) *Stripped interests*. A stripped bond or stripped coupon (as defined in section 1286(e)) not otherwise traded on an established securities market is considered as being traded on an established securities market, if—

(i) The underlying bond (the bond from which the stripped bond or stripped coupon is created) is traded on an established securities market; and

(ii) The stripped bond or stripped coupon is valued using a commercially reasonable method based on the market value of the underlying bond.

(3) *Contemporaneous purchase and transfer of debt instruments*—(i) Notwithstanding paragraph (a) of this section, the value of a debt instrument not traded on

an established securities market is its cost to the Owner (or a related person) if—

(A) The debt instrument is purchased from an unrelated person in an arm's length transaction in which no other property is transferred or services provided;

(B) The debt instrument is acquired solely for cash;

(C) The price of the debt instrument is fixed no more than 15 days before the date of purchase; and

(D) The debt instrument is transferred to the FASIT no more than 15 days after the date of purchase.

(ii) For purposes of paragraph (d)(3)(i) of this section, the date of purchase is the earliest date on which the burdens and benefits of ownership of the debt instrument irrevocably pass to the Owner (or a related person).

(4) *Guarantees*. Notwithstanding paragraph (c)(1) of this section, if a guarantee qualifying as a permitted hedge under this paragraph (d) relates solely to a debt instrument not traded on an established securities market and the taxpayer determines the reasonably expected payments on the debt instrument by including the reasonably expected payments on the guarantee, then the guarantee and the property need not be valued separately.

(e) *Definitions*. For purposes of §1.860I–2—

(1) An *industry custom* is any long-standing practice in use by entities that engage in asset securitization as part of their ordinary business activities; and

(2) An *industry standard* is any standard that is both—

(i) Commonly used in evaluating the expected payments on securitized debt instruments (or debt instruments pending securitization) in similar transactions; and

(ii) Disseminated through written or electronic means by any independent, nationally recognized trade association or other authority that is recognized as competent to issue the standard.

§1.860J–1 Non-FASIT losses not to offset certain FASIT inclusions.

(a) *In general*. For purposes of applying section 860J(a)(1), an Owner's taxable income from a FASIT includes any gains recognized by the Owner under §1.860I–1(a).

(b) *Special rule for holders of multiple ownership interests*. For purposes of applying section 860J and the rules of §1.860J–1, a person may aggregate the net income (or loss) from all FASITs in which the person holds the ownership interest.

(c) *Related persons*—(1) *Taxable income*. The taxable income of a related person for any taxable year is no less than the sum of—

(i) The amounts specified in section 860J(a); plus

(ii) Any gains recognized under §1.860I–1(a).

(2) *Effect on net operating loss*. Any increase in a related person's taxable income attributable to paragraph (c)(1) of this section is disregarded—

(i) In determining under section 172 the amount of the related person's net operating loss for the taxable year; and

(ii) In determining the related person's taxable income for such taxable year for purposes of the second sentence of section 172(b)(2).

(3) *Coordination with minimum tax*. For purposes of part VI of subchapter A of chapter 1 of subtitle A of Title 26 U.S.C., the alternative minimum taxable income of any related person is in no event less than the related person's taxable income as computed under paragraph (c)(1) of this section.

§1.860L–1 Prohibited transactions.

(a) *Loan origination*—(1) *In general*. Section 860L(e) imposes a prohibited transactions tax on the receipt of any income derived from any loan originated by a FASIT. Except as provided in paragraphs (a)(2) and (3) of this section, whether a FASIT originates a loan for purposes of section 860L(e) depends on all the facts and circumstances.

(2) *Acquisitions presumed not to be loan origination*. Except as provided in paragraph (a)(3) of this section, a FASIT is considered not to have originated a loan if the FASIT acquires the loan—

(i) From an established securities market described in §1.1273–2(f)(2), (3), or (4);

(ii) On a date more than 12 months after the loan was issued; or

(iii) From a person (including the Owner or a related person) that regularly originates similar loans (such as through a standardized contract) in the ordinary course of its business.

(3) *Activities presumed to be loan origination*. (i) Notwithstanding paragraph (a)(2) of this section, a FASIT is considered to originate a loan if the FASIT either engages in or facilitates (other than through a person from whom the FASIT acquires the loan and who is described in paragraph (a)(2)(iii) of this section)—

(A) Soliciting the loan, including advertising to solicit borrowers, accepting the loan application, or generally making any offer to lend funds to any person;

(B) Evaluating an applicant's financial condition;

(C) Negotiating or establishing any terms of the loan;

(D) Preparing or processing any document related to negotiating or entering into the loan; or

(E) Closing the loan transaction.

(ii) For purposes of paragraph (a)(3)(i) of this section, if a FASIT enters into a contract to engage in purchases described in paragraph (a)(2)(iii) of this section, the FASIT is not treated as originating the loans it acquires solely because it was a party to the contract.

(4) *Loan workouts*. If a FASIT holds a loan, the FASIT is not treated as originating a new loan that it receives from the same obligor in exchange for the old loan in the context of a workout.

(b) *Origination of a contract or agreement in the nature of a line of credit*–(1) *In general*. A FASIT is presumed not to have originated a contract or agreement in the nature of a line of credit if the FASIT acquires the contract or agreement from a person (including the Owner or a related person) that regularly originates similar contracts or agreements in the ordinary course of its business.

(2) *Activities presumed to be origination*. If a FASIT assumes the role of a lender under a contract or agreement in the nature of a line of credit from a person that does not regularly originate similar contracts or agreements in the ordinary course of its business, the FASIT is considered to originate the contract or agreement if, with respect to the contract or agreement, the FASIT engages in any of the activities described in paragraphs (A) through (E) of §1.860L–1(a)(3)(i) of this section.

(3) *Debt instruments issued under contracts or agreements in the nature of a line of credit*. If a FASIT acquires a debt instrument as a result of the FASIT's position as a lender under a contract or agree-

ment in the nature of a line of credit, the FASIT is presumed to have originated the debt instrument if and only if the FASIT originated the related contract or agreement.

(c) *Disposition of debt instruments*. Notwithstanding sections 860L(e)(3)(B)(i) and (ii) (certain exceptions from the prohibited transactions tax), the distribution to the Owner of a debt instrument contributed by the Owner, and the transfer to the Owner of one debt instrument in exchange for another, are prohibited transactions, if within 180 days of receiving the debt instrument the Owner realizes a gain on the disposition of the instrument to any person, regardless of whether the realized gain is recognized.

(d) *Exclusion of prohibited transactions tax to dispositions of hedges*. The rules of section 860L(e) and paragraph (b) of this section do not apply to the disposition of any asset described in section 860L(c)(1)(D).

§1.860L–2 Anti-abuse rule.

(a) *Intent of FASIT provisions.* Part V of subchapter M of the Internal Revenue Code (the FASIT provisions) is intended to promote the spreading of credit risk on debt instruments by facilitating the securitization of those debt instruments. Implicit in the intent of the FASIT provisions are the following requirements—

(1) Assets to be securitized through a FASIT consist primarily of permitted debt instruments;

(2) The source of principal and interest payments on a FASIT's regular interests is primarily the principal and interest payments on permitted debt instruments held by the FASIT (as opposed to receipts on other assets or deposits of cash); and

(3) No FASIT provision may be used to achieve a Federal tax result that cannot be achieved without the provision unless the provision clearly contemplates that result.

(b) *Application of FASIT provisions*. The FASIT provisions and the FASIT regulations must be applied in a manner consistent with the intent of the FASIT provisions as set forth in paragraph (a) of this section. Therefore, if a principal purpose of forming or using a FASIT is to achieve results inconsistent with the intent of the FASIT provisions and the FASIT regulations, the Commissioner may make any appropriate adjustments with regard to the FASIT and any arrangement or transaction (or series of transactions) involving the FASIT. The Commissioner's authority includes—

(1) Disregarding a FASIT election;

(2) Treating one or more assets of a FASIT as held by a person or persons other than the Owner;

(3) Allocating FASIT income, loss, deductions and credits to a person or persons other than the Owner;

(4) Disallowing any item of FASIT income, loss, deduction, or credit;

(5) Treating the ownership interest in a FASIT as held by a person other than the nominal holder;

(6) Treating a FASIT regular interest as other than a debt instrument; and

(7) Treating a regular interest held by any person as having the same tax characteristics as one or more of the assets held by the FASIT.

(c) *Facts and circumstances analysis*. Whether a FASIT is created or used for a principal purpose of achieving a result inconsistent with the intent of the FASIT provisions is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction.

(d) *Effective date*. This section is applicable on February 4, 2000.

§1.860L–3 Transition rule for pre-effective date FASITs.

(a) *Scope*. This section applies if a pre-effective date FASIT has one or more pre-FASIT interests outstanding on the startup day of the FASIT.

(1) *Pre-effective date FASIT defined*. A *pre-effective date FASIT* is a FASIT whose underlying qualifying arrangement was in existence on August 31, 1997.

(2) *Pre-FASIT interest defined*. A *pre-FASIT interest* is an interest in a pre-effective date FASIT that—

(i) Was issued before February 4, 2000**;**

(ii) Was outstanding on the date the FASIT election for the underlying qualifying arrangement goes into effect; and

(iii) Is considered debt of the Owner under general principles of Federal income tax law.

(3) *FASIT gain defined*. For purposes of this section, the term FASIT gain means any gain that the Owner of a pre-effective date FASIT must recognize under the rules of this section.

(b) *Election to defer gain*. The Owner of a pre-effective date FASIT may elect to defer the recognition of FASIT gain on assets that are held by the FASIT but that are allocable to pre-FASIT interests. An Owner that elects under this section must establish a method of accounting for its FASIT gain. To clearly reflect income, this method must periodically determine the aggregate amount of FASIT gain on all of the assets in the FASIT and exclude the portion of the FASIT gain attributable to the pre-FASIT interests.

(c) *Safe-harbor method*. This paragraph (c) provides a safe-harbor method for determining the amount of FASIT gain that can be deferred under this section. The method has the following steps:

(1) *Step one: Establish pools*—(i) *Group assets into pools.* The Owner must group the assets of the FASIT into one or more pools. No pool may contain assets of more than one of the following three types—

(A) Assets that are valued under the special valuation rule of §1.860I–2(a) and that have FASIT gain on the first day held by the FASIT;

(B) Assets that are valued for FASIT gain purposes under a standard other than the special valuation rule of §1.860I–2(a) and that have FASIT gain on the first day held by the FASIT; and

(C) Assets that do not have FASIT gain on the first day held by the FASIT.

(ii) *Treatment of pools*. If a pool contains assets described in paragraph (c)(1)(i)(A) or (B) of this section, the Owner must apply paragraphs (c)(2) through (5) of this section to the pool. If a pool contains assets described in paragraph (c)(1)(i)(C) of this section, the pool is ignored for FASIT gain purposes.

(2) *Step two: Determine the FASIT gain (or loss) at the pool level*–(i) *In general.* For each taxable year, the FASIT gain (or loss) at the pool level is equal to the net increase (or decrease) in the value of the pool minus the income that is included with respect to the pool under general income tax principles (without regard to the FASIT rules). For purposes of the preceding sentence, the net increase (or decrease) in the value of the pool is equal to—

(A) The sum of the value of the pool (as determined under §1.860I–2) at the end of the taxable year and the amount of

any cash distributed (even if reinvested) from the pool during the taxable year; minus

(B) The sum of the value of the pool (as determined under §1.860I–2) at the end of the previous taxable year and the Owner's adjusted basis in the assets contributed to the pool during the taxable year.

(ii) *Limitation*. This paragraph applies if the calculation in paragraph (c)(2)(i) of this section produces a loss for the taxable year and the amount of the loss exceeds the net amount of the FASIT gain from the pool in all prior years. In this case, the amount of the loss for the current year is limited to the amount of net FASIT gain for all previous years.

(3) *Step three: Determine the percentage of total FASIT gain that must be recognized by the end of the current taxable year*. The percentage of FASIT gain that must be recognized by the end of the current taxable year is equal to 100 percent minus the percentage of FASIT gain that may be deferred at the end of the current taxable year. The percentage of FASIT gain that may be deferred at the end of the taxable year is equal to the lesser of 100 percent and the ratio of—

(i) The product of 107 percent and aggregate adjusted issue prices of all pre-FASIT interests outstanding on the last day of the taxable year; over

(ii) The total value of all assets held by the FASIT on the last day of the taxable year.

(4) *Step four: Determine the total amount of FASIT gain that is not attributed to pre- effective date FASIT interests*. The total amount of FASIT gain that is not attributed to pre- effective date FASIT interests is equal to the product of—

(i) The sum of the amount of FASIT gain (as determined under paragraph (c)(2) of this section) for the current taxable year and all previous taxable years; and

(ii) The percentage of FASIT gain that must be recognized in the current taxable year (as determined under paragraph (c)(3) of this section).

(5) *Step five: Determine the amount of FASIT gain (or loss) to be recognized in the taxable year*. For the taxable year that includes the startup date, the amount of FASIT gain to be recognized is equal to the total amount of FASIT gain not attributable to pre-effective date FASIT interests (as determined under paragraph (c)(4) of this section). Thereafter, the amount of FASIT gain (or loss) to be recognized in a given taxable year is equal to the total amount of FASIT gain not attributable to pre-effective date FASIT interests for that taxable year (as determined under paragraph (c)(4) of this section) less the amount of FASIT gain not attributable to pre-effective date FASIT interests for the immediately preceding taxable year (as determined under paragraph (c)(4) of this section).

(d) *Example*. The rules of this section are illustrated by the following example:

Example. (i) *Facts*. *O* is an eligible corporation within the meaning of section 860(a)(2) that uses the calendar year as its taxable year. On July 1, 1996, *O* forms *TR*, a trust. Shortly thereafter, *O* contributes credit card receivables to *TR* and *TR* issues certificates that, for Federal income tax purposes, are characterized as debt of *O*. Effective March 31, 1999, *O* elects FASIT status for *TR*. On March 31, 1999, *TR* holds credit card receivables that have an outstanding principal balance of $20,000,000 and *TR* has outstanding certificates (that are characterized for Federal income tax purposes as debt of *O*) that have an aggregate adjusted issue price of $10,000,000.

(ii) *Status as a pre-effective date FASIT*. *TR* is a pre-effective date FASIT because *TR* was a trust that was in existence on August 31, 1997. The certificates outstanding on March 1, 1999, are pre-FASIT interests because they were outstanding on March 31, 1999, and they were considered debt of *O* under general principles of Federal income tax law.

(iii) *Facts: 1999*. From April 1, 1999, through December 31, 1999, the credit card receivables held by *TR* generated $800,000 of taxable income and $4,000,000 of total cash flow. *TR* distributed $2,500,000 of the cash flow to *O* in exchange for new receivables having an outstanding principal balance of $2,500,000. *TR* used the remaining $1,500,000 of cash flow to make payments on its outstanding debt instruments. On December 31, 1999, *TR* contributed additional credit card receivables with an outstanding principal balance of $10,700,000 and an aggregate adjusted basis of $10,700,000. On December 31, 1999, *TR* held credit card receivables that had an outstanding principal balance of $30,000,000, an aggregate adjusted basis of $30,000,000, and a value (as determined under §1.860I–2(a)) of $30,300,000. In addition, on December 31, 1999, the outstanding adjusted issue price of the pre-FASIT interests was $9,000,000.

(iv) *FASIT gain recognition for 1999*—(A) *Establish pools*. *TR* elects to defer gain recognition under the safe harbor method. Consistent with paragraph (c)(1) of this section, *TR* groups the assets of the FASIT into a single pool because all of the assets of the FASIT are credit card receivables subject to the special valuation rule of §1.860I–1(a) and the assets have FASIT gain on the date they are acquired by the FASIT.

(B) *Determination of FASIT gain for 1999*. The sum of the value of the pool at the end of 1999 ($30,300,000) and the cash distributed during 1999 ($4,000,000) is $34,300,000. There are three contributions of assets by *O* during 1999: one of $20,000,000 on March 31, 1999; one of $2,500,000 over the course of 1999; and an additional contribution of $10,700,000 on December 31, 1999. Thus, *O*'s basis in assets contributed to the pool during 1999 is $33,200,000. The net increase in the value of the pool is $1,100,000 ($34,300,000 minus $33,200,000). Under paragraph (c)(2) of this section, the FASIT gain for 1999 is $300,000 ($1,100,000 net increase in value minus $800,000 taxable income).

(C) *Determination of percentage of total FASIT gain that must be recognized by the end of 1999*. Under paragraph (c)(3) of this section, the percentage of FASIT gain that may be deferred for the taxable year is 31.78 percent (107 percent x $9,000,000 adjusted issue price of pre-FASIT interests divided by $30,300,000 value of the assets). The percentage of the FASIT gain that must be recognized is for the taxable year, therefore, 68.22 percent (1 - 31.78 percent).

(D) *Determination of total amount of FASIT gain not attributed to pre-effective date FASIT interests in 1999*. Under paragraph (c)(4) of this section, the total amount of FASIT gain not attributed to pre-effective date FASIT interests in 1999 is $204,660 ($300,000 FASIT gain x 68.22 percent).

(E) *Determine the amount of FASIT gain to be recognized in 1999*. Under paragraph (c)(5) of this section, because 1999 includes the startup date, *TR* must include in income the entire $204,660 of FASIT gain not attributed to pre-effective date FASIT interests.

(v) *Facts: 2000*. In 2000, the credit card receivables held by *TR* generated $1,500,000 of taxable income and $5,000,000 of cash flow. *TR* distributed $4,000,000 of the cash flow to *O* in exchange for new receivables having an outstanding principal balance of $4,000,000. *TR* used the remaining $1,000,000 of cash flow to make payments on its outstanding debt instruments. On December 31, 2000, *TR* contributed additional credit card receivables with an outstanding principal balance of $9,500,000 and an aggregate adjusted basis of $9,500,000. On December 31, 2000, *TR* held credit card receivables that had an outstanding principal balance of $40,000,000, an aggregate adjusted basis of $40,000,000, and a value (as determined under §1.860I–2(a)) of $40,800,000. In addition, on December 31, 2000, the outstanding adjusted issue price of the pre-FASIT interests was $8,500,000.

(vi) *FASIT gain recognition for 2000*—(A) *Determination of FASIT gain for 2000*. The sum of the value of the pool on December 31, 2000 ($40,800,000) and the cash distributed during 2000 ($5,000,000) is $45,800,000. The value of the pool on December 31, 1999, was $30,300,000. During 2000, O contributed receivables in which O had a basis of $13,500,000 ($4,000,000 over the course of the year and $9,500,000 on December 31, 2000). The net increase in the value of the pool during 2000 is $2,000,000 ($45,800,000 minus $43,800,000). Under paragraph (c)(2), the FASIT gain for 2000 is $500,000 ($2,000,000 net increase in value minus $1,500,000 taxable income).

(B) *Determination of percentage of total FASIT gain that must be recognized by the end of 2000*. Under paragraph (c)(3), the percentage of FASIT gain that may be deferred for the taxable year is

22.29 percent (107 percent times $8,500,000 adjusted issue price of pre-FASIT interests divided by $40,800,000 value of the assets). The percentage of the FASIT gain that must be recognized is, therefore, 77.71 percent (1 – 22.29 percent).

(C) *Determination of total amount of FASIT gain not attributed to pre-effective date FASIT interests in 2000*. Under paragraph (c)(4) of this section, the total amount of FASIT gain not attributed to pre-effective date FASIT interests in 2000 is $388,500 ($500,000 FASIT gain multiplied by 77.71 percent).

(D) *Determine the amount of FASIT gain to be recognized in 2000*. Under paragraph (c)(5) of this section, the FASIT gain to be recognized for 2000 is equal to the FASIT gain that not attributable to pre-effective date FASIT interests in 2000 ($388,500) minus the FASIT gain not attributable to pre-effective date FASIT interests in 1999 ($204,660). Thus, in 2000, *TR* must include $183,840.

(e) *Election to apply gain deferral retroactively.* The Owner of a pre-effective date FASIT, including a pre-effective date FASIT having a startup date before February 4, 2000, may apply the rules of paragraph (a) of this section for the period beginning on the startup date by making an election in the manner prescribed by the Commissioner.

(f) *Effective date.* This section is applicable on February 4, 2000.

§1.860L–4 Effective date.

Except as otherwise provided in §1.860L–2(e) (relating to the rules on anti-abuse) and §1.860L–3(f) (relating to the rules governing transition entities) this section is applicable on the date final regulations are filed with the **Federal Register.**

Par. 4. Section 1.861–9T is amended by redesignating the text of paragraph (g)(2)(iii) as paragraph (g)(2)(iii)(A) and adding a heading to new paragraph (g)(2)(iii)(A), and adding paragraph (g)(2)(iii)(B):

§1.861–9T Allocation and apportionment of interest expense (temporary regulation).

* * * * *

(g) * * *

(2) * * *

(iii) *Adjustment for directly allocated interest*— (A)_*Nonrecourse indebtedness and integrated financial transactions*.* * *

(B) *FASIT Interest Expense*. The rules of paragraph (g)(2)(iii)(A) of this section shall also apply to all assets to which FASIT interest expense is directly allocated during the current taxable year under the rules of §1.861–10T(f). This paragraph (g)(2)(iii)(B) applies on the date final regulations are filed with the **Federal Register.**

Par. 5. Section 1.861–10T is amended by—

1. Revising paragraph (a); and
2. Adding paragraph (f).

§1.861–10T Special allocations of interest expense (temporary regulation).

(a) *In general*. This section applies to all taxpayers and provides four exceptions to the rules of §1.861–9T that require the allocation and apportionment of interest expense on the basis of all assets of all members of the affiliated group. Paragraph (b) of this section describes the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness. Paragraph (c) of this section describes the direct allocation of interest expense to income generated by certain assets that are acquired in integrated financial transactions. Paragraph (d) of this section provides special rules that are applicable to all transactions described in paragraphs (b) and (c) of this section. Paragraph (e) of this section requires the direct allocation of third party interest of an affiliated group to such group's investment in related controlled foreign corporations in cases involving excess related person indebtedness (as defined therein). Paragraph (f) of this section provides rules for the direct allocation and apportionment of all FASIT interest expense to all FASIT gross income, on the basis of all FASIT assets. See also §1.861–9T(b)(5), which requires direct allocation of amortizable bond premium.

* * * * *

(f) *FASIT Interest Expense* —(1) *In general*. All FASIT interest expense of the taxpayer's affiliated group (or the taxpayer, if the taxpayer is not a member of an affiliated group) shall be directly allocated solely to the FASIT gross income of the affiliated group (or the taxpayer, if the taxpayer is not a member of an affiliated group).

(2) *Asset method*. Interest expense that is directly allocated under this paragraph (f) shall be treated as directly related to all the activities and assets of all FASITs in which the taxpayer or any member of the taxpayer's affiliated group holds the ownership interest. The directly allocated interest expense shall be apportioned among all of the FASIT gross income of the affiliated group (or the taxpayer, if the taxpayer is not a member of an affiliated group) under the asset method described in §1.861–9T(g).

(3) *FASIT period*. After a FASIT's startup day (as defined in section 860L(d)(1)), the taxpayer must allocate the interest expense of the FASIT according to the rules of this paragraph (f) during the entire period that the arrangement continues to be a FASIT. If an arrangement ceases to be a FASIT, interest expense with respect to the ceased FASIT arrangement shall no longer be allocated and apportioned under the rules of this paragraph (f) as of the time the arrangement is treated as having ceased in accordance with §1.860H–3(b). The Commissioner may continue to allocate interest expense with respect to a ceased FASIT arrangement under this paragraph (f) if the Commissioner determines that the principal purpose of ending the arrangement's qualification as a FASIT was to affect the taxpayer's interest expense allocation.

(4) *Application of special rules*. In applying this paragraph (f), the rules of paragraph (d)(2)of this section shall apply.

(5) *Definitions*. For purposes of this paragraph (f):

(i) *FASIT defined*. FASIT has the meaning given such term in §1.860H–1(a).

(ii) *FASIT interest expense defined*. (A) In general. FASIT interest expense means any amount paid or accrued by or on behalf of a FASIT to a holder of a regular interest in such FASIT, if such amount is—

(*1*) Treated as incurred by the taxpayer or any member of the taxpayer's affiliated group by reason of §1.860H–6(a), because the taxpayer or such member holds the ownership interest in a FASIT; and

(*2*) Treated as interest by reason of section 860H(c).

(B) *Interest equivalents*. FASIT interest expense includes any expense or loss from a hedge that is a permitted asset (as described in §1.860H–2(d) and (e)), but only to the extent such expense or loss is an interest equivalent as described in §1.861–9T(b).

(iii) *FASIT gross income defined*. FASIT gross income means gross income

of the taxpayer's affiliated group (or the taxpayer, if the taxpayer is not a member of an affiliated group) treated as received or accrued by the taxpayer, or any member of the taxpayer's affiliated group, by reason of §1.860H–6(a).

(iv) *Affiliated group defined.* Affiliated group has the meaning given such term by §1.861– 11T(d).

(6) *Coordination with other provisions*. If any FASIT interest expense is directly allocable under both this paragraph (f) and paragraph (b) or (c) (determined without regard to this paragraph (f)(6)), only the rules of this paragraph (f) shall apply.

(7) *Effective date*. The rules of this section apply for taxable years beginning after December 31, 1986. However, paragraphs (a) and (f) apply as of the date final regulations are filed with the **Federal Register**, and paragraph (e) applies to all taxable years beginning after December 31, 1991.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 4, 2000, 8:45 a.m., and published in the issue of the Federal Register for February 7, 2000, 65 F.R. 5807)

Notice of Proposed Rulemaking and Notice of Public Hearing

Depletion; Treatment of Delay Rental

REG–103882–99

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments conforming regulations relating to delay rental to the requirements of section 263A relating to capitalization and inclusion in inventory of costs of certain expenses. Changes to the applicable law were made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. The proposed regulations provide the public with guidance concerning the application of section 263A to delay rental.

DATES: Written comments must be received by May 8, 2000. Outlines of topics to be discussed at the public hearing scheduled for May 26, 2000, at 10 a.m. must be received by May 5, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–103882–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–103882–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/reglslist.html.

The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulation, Brenda M. Stewart, (202) 622-3120; concerning submissions and the hearing, LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 612 to conform them to the requirements of section 263A. Section 263A was enacted by the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085), and amended by the Technical and Miscellaneous Revenue Act of 1988, Public Law 100–647 (102 Stat. 3342).

Explanation of Provisions

Under the terms of a lease of mineral property, the lessee acquires, for a stated term, the right and obligation to obtain production of minerals from the property. A lease may provide that for each year that the lessee fails to make efforts to obtain production, the lessee must pay a "delay rental" to the lessor.

Section 1.612–3(c)(1) of the final regulations defines a delay rental as an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production. Section 1.612–3(c)(2) of the final regulations provides that since a delay rental is in the nature of rent, it is ordinary income to the payee and not subject to depletion. The payor may at his election deduct the delay rental as an expense, or charge it to depletable capital account under section 266.

Section 263A was enacted subsequent to the issuance of §1.612–3(c) of the final regulations. The uniform capitalization rules of section 263A generally require the capitalization of all direct costs and certain indirect costs properly allocable to property produced by the taxpayer. Capitalization may be required even though production (development) has not yet begun. §1.263A–2(a)(3)(ii). In some situations, a delay rental may be required to be capitalized under section 263A. Accordingly, the proposed regulation clarifies that subsequent to the enactment of section 263A, the payor of a delay rental may elect to expense currently the delay rental or charge it to depletable capital account under section 266 to the extent that the delay rental is not required to be capitalized under section 263A and the regulations thereunder.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, 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, considera-

tion will be given to any written comments that are submitted timely (a signed original and eight copies) to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulations and they may be made easier to understand. All comments will be made available for public inspection and copying.

A public hearing has been scheduled for May 26, 2000, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 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 (a signed original and eight (8) copies) by May 8, 2000. The outline of topics to be discussed at the hearing must be received by May 5, 2000.

A period of 10 minutes will be allotted for 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 this proposed regulation is Brenda M. Stewart of the Office of Assistant Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in its development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAX

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

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

Par. 2. In §1.612–3, the second sentence of paragraph (c)(2) is removed and two sentences are added in its place to read as follows:

§1.612–3 Depletion; treatment of bonus and advanced royalty.

* * * * *

(c) * * *

(2) * * * To the extent the delay rental is not required to be capitalized under section 263A and the regulations thereunder, the payor may at his election deduct such amount or under section 266 and the regulations thereunder, charge it to depletable capital account. The second sentence of this paragraph (c)(2) applies to delay rentals paid with respect to leasing transactions entered into on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 7, 2000, 8:45 a.m., and published in the issue of the Federal Register for February 8, 2000, 65 F.R. 6090)

Notice of Proposed Rulemaking

Extension of Due Date for Electronically Filed Information Returns; Limitation of Failure to Pay Penalty for Individuals During Period of Installment Agreement

REG–105279–99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations implementing section 6071(b) relating to the extension of the due date for certain electronically filed information returns. The regulations also provide rules under section 6651(h) relating to a penalty reduction for certain individuals who have agreed with the IRS to make installment payments in satisfaction of their tax liability. The regulations relating to extension of filing dates affect payors required to file information returns after December 31, 1999. The regulations relating to penalty reduction affect individual taxpayers with installment agreements in effect during months beginning after December 31, 1999.

DATES: Written or electronic comments and requests for a public hearing must be received by April 26, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–105279–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–105279–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/reglist.html.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations relating to the extension of due dates, Marilyn E. Brookens, (202) 622-4920; concerning the regulations relating to penalty reductions, Robert B. Taylor, (202) 622-4940; concerning submissions of comments, Guy Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations, Employment Tax Regulations, and Procedure and Administration Regulations (26 CFR Parts 1, 31, and 301), and implements sections 6071(b) and 6651(h), which were added to the Internal Revenue Code (Code) by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685, 724 (1998 Act)). Section 6071(b) was added to the Code by section 2002 of the 1998 Act and extends the due date for information returns required by chapter 61, subchapter A, part III, subparts B and C (sections 6041 through 6053) that are filed electronically. Under section 6071(b) such information returns are due on or before March 31 of the year following the calendar year to which the returns relate. Section 6071(b) applies to information returns required to be filed with the IRS or the Social Security Administration after December 31, 1999.

Section 6651(h) was added to the Code by section 3303 of the 1998 Act and provides that, for individuals, the failure to pay penalty is reduced from 0.5 percent per month to 0.25 percent per month during the period an installment agreement under section 6159 is in effect with regard to a timely filed return. Section 6651(h) applies to any Federal tax liability of an individual (including a liability under subtitle C) and is effective for determining the addition to tax for months beginning after December 31, 1999.

1. *Proposed Regulations Implementing Section 6071(b)*

Sections 6041 through 6053 of the Code require the filing of information returns that report income, payments, or gross proceeds resulting from certain transactions. Under current law, these returns are generally due to the IRS or the Social Security Administration by (1) February 28 of the year following the calendar year to which the returns relate or (2) the last day of February following the calendar year to which the returns relate. Certain returns, however, such as those required by section 6050I (relating to cash receipts of more than $10,000) are due on a date other than February 28 or the last day of February. The due date for filing information returns is the same whether the returns are filed on paper, electronically, or by other forms of magnetic media (such as magnetic tape, cartridges, and diskettes).

As an incentive to filers of information returns to use electronic filing, section 6071(b) extends by 1 month the due date for certain information returns required by sections 6041 through 6053 if the return is filed electronically. H.R. Conf. Rep. No. 599, 105th Cong., 2nd Sess. 235. Accordingly, beginning on January 1, 2000, information returns currently required by sections 6041 through 6053 to be filed by February 28, or the last day of February, of the year following the calendar year to which the returns relate may be filed electronically as late as March 31 of the year following the calendar year to which the returns relate. The information returns affected by the proposed regulations include the Form W-2 series, Form W-2G, the Form 1098 series, the Form 1099 series, and Form 8027. Section 6071(b) does not affect information returns required to be filed on or before a date other than February 28 or the last day of February. Section 6071(b) also does not affect information returns filed on paper or by means of magnetic media (such as magnetic tape, cartridges or diskettes) other than electronic filing.

The proposed regulations affect only information returns for which a due date is currently prescribed by regulation. Section 6071(b) also applies to other information returns required under sections 6041 through 6053 and extends the due date for electronic filing of those returns in cases in which a due date of February 28 or the last day of February is prescribed by form or other nonregulatory guidance.

The proposed regulations also remove references to two obsolete forms (Form 1099F and Form 1099L) and make ministerial changes to the phrasing and forms of citation used in various provisions.

2. *Proposed Regulations Implementing Section 6651(h)*

Section 6651(a)(2) imposes a penalty for failure to pay the amount shown as tax on a return on or before the due date prescribed for payment of such tax (with regard to extensions), unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The amount of the penalty is 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

Section 6651(a)(3) imposes a penalty for failure to pay any amount in respect of any tax required to be shown on a return, which is not so shown, within 21 calendar days from the date of notice and demand therefor (10 business days if the amount for which such notice and demand is made equals or exceeds $100,000), unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The amount of the penalty is 0.5 percent of the amount of tax stated in the notice and demand if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

Section 6651(h), added to the Code by section 3303 of the 1998 Act, provides that for an individual who enters into an installment agreement under section 6159 with regard to a timely filed return, the failure to pay penalties will be reduced from 0.5 percent to 0.25 percent during the period of the installment agreement. This provision was added to the Code because Congress believed that it was "inappropriate to apply the full penalty for failure to pay taxes to taxpayers who are in fact paying their taxes through an installment agreement." H.R. Rep. No. 364, 105th Cong., 1st Sess. 81; S. Rep. No. 174, 105th Cong., 2nd Sess. 63. This provision is effective for purposes of determining additions to tax for months beginning after December 31, 1999.

Accordingly, for an individual who enters into an installment agreement under section 6159 with regard to a timely filed return, the proposed regulations provide that the failure to pay penalties under section 6651(a)(2) and (3) will be reduced from 0.5 percent per month to 0.25 percent per month during the period of the installment agreement.

Proposed Effective Date

The provisions of these regulations under section 6071(b) are proposed to be applicable for returns required to be filed after December 31, 1999. The provisions of these regulations under section 6651(h) are proposed to be applicable for determining the addition to tax for months beginning after December 31, 1999.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, 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 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, considera-

tion will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested by any person that timely submits 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 the regulations relating to the extension of due dates under section 6071(b) is Marilyn E. Brookens, Office of Assistant Chief Counsel (Income Tax & Accounting). The principal author of the regulations relating to the reduction in the penalty under section 6651(h) is Robert B. Taylor, Office of Assistant Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1, 31, and 301 are proposed to be amended as follows:

PART 1–INCOME TAXES

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

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

Par. 2. In §1.6041–2, paragraph (a)(3)(ii) is revised to read as follows:

§1.6041–2 Return of information as to payments to employees.

(a) * * *

(3) * * *

(ii) *Exception.* In a case where an employer is not required to file Forms W-3 and W-2 under §31.6011(a)–4 or 31.6011(a)–5 of this chapter, returns on Forms W-3 and W-2 required under this paragraph for any calendar year shall be filed on or before February 28 (March 31 if filed electronically) of the following year.

* * * * *

Par. 3. In §1.6041–6, the first sentence is revised to read as follows:

§1.6041–6 Returns made on Forms 1096 and 1099 under section 6041; contents and time and place for filing.

Returns made under section 6041 on Forms 1096 and 1099 for

any calendar year shall be filed on or before February 28 (March 31 if filed electronically) of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms. * * *

Par. 4. In §1.6042–2, the first sentence of paragraph (c) is revised to read as follows:

§1.6042–2 Returns of information as to dividends paid in calendar years after 1962.

* * * * *

(c) *Time and place for filing.* The returns required under this section for any calendar year shall be filed after September 30 of such year, but not before the payer's final payment for the year, and on or before February 28 (March 31 if filed electronically) of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096. * * *

* * * * *

Par. 5. In §1.6043–2, paragraph (a) is revised to read as follows:

§1.6043–2 Return of information respecting distributions in liquidation.

(a) Unless the distribution is one in respect of which information is required to be filed pursuant to §1.332–6(b), 1.368–3(a), or 1.1081–11, every corporation making any distribution of $600 or more during a calendar year to any shareholder in liquidation of the whole or any part of its capital stock shall file a return of information on Forms 1096 and 1099, giving all the information required by such form and by the regulations in this part. A separate Form 1099 must be prepared for each shareholder to whom such distribution was made, showing the name and address of such shareholder, the number and class of shares owned by him in liquidation of which such distribution was made, and the total amount distributed to him on each class of stock. If the amount distributed to such shareholder on any class of stock consisted in whole or in part of property other than money, the return on such form shall in addition show the amount of money distributed, if any, and shall list separately each class of property other than money distributed, giving a description of the property in each such class and a statement of its fair market value at the time of the distribution. Such forms, accompanied by transmittal Form 1096 showing the number of Forms 1099 filed therewith, shall be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which such distribution was made with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096.

* * * * *

Par. 6. In §1.6044–2, the first sentence of paragraph (d) is revised to read as follows:

§1.6044–2 Returns of information as to payments of patronage dividends with respect to patronage occurring in taxable years beginning after 1962.

* * * * *

(d) *Time and place for filing.* The return required under this section on Forms 1096 and 1099 for any calendar year shall be filed after September 30 of such year, but not before the payer's final payment for the year, and on or before February 28 (March 31 if filed electronically) of the following year, with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms. * * *

* * * * *

Par. 7. Section §1.6045–1 is amended by adding paragraph (r) to read as follows:

§1.6045–1 Returns of information of brokers and barter exchanges.

* * * * *

(r) *Electronic filing.* Notwithstanding the time prescribed for filing in paragraph (j) of this section, Forms 1096 and 1099 required under this section for reporting periods ending during a calendar year shall, if filed electronically, be filed after the last calendar day of the reporting period elected by the broker or barter exchange and on or before March 31 of the following calendar year.

Par. 8. In §1.6045–2, paragraph (g)(3) is revised to read as follows:

§1.6045–2 Furnishing statement required with respect to certain substitute payments.

* * * * *

(g) * * *

(3) *Time and place of filing.* The returns required under this paragraph (g) for

any calendar year shall be filed after September 30 of such year, but not before the final substitute payment for the year is received by the broker, and on or before February 28 (March 31 if filed electronically) of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096.

* * * * *

Par. 9. In §1.6045–4, the first sentence of paragraph (j) is revised to read as follows:

§1.6045–4 Information reporting on real estate transactions with dates of closing on or after January 1, 1991.

* * * * *

(j) *Time and place for filing.* A reporting person shall file the information returns required by this section with respect to a real estate transaction after December 31 of the calendar year that includes the date of closing (as determined under paragraph (h)(2)(ii) of this section) and on or before February 28 (March 31 if filed electronically) of the following calendar year. * * *

* * * * *

Par. 10. In §1.6047–1, the first sentence of paragraph (a)(6) is revised to read as follows:

§1.6047–1 Information to be furnished with regard to employee retirement plan covering an owner-employee.

(a) * * *

(6) *Time and place for filing.* The return required under this section for any calendar year shall be filed after the close of that year and on or before February 28 (March 31 if filed electronically) of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for Form 1096. * * *

* * * * *

Par. 11. Section 1.6049–4 is amended by:

1. Revising the first sentence of paragraph (g)(1).

2. Revising the first sentence of paragraph (g)(2).

The revisions read as follows:

§1.6049–4 Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

* * * * *

(g) * * * (1) *Annual return.* Except as provided in paragraph (g)(2) of this section, the returns required under this section for any calendar year for the payment of interest shall be filed after September 30 of such year, but not before the payor's final payment to the payee for the year, and on or before February 28 (March 31 if filed electronically) of the following year. * * *

(2) *Transactional return.* In the case of a return under paragraph (e) of this section, relating to returns on a transactional basis, such return shall be filed at any time but in no event later than February 28 (March 31 if filed electronically) of the year following the calendar year in which the interest was paid. * * *

* * * * *

Par. 12. In §1.6049–7, the first sentence of paragraph (b)(2)(iv) is revised to read as follows:

§1.6049–7 Returns of information with respect to REMIC regular interests and collateralized debt obligations.

* * * * *

(b) * * *

(2) * * *

(iv) *Time and place for filing a return with respect to amounts includible as interest.* The returns required under paragraph (b)(2) of this section for any calendar year must be filed after September 30 of that year, but not before the payor's final payment to the payee for the year, and on or before February 28 (March 31 if filed electronically) of the following year. * * *

* * * * *

Par. 13. In §1.6050A–1, paragraph (b) is revised to read as follows:

§1.6050A–1 Reporting requirements of certain fishing boat operators.

* * * * *

(b) *Time and place for filing.* Returns required to be made under this section on Form 1099-MISC shall be filed with the Internal Revenue Service Center, designated in the instructions for Form 1099-MISC, on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the relevant services were performed.

* * * * *

Par. 14. In §1.6050D–1, paragraph (b) is revised to read as follows:

§1.6050D–1 Information returns relating to energy grants and financing.

* * * * *

(b) *Time and place for filing.* Returns required to be made under this section shall be filed with the Internal Revenue Service Center designated in the instructions for Form 6497 or 1099-G on or before the last day of February (March 31 if filed electronically) of the year following the calendar year for which the return is made.

Par. 15. In §1.6050E–1, the first sentence of paragraph (h) is revised to read as follows:

§1.6050E–1 Reporting of State and local income tax refunds.

* * * * *

(h) *Time and place for filing.* The returns required under this section for any calendar year shall be filed after September 30 of that calendar year, but not before the refund officer's final payment (or allowance of credit or offset) for the year, and on or before February 28 (March 31 if filed electronically) of the following year. * * *

* * * * *

Par. 16. In §1.6050H–2, the first and second sentences of paragraph (a)(4) are revised to read as follows:

§1.6050H–2 Time, form, and manner of reporting interest received on qualified mortgage.

(a) * * *

(4) *Time and place for filing return.* An interest recipient must file a return required by paragraph (a) of this section on or before February 28 (March 31 if filed electronically) of the year following the calendar year for which it receives the mortgage interest. If no interest is required to be reported for the calendar year, but a reimbursement of interest on a qualified mortgage is required to be reported for the calendar year, then a return required by paragraph (a) of this section must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the reimbursement was made. * * *

* * * * *

Par. 17. In §1.6050J–1T, A–33 is revised to read as follows:

§1.6050J–1T Questions and answers concerning information returns relating to foreclosures and abandonments of security (temporary).

* * * * *

A-33: The return or returns must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the acquisi-

tion of an interest in the property occurs or in which the lender knows or has reason to know of the abandonment of the property.

* * * * *

Par. 18. In §1.6050P–1, paragraph (a)(4)(i) is revised to read as follows:

§1.6050P–1 Information reporting for discharges of indebtedness by certain financial entities.

(a) * * *

(4) * * * (i) *In general.* Except as provided in paragraph (a)(4)(ii) of this section, returns required by this section must be filed with the Internal Revenue Service office designated in the instructions for Form 1099-C on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the identifiable event occurs.

* * * * *

Par. 19. In §1.6052–1, paragraph (b)(1)(ii) is revised to read as follows:

§1.6052–1 Information returns regarding payment of wages in the form of group-term life insurance.

* * * * *

(b) * * * (1) * * *

(ii) *Exception.* In a case where an employer is not required to file Forms W-3 and W-2 under §31.6011(a)–4 or §31.6011(a)–5 of this chapter, returns on Forms W-3 and W-2 required under paragraph (a) of this section for any calendar year shall be filed on or before February 28 (March 31 if filed electronically) of the following year.

* * * * *

PART 31-EMPLOYMENT TAXES

Par. 20. The authority citation for part 31 continues to read in part as follows:

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

Par. 21. In §31.3402(q)–1, the first sentence of paragraph (f)(1) is revised to read as follows:

§31.3402(q)–1 Extension of withholding to certain gambling winnings.

* * * * *

(f) * * * (1) *In general.* Every person making payment of winnings for which a statement is required under paragraph (e) of this section shall file a return on Form W-2G with the Internal Revenue Service Center serving the district in which is located the principal place of business of the person making the return on or before February 28 (March 31 if filed electronically) of the calendar year following the calendar year in which the payment of winnings is made. * * *

* * * * *

Par. 22. In §31.6053–3, the first sentence of paragraph (a)(4) is revised to read as follows:

§31.6053–3 Reporting by certain large food or beverage establishments with respect to tips.

(a) * * *

(4) *Time and place for filing.* The information return required by this paragraph shall be filed on or before the last day of February (March 31 if filed electronically) of the year following the calendar year for which the return is made with the Internal Revenue Service Center specified by the Form 8027 or its instructions. * * *

* * * * *

Par. 23. In §31.6071(a)–1, paragraph (a)(3)(i) is revised to read as follows:

§31.6071(a)–1 Time for filing returns and other documents.

(a) * * *

(3) * * * (i) *General rule.* Each information return in respect of wages as defined in the Federal Insurance Contributions Act or of income tax withheld from wages which is required to be made under §31.6051–2 shall be filed on or before the last day of February (March 31 if filed electronically) of the year following the calendar year for which it is made, except that, if a tax return under §31.6011(a)–5(a) is filed as a final return for a period ending prior to December 31, the information statement shall be filed on or before the last day of the second calendar month following the period for which the tax return is filed.

* * * * *

PART 301-PROCEDURE AND ADMINISTRATION

Par. 24. The authority citation for part 301 continues to read in part as follows:

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

Par. 25. Section 301.6651–1 is amended by:

1. Revising the last sentence in paragraph (a)(2).

2. Revising the second sentence in paragraph (a)(3).

3. Adding paragraph (a)(4).

The revisions and additions read as follows:

§301.6651–1 Failure to file tax return or to pay tax.

(a) * * *

(2) * * * Except as provided in paragraph (a)(4) of this section, the amount to be added to the tax is 0.5 percent of the amount of tax shown on the return if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which the failure continues, but not to exceed 25 percent in the aggregate.

(3) * * * Except as provided in paragraph (a)(4) of this section, the amount to be added to the tax is 0.5 percent of the amount stated in the notice and demand if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which the failure continues, but not to exceed 25 percent in the aggregate. * * *

(4) *Reduction of failure to pay penalty during the period an installment agreement is in effect*—(i) *In general.* In the case of a return filed by an individual on or before the due date for the return (including extensions)—

(A) The amount added to tax for a month or fraction thereof is determined by substituting 0.25 percent for 0.5 percent under paragraph (a)(2) of this section if at any time during the month an installment agreement under section 6159 is in effect for the payment of such tax; and

(B) The amount added to tax for a month or fraction thereof is determined by substituting 0.25 percent for 0.5 percent under paragraph (a)(3) of this section if at any time during the month an installment agreement under section 6159 is in effect for the payment of such tax.

(ii) *Effective date.* This paragraph (a)(4) applies for purposes of determining additions to tax for months beginning after December 31, 1999.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 26, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 27, 2000, 65 F.R. 4396)

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 Procedral 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.

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