

(vii) Disclosure would impair an ongoing Inspector General or Department of Justice investigation.

Dated: June 25, 2003.

**Tyler S. Posey,**  
*General Counsel.*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[REG-116914-03]

RIN 1545-BC06

#### Transfers of Compensatory Options

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking by cross-reference to temporary regulations.

**SUMMARY:** In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing temporary regulations relating to the sale or other disposition of compensatory nonstatutory stock options to related persons. The text of those regulations also serves as the text of these proposed regulations.

**DATES:** Written or electronic comments and requests for a public hearing must be received by September 30, 2003.

**ADDRESSES:** Send submissions to: CC:PA:RU (REG-116914-03), 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 4 p.m. to: CC:PA:RU (REG-116914-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs).

**FOR FURTHER INFORMATION CONTACT:** Concerning the temporary regulations, Stephen Tackney (202) 622-6030; concerning submissions of comments and/or requests for a hearing, Guy Traynor, (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

#### Background and Explanation of Provisions

Temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** amend 26 CFR part 1. The regulations provide that a sale or

other disposition of a nonstatutory stock option to a related person will not be treated as a transaction that closes the application of section 83 with respect to the option. The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

#### Special Analyses

It has been determined that these temporary 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 533(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations are being submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (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. The IRS and Treasury Department specifically request comments on the clarity and efficacy of the proposed definition of a related person. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

#### Drafting Information

The principal author of these proposed regulations is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

#### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Adoption of Amendments to the Regulations

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

#### PART 1—INCOME TAXES

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

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

#### § 1.83-7 [Amended]

2. Section 1.83-7 is amended as follows:

1. Paragraph (a) is amended by adding a sentence at the end.

2. Paragraphs (a)(1) and (a)(2) are added.

3. Paragraph (d) is added.

The additions read as follows:

(a) [The text of proposed § 1.83-7(a) is the same as the text of § 1.83-7T(a) published elsewhere in this issue of the **Federal Register**.  
\* \* \* \* \*

(d) *Effective dates.* This section is applicable to sales or other dispositions of options on or after the publication of final regulations in the **Federal Register**. For dates on or after July 2, 2003, see § 1.83-7T(d).

**Robert E. Wenzel,**

*Deputy Commissioner of Internal Revenue.*  
[FR Doc. 03-16787 Filed 7-1-03; 8:45 am]  
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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 301

[REG-139796-02]

RIN 1545-BB10

#### Section 704(b) and Capital Account Revaluations

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations relating to the capital account maintenance rules under section 704 of the Internal Revenue Code. These regulations expand the rules regarding a partnership's right to adjust capital accounts to reflect unrealized appreciation and depreciation in the value of partnership assets.

**DATES:** Written or electronic comments and requests for a public hearing must be received by September 30, 2003.

**ADDRESSES:** Send submissions to: CC:PA:RU (REG-139796-02), 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:PA:RU (REG-139796-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs).

**FOR FURTHER INFORMATION CONTACT:** Craig Gerson at (202) 622-3050; concerning submissions, the hearing, and/or placement on the building access list to attend the hearing, Sonya Cruse, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

Section 704(b) of the Internal Revenue Code provides that a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership if the partnership agreement does not provide as to the partner's distributive shares of these items, or the allocation to a partner of these items under the agreement does not have substantial economic effect. Regulations under section 704 provide extensive rules for determining whether allocations under an agreement have substantial economic effect. One requirement for finding substantial economic effect is that the partnership maintains partners' capital accounts in accordance with certain rules. Compliance with these capital account maintenance rules, and other related rules, provides taxpayers a safe harbor under which the IRS will respect a partnership agreement's allocations.

Under the capital account maintenance rules of § 1.704-1(b)(2)(iv), partnership property is generally reflected on the partnership's books at historic cost, rather than at fair market value. However, newly contributed property is reflected in the capital accounts of the partners at fair market value, rather than the contributing partner's cost; that is, the contributed property is essentially revalued at the time of contribution. § 1.704-1(b)(2)(iv)(d)(1). In addition, under § 1.704-1(b)(2)(iv)(f), a partnership is permitted to, and generally does, revalue its assets to their current fair market values if there is a contribution to the partnership by a new or existing partner as consideration for an interest in the partnership or a distribution from

the partnership to a retiring or continuing partner as consideration for an interest in the partnership. Also, a revaluation is permitted under generally accepted industry accounting practices if substantially all of a partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

Commentators have suggested that there are additional situations beyond those described in § 1.704-1(b)(2)(iv)(f) where revaluations are useful to properly reflect a partnership's economic arrangements. In particular, several commentators have noted that the section 704 regulations do not specifically permit a revaluation of partnership property in connection with the admission of a service partner because the service partner does not contribute property. Those commentators argue that a revaluation upon the admission of a service partner allows a partnership to allocate the existing partnership capital to the other partners. In this manner, the partnership keeps its capital accounts consistent with an intent to provide the service partner with only a profits interest. See Rev. Proc. 93-27 (1993-2 C.B. 343) and Rev. Proc. 2001-43 (2001-2 C.B. 191).

**Explanation of Provisions**

*1. Revaluations of Property Under Section 704 on Provision of Services*

The proposed regulations expand the circumstances under which a partnership is specifically permitted to increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership's books. Specifically, the proposed regulations allow revaluations in connection with the grant of an interest in the partnership (other than a *de minimis* interest) on or after the date final regulations are published in the **Federal Register** as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.

*2. Possible Expansion of Regulations*

The IRS and the Treasury Department are considering further increasing the number of situations in which revaluations of partnership property are permitted. One approach under consideration would allow revaluations any time there is more than a *de minimis bona fide* change in the manner in which partners agree to share profits or losses. Comments are requested

concerning whether the regulations should adopt this standard or another standard for revaluations.

*3. Other Future Guidance*

The IRS recently issued proposed regulations on the taxation of noncompensatory partnership options and is currently studying the taxation of compensatory partnership options. This notice of proposed rulemaking concerning revaluations is not intended to provide guidance regarding when a partnership interest is considered to be granted.

**Effective Date**

The regulations are proposed to apply to the grant of an interest in a partnership (other than a *de minimis* interest) on or after the date final regulations are published in the **Federal Register** as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.

**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. 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. 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 businesses.

**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 timely submitted to the IRS. The IRS and the Treasury Department request comments on the proper scope of the rule allowing revaluations. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

**Drafting Information**

The principal author of these regulations is Craig Gerson, Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

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

**PART 1—INCOME TAXES**

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

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

2. Section 1.704-1 is amended as follows:

1. Paragraph (b)(2)(iv)(f)(5)(iii) is redesignated as paragraph (b)(2)(iv)(f)(5)(iv).

2. New paragraph (b)(2)(iv)(f)(5)(iii) is added.

**§ 1.704-1 Partner's distributive share.**

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(iv) \* \* \*

(f) \* \* \*

(5) \* \* \*

(iii) In connection with the grant of an interest in the partnership (other than a *de minimis* interest) on or after the date final regulations are published in the **Federal Register** as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.

\* \* \* \* \*

**Judith B. Tomaso,**

*Acting Deputy Commissioner of Internal Revenue.*

[FR Doc. 03-16788 Filed 7-1-03; 8:45 am]

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**DEPARTMENT OF THE TREASURY****Alcohol and Tobacco Tax and Trade Bureau****27 CFR Parts 4 and 24**

[Notice No. 13]

RIN 1512-AC48

**Production of Dried Fruit and Honey Wines (2001R-136P)**

**AGENCY:** Alcohol and Tobacco Tax and Trade Bureau, Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Alcohol and Tobacco Tax and Trade Bureau (TTB) requests comments on two proposed amendments to the regulations relating to the production of dried fruit and honey wines. The first amendment will allow the production of dried fruit wines with an alcohol by volume content of more than 14 percent. The second will lower the minimum starting Brix of 22 degrees to 13 degrees in the production of honey wines. These proposals are the result of two petitions submitted by producers of raisin and honey wines. We also correct a technical error in the wine labeling regulations by raising the maximum limit on alcohol content derived from fermentation from 13 to 14 percent for ameliorated agricultural wines.

**DATES:** Submit written comments on or before September 2, 2003.

**ADDRESSES:** You may view copies of the proposed regulations, related documents, and any comments received on this notice by appointment at the ATF Reference Library, Room 6480, 650 Massachusetts Avenue, NW., Washington, DC 20226.

You may send comments to any of the following addresses—

- Chief, Regulations and Procedures Division, Alcohol and Tobacco Tax and Trade Bureau, PO Box 50221, Washington, DC 20091-0221 (Attn: Notice No. 13);

- (202) 927-8525 (facsimile);
- [nprm@ttb.gov](mailto:nprm@ttb.gov) (e-mail); or
- <http://www.ttb.gov> (online). A comment form is available with the copy of this notice posted on our Web site.

See the Public Participation section of this notice for specific instructions and requirements.

**FOR FURTHER INFORMATION CONTACT:** Jennifer Berry, Alcohol and Tobacco Tax and Trade Bureau, Regulations and Procedures Division, PO Box 18152, Roanoke, VA 24014; or telephone (540) 344-9333.

**SUPPLEMENTARY INFORMATION:**

**Background**

*Has Passage of the Homeland Security Act Affected Department of Treasury Rulemaking?*

Effective January 24, 2003, the Homeland Security Act of 2002 divided the Bureau of Alcohol, Tobacco and Firearms (ATF) into two new agencies, the Alcohol and Tobacco Tax and Trade Bureau (TTB) in the Department of the Treasury and the Bureau of Alcohol, Tobacco, Firearms, and Explosives in the Department of Justice. Regulation of wine production is the responsibility of the new TTB. References to ATF and TTB in this document reflect the timeframe, before or after January 24, 2003, of the rulemaking process.

*What Is TTB's Authority To Regulate the Production of Dried Fruit and Honey Wines?*

The Internal Revenue Code (IRC) of 1986 (26 U.S.C. 5387) states that wines made from agricultural products other than the juice of fruit must be made "in accordance with good commercial practice," as prescribed by the Secretary of the Treasury through regulations. We define wines made according to these regulations, including those made from dried fruit and honey, as "standard agricultural wines." The IRC specifies these production limitations:

- You may not add wine spirits to agricultural wines;
- You may not add coloring or flavoring materials to agricultural wines, with the exception of hops to honey wine; and
- You may not blend wines from different agricultural commodities.

Title 27 CFR part 24, Wine, Subpart I—Production of Agricultural Wine, contains regulations under the jurisdiction of TTB that implement these statutory requirements.

*What Are the Current Regulatory Requirements for the Production of Dried Fruit and Honey Wines?*

Subpart I contains provisions for the production of agricultural wines, including some derived from the IRC's "good commercial practice" provision. Sections 24.202 and 24.203 contain provisions specific to dried fruit wine and honey wine, respectively. Section 24.204 contains requirements for all agricultural wines other than dried fruit and honey wines. Among other requirements, all three of these sections prohibit the production of any agricultural wine with an alcohol content of more than 14 percent by volume after complete fermentation or complete fermentation and sweetening. The IRC does not specify this limitation,