Internal Revenue
bulletin

Bulletin No. 2002–4
January 28, 2002

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. 2002–4, page 389.
LIFO; price indexes; department stores. The November 2001 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, November 30, 2001.

T.D. 8973, page 391.
Final regulations under section 865(j)(1) of the Code relate to the allocation of loss recognized on the disposition of stock and other personal property.

T.D. 8975, page 379.
REG–142299–01, REG–209135–88, page 418.
Temporary and proposed regulations apply to certain transactions or events that result in a Regulated Investment Company (RIC) or a Real Estate Investment Trust (REIT) owning property that has a basis determined by reference to a C corporation's basis in the property. These regulations clarify the tax treatment of transfers of C corporation property to a RIC or REIT.

Notice 2002–8, page 398.
Split-dollar life insurance arrangements. This notice announces that the Treasury and the Service intend to publish proposed regulations providing comprehensive guidance on the Federal tax treatment of split-dollar life insurance arrangements. In addition, this notice indicates that any regulations will not be effective until the publication date of the final regulations, and provides information on the tax treatment of split-dollar life insurance arrangements entered into prior to the effective date of final regulations. Notice 2001–10 revoked. Rev. Rul. 55–747 revoked, Rev. Ruls. 64–328 and 66–110 modified.

REG–112991–01, page 404.
Proposed regulations modify the following provisions of T.D. 8930: (1) that qualified research be undertaken for the purpose of discovering information that is technological in nature; (2) the process of experimentation; (3) the type of computer software constituting internal use software; (4) the first part of the three-part high threshold of innovation test for internal-use software to be excepted from the exclusion from qualified research; and (5) the documentation required to substantiate the research credit. A public hearing is scheduled for March 27, 2002.

EMPLOYEE PLANS

Rev. Proc. 2002–10, page 401.
Opinion letters; prototype SEPs, SIMPLEs, and IRAs. This revenue procedure describes the opinion letter program for all prototype plans within the meaning of sections 408(a), (b), (k), and (p) and 408A of the Code. Rev. Proc. 87–50 modified.

ADMINISTRATIVE

Announcement 2002–5, page 420.
Inflation-adjusted items; expatriation to avoid tax. This annoucement provides corrections to Rev. Proc. 2001–13 (2001–3 I.R.B. 337), which sets forth inflation-adjusted items for 2001. The corrections relate to amounts used to determine whether taxpayers are subject to section 877 of the Code regarding expatriation to avoid tax.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

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 Other Related Items, 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.

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

Section 61.—Gross Income Defined.

This notice announces that the Treasury and the Service intend to publish proposed regulations providing comprehensive guidance on the Federal tax treatment of split-dollar life insurance arrangements. In addition, this notice indicates that any regulations will not be effective until the publication date of the final regulations, and provides information on the tax treatment of split-dollar life insurance arrangements entered into prior to the effective date of final regulations. Notice 2001–10 (2001–5 I.R.B. 459) is revoked. Notwithstanding that revocation, Rev. Rul. 55–747 (1955–2 C.B. 228) remains revoked, and Rev. Rul. 64–328 (1964–2 C.B. 11) and Rev. Rul. 66–110 (1966–1 C.B. 12) remain modified to the extent that those rulings indicate that an employer's premium payments under a split-dollar life insurance arrangement may not be treated as loans. See Notice 2002–8, page 398.

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. 8975

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

Certain Transfers of Property 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 to certain transactions or events that result in a Regulated Investment Company [RIC] or a Real Estate Investment Trust [REIT] owning property that has a basis determined by reference to a C corporation's basis in the property. These regulations affect RICs, REITs, and C corporations and clarify the tax treatment of transfers of C corporation property to a RIC or REIT. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin (REG–142299–01, REG–209135–88, page 418).

DATES: *Effective Date*: These regulations are effective January 2, 2002.

Applicability Dates: For dates of applicability, see §§1.337(d)–6T(e) and 1.337(d)–7T(f).

FOR FURTHER INFORMATION CONTACT: Lisa A. Fuller (202) 622–7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 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 recognize gain as if the C corporation had sold the property at fair market value or to elect section 1374 treatment.

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.

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 for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published elsewhere in this issue of the Bulletin.

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, 100 Stat. 2085, 2272), as amended by section 1006(e) and (g) of the Technical and Miscellaneous Revenue Act of 1988 (the 1988 Act) (Public Law 100–647, 102 Stat. 3342, 3400–01), amended the Internal Revenue Code (Code) to repeal the *General Utilities* doctrine. In particular, the 1986 Act amended sections 336 and 337 to require corporations to recognize gain or loss on the distribution of property in connection with complete liquidations other than certain subsidiary liquidations. 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 may not be circumvented . . . through the use of a regulated investment company, a real estate investment trust, or tax-exempt entity . . . ." Absent special rules, the transfer of property owned by a C corporation to a RIC or REIT could result in permanently removing the property's built-in gain from tax at the corporate level, because RICs and REITs generally are not subject to tax on income that is distributed to their shareholders.

On February 4, 1988, the IRS issued Notice 88–19 (1988–1 C.B. 486) announcing its intention to promulgate regulations under the authority of section 337(d) with respect to transactions or events that result in a RIC or REIT owning property that has a basis determined by reference to a C corporation's basis (a carryover basis). Notice 88–19 provided that the regulations would apply with respect to the net built-in gain of C corporation assets that become assets of a RIC or 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 (a conversion transaction). The Notice further provided that, where the regulations apply, the C corporation would be treated, for all purposes, as if it had sold all of its assets at their respective fair market values and immediately liquidated. The Notice provided, however, that the regulations would not allow the recognition of a net loss and that, except as provided in the Notice, the regulations would not affect the characterization for tax purposes of, or the tax treatment of parties to, any transactions to which they apply. For example, shareholders of a C corporation who received RIC shares in a transaction that qualified as a reorganization under section 368(a)(1)(C) would not recognize gain or loss solely because the C corporation was subject to tax. The Notice also provided that immediate gain recognition could be avoided if the C corporation that qualified as a RIC or REIT or the transferee RIC or REIT, as the case may have been, elected to be subject to tax under section 1374 with respect to the C corporation property. Notice 88–19 also indicated that the regulations would apply retroactively to June 10, 1987. Notice 88–96 (1988–2 C.B. 420) amplifies Notice 88–19 by providing that the regulations described in Notice 88–19 would provide an exception to the general gain recognition rules for any C corporation that qualified to be taxed as a RIC for at least one taxable year, then failed to so qualify for one taxable year, and then requalified to be taxed as a RIC in the next taxable year.

On February 7, 2000, Treasury and the IRS published temporary regulations (T.D. 8872, 2000–8 I.R.B. 639) (the 2000 temporary regulations) reflecting the principles set forth in Notice 88–19 and Notice 88–96, a notice of proposed rulemaking by cross-reference to temporary regulations, and a notice of public hearing (REG–209135–88, 2000–8 I.R.B. 681). The 2000 temporary regulations apply retroactively to June 10, 1987.

Treasury and the IRS have received a number of comments, both written and oral, on the 2000 temporary regulations. A public hearing was held on May 10, 2000. After considering these comments, Treasury and the IRS have decided to issue two new sets of temporary regulations, one that will apply to conversion transactions occurring on or after June 10, 1987, and before January 2, 2002 (the –6T regulations), and another that will apply to conversion transactions occurring on or after January 2, 2002 (the –7T regulations). Alternatively, taxpayers generally may apply the 2000 temporary regulations in lieu of the –6T regulations to any conversion transaction that occurred on or after June 10, 1987, and before January 2, 2002. However, RICs and REITs that rely on the 2000 temporary regulations and that are subject to section 1374 treatment may not rely on certain provisions in the 2000 temporary regulations, but instead must apply certain provisions of the –6T regulations, with respect to built-in gains and losses recognized in taxable years beginning on or after January 2, 2002. Furthermore, taxpayers are not prevented from relying on the 2000 temporary regulations merely because they elect section 1374 treatment in the manner described in the –6T regulations rather than in the manner described in the 2000 temporary regulations.

Explanation of Provisions

This preamble first discusses the –6T regulations and how the –6T regulations differ from the 2000 temporary regulations. This preamble then explains the differences between the –7T regulations and the –6T regulations.

Summary of –6T Regulations

The –6T regulations provide that, if property of a C corporation that is not a RIC or REIT becomes the property of a RIC or REIT in a conversion transaction, then the C corporation is subject to deemed sale treatment, unless the RIC or REIT elects to be subject to section 1374 treatment. Thus, the C corporation generally recognizes gain and loss as if it sold the property converted to RIC or REIT property or transferred to the RIC or REIT (the converted property) to an unrelated party at fair market value immediately before the conversion transaction. If the C corporation recognizes net gain on the deemed sale, then the basis of the converted property in the hands of the RIC or REIT is adjusted to its fair market value immediately before the conversion transaction. The –6T regulations do not permit a C corporation to recognize a net loss on the deemed sale. For this purpose, net loss is defined as the excess of aggregate losses over aggregate gains (including items of income), without regard to character. Where there is a net loss, the C corporation recognizes no gain or loss on the deemed sale, and the C corporation's basis in the converted property carries over to the RIC or REIT.

Clarification of Deemed Sale Treatment

The 2000 temporary regulations provide that, unless a section 1374 election is made, a C corporation that elects RIC or REIT status or transfers property to a RIC or REIT is "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 . . . and immediately liquidated." Commentators objected to this provision on two grounds. First, they argued that the provision is overly broad, because it treats the C corporation that is transferring property to a RIC or REIT as having sold all of its property, even where all of its property may not have been transferred to the RIC or REIT. Second, they argued that the "for all purposes" language could be read to suggest that the deemed liquidation results in the imposition of a shareholder tax, a result that they view as inconsistent with Notice 88–19 and the purposes of section 337(d). Commentators also argued that deemed liquidation treatment would inappropriately eliminate the C corporation's tax attributes, such as net operating loss carryforwards and earnings and profits, to which the RIC or REIT might otherwise succeed.

Treasury and the IRS agree with these comments. Accordingly, the –6T regulations clarify that the C corporation is treated as having sold only that property actually transferred to the RIC or REIT and that a shareholder-level tax is not imposed. In addition, the deemed liquidation construct has been eliminated.

Deemed Sale Loss Disallowance

The 2000 temporary regulations do not permit a C corporation to recognize a net loss on a conversion transaction. Some commentators argued that loss disallowance is inappropriate, noting that a net loss can be recognized under sections 336 and § 1.337(d)–4, which govern certain transfers of property from taxable to tax-exempt entities.

Treasury and the IRS believe that loss disallowance is appropriate in the context of the –6T regulations for two reasons. First, Treasury and the IRS are concerned that a C corporation may selectively contribute loss property to a RIC or REIT in a section 351 transaction, generating an immediate loss. Because sections 336 and § 1.337(d)–4 apply only where a C corporation transfers substantially all of its assets, selective contribution concerns are minimal in those contexts. Second, sections 336 and § 1.337(d)–4 require C corporations to recognize both gains and losses immediately, whereas the –6T regulations allow taxpayers to defer the recognition of net gain on a conversion transaction by making an election to be subject to tax under section 1374. Allowing immediate net loss recognition while allowing deferral of net gain would provide C corporations engaging in conversion transactions with an inappropriate degree of selectivity. Taxpayers that otherwise would recognize a net gain on a conversion transaction would likely elect section 1374 treatment. Taxpayers that would recognize a net loss on a conversion transaction would likely choose deemed sale treatment. For these reasons, the –6T regulations disallow recognition of a net loss on a conversion transaction.

Section 1374 Double Tax Issue

Some commentators argued that conversion transactions do not implicate concerns regarding avoidance of *General Utilities* repeal to the extent that the RIC or REIT has C corporations as shareholders after the conversion transaction. The commentators explained that, if a C corporation continues to own stock in the RIC or REIT after a conversion transaction, then the built-in gain attributable to the transferred property is preserved in the basis of the C corporation's RIC or REIT stock. Further, the C corporation generally will be fully taxable on dividends distributed by the RIC or REIT, even where the RIC or REIT pays tax on built-in gains. Accordingly, the commentators requested that the 2000 temporary regulations be modified to mitigate the combined impact of tax at the RIC or REIT level under section 1374 and tax at the C corporation shareholder level on RIC and REIT dividends.

Treasury and the IRS considered several approaches suggested by commentators for mitigating this double corporate tax. These approaches include: (1) exempting section 351 transfers of property by a C corporation to a RIC or REIT from the scope of these regulations, (2) removing the requirement that RICs and REITs distribute recognized built-in gains, and (3) allowing C corporation shareholders of RICs and REITs to claim a dividends received deduction for built-in gains distributed by the RIC or REIT.

After consideration, Treasury and the IRS decided that it could not accept any of these approaches. The first two approaches were not accepted because they could create opportunities to avoid corporate-level tax on built-in gains. The third approach was not accepted because the dividends received deduction is only available for distributions characterized as ordinary income, not distributions characterized as capital gains. As explained below, under the –6T regulations, RICs and REITs may characterize most distributions of built-in gains as capital gain dividends. Moreover, all three approaches would give rise to administrative difficulties that could be addressed only through extensive rulemaking.

Section 1374 Operational Rules

The 2000 temporary regulations provide that the built-in gain of a RIC or REIT electing section 1374 treatment and the corporate-level tax imposed on that gain are subject to rules similar to the rules relating to net income from foreclosure property (NIFP) of REITs. The comments pointed out certain differences between the section 1374 rules and the NIFP rules. For example, under section 1374, any recognized built-in gain retains its character as capital gain or ordinary income. In contrast, NIFP is always treated as ordinary income. In addition, net operating losses of a C corporation can offset recognized built-in gains of an S corporation but cannot offset NIFP. Similarly, business credit carryforwards from a C corporation can reduce the tax on the net recognized built-in gain of an S corporation but cannot reduce the tax on NIFP.

In light of these differences, Treasury and the IRS have adopted an alternative approach that does not rely on the NIFP rules for coordinating the built-in gains tax imposed by this section with the provisions of subchapter M. Unlike the NIFP rules, this approach generally preserves the character of recognized built-in gains and recognized built-in losses. Under this approach, recognized built-in gains and recognized built-in losses that have been taxed in accordance with these regulations are treated like other gains and losses of RICs and REITs that are not subject to tax under these regulations. Thus, they are included in computing investment company taxable income for purposes of section 852(b)(2), real estate investment trust taxable income for purposes of section 857(b)(2), net capital gain for purposes of sections 852(b)(3) and 857(b)(3), gross income derived from sources within any foreign country or possession of the United States for purposes of section 853, and the dividends paid deduction for purposes of sections 852(b)(2)(D), 852(b)(3)(A), 857(b)(2)(B), and 857(b)(3)(A).

In addition, consistent with section 1374, the –6T regulations generally allow RICs and REITs to use loss carryforwards and credits and credit carryforwards arising in taxable years for which the corporation that generated the attribute was a C corporation (and not a RIC or REIT) to reduce net recognized built-in gain and the tax thereon, subject to the limitations imposed by sections 1374(b)(2) and (b)(3) and §§ 1.1374–5 and 1.1374–6. In addition, the –6T regulations provide an ordering rule for applying loss carryforwards, credits, and credit carryforwards to reduce net recognized built-in gain (and the tax thereon) and RIC or REIT taxable income (and the tax thereon). Under this ordering rule, loss carryforwards of a RIC or REIT must be used to reduce net recognized built-in gain for a taxable year to the greatest extent possible before such losses can be used to reduce investment company taxable income for purposes of section 852(b) or real estate investment trust taxable income for purposes of section 857(b) for that taxable year. Similarly, credits and credit carryforwards of a RIC or REIT must be used to reduce the tax on net recognized built-in gain imposed under this section for the taxable year to the greatest extent possible before such credits and credit carryforwards can be used to reduce the tax, if any, on investment company taxable income for purposes of section 852(b) or on real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

The –6T regulations also make adjustments to the taxable income limitation of section 1374 to take into account items that are unique to REITs. Under the –6T regulations, taxable income of a RIC or REIT is initially computed under sections 1374(d)(2) and 1375(b)(1)(B) as if the RIC or REIT were an S corporation. Thus, the RIC's or REIT's taxable income is its taxable income under section 63(a) without regard to — (i) deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organizational expenditures), and (ii) the deduction under section 172. In addition, the RIC or REIT would not be allowed a deduction for dividends paid, as the dividends paid deduction is not available to S corporations. Under the –6T regulations, this amount is then reduced for REITs by certain items that are subject to a 100-percent penalty tax. Items subject to a 100-percent penalty tax, along with net income from foreclosure property, are also excluded in computing a REIT's net recognized built-in gain.

In response to comments, the –6T regulations also provide that the entity-level tax imposed on net recognized built-in gain is treated as a loss that reduces the RIC's or REIT's taxable income and earnings and profits. The character of the loss attributable to the tax on net recognized built-in gain is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. With respect to RICs, the tax imposed on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

Commentators also requested that built-in gain recognized by a RIC or REIT that is subject to section 1374 treatment generate subchapter M earnings and profits. They explained that a RIC or REIT cannot qualify as such under subchapter M if it retains any subchapter C earnings and profits. Thus, if earnings and profits attributable to recognized built-in gain were subchapter C earnings and profits, a RIC or REIT would retain its qualification only if it distributed 100 percent of the net recognized built-in gain in excess of the entity-level tax. In response to these comments, the examples in the –6T regulations clarify that earnings and profits attributable to built-in gain recognized by a RIC or REIT are subchapter M earnings and profits.

Electing Section 1374 Treatment

The 2000 temporary regulations provide that a RIC or REIT makes a section 1374 election by attaching a statement to its Federal income tax return for the first taxable year in which the assets of a C corporation become assets of the RIC or REIT. The 2000 temporary regulations also provide a special rule for making a section 1374 election where the first taxable year in which the assets of a C corporation became the assets of a RIC or REIT ends after June 10, 1987, but before March 8, 2000 (an interim period election). Under the 2000 temporary regulations, a RIC or REIT may file an interim period election with its first Federal income tax return filed after March 8, 2000.

Commentators expressed concern that the rule applicable to interim period elections required a RIC or REIT to make an election on its first Federal income tax return filed after March 8, 2000, even if the RIC or REIT previously had made a section 1374 election. They also expressed concern that RICs and REITs were not given sufficient time after the promulgation of the 2000 temporary regulations to make interim period elections. In response to these comments, the –6T regulations allow a RIC or REIT that converted from a C corporation or acquired property with a carryover basis from a C corporation before January 2, 2002, to make a section 1374 election with any Federal income tax return filed by the RIC or REIT on or before March 15, 2003, provided that the RIC or REIT has reported consistently with such election for all periods. In addition, under the –6T regulations, an interim period election is not necessary if the RIC or REIT can demonstrate that it has previously informed the IRS of its intent to make a section 1374 election.

Some commentators also requested that Treasury and the IRS clarify that a RIC or REIT must make a separate section 1374 election for each conversion transaction in which it participates. The –6T regulations make this clarification. Thus, a RIC or REIT can elect section 1374 treatment for one conversion transaction and not elect section 1374 treatment for another conversion transaction.

Exception for Re-Election of RIC or REIT Status

Under the 2000 temporary regulations, the rule requiring recognition of gain on a conversion transaction does not apply to a C corporation that qualified to be a RIC for at least one taxable year, then failed to so qualify for a period not in excess of one taxable year, and then requalifies as a RIC. Although this exception implements Notice 88–96, the language of the 2000 temporary regulations differs slightly from the language used in Notice 88–96. Some commentators have noted that the change in language might be misinterpreted as a substantive change where none was intended. In response to these comments, this language has been clarified in the –6T regulations.

In addition, some commentators requested that the exception be expanded to cover periods longer than one taxable year. They argued that a corporation that fails to meet the RIC qualification requirements for as short a period as 6 months could be taxed as a C corporation for two taxable years. This could happen where a RIC fails the quarterly diversification test for the last quarter of one calendar year and the first quarter of the subsequent calendar year.

Other commentators requested that this exception be expanded to cover REITs. They noted that Congress generally treats RICs and REITs similarly and that there is no justification for excluding REITs from the benefit of this exception.

The –6T regulations incorporate these comments by extending the exception to REITs and the maximum period for loss of RIC or REIT status from one taxable year to two taxable years.

Retention of Retroactive Effective Date

Commentators argued that, due to the 12-year gap between the promulgation of Notice 88–19 and the issuance of the regulations implementing Notice 88–19, the regulations should not apply retroactively.

Notice 88–19 notified taxpayers that the section 337(d) regulations would apply as of June 10, 1987. The 2000 temporary regulations, which were published on February 7, 2000, do, in fact, apply as of June 10, 1987. Moreover, since February 7, 2000, taxpayers have relied on the 2000 temporary regulations. For these reasons, the 2000 temporary regulations and the –6T regulations retain the June 10, 1987, applicability date.

Summary of –7T Regulations

The –7T regulations follow the –6T regulations in most respects. However, certain changes were included in the –7T regulations that were not included in the –6T regulations, because Treasury and the IRS were concerned that these changes, if made retroactively, could have an adverse impact on taxpayers that have relied on the 2000 temporary regulations. The following sections highlight these differences between the –6T regulations and the –7T regulations.

Section 1374 Treatment as Default Rule

A number of commentators, particularly REIT commentators, expressed the view that, when a C corporation engages in a conversion transaction, section 1374 treatment should apply automatically and taxpayers that desire deemed sale treatment should be allowed to elect such treatment. They pointed out that the automatic application of a section 1374 regime is consistent with the treatment of C corporations that elect S status. Further, they argued that most taxpayers would prefer to be subject to section 1374 treatment than to deemed sale treatment. If section 1374 treatment is the default treatment, then the incidence of inadvertent failures to make elections will be reduced. However, to protect the expectations of taxpayers that engaged in conversion transactions prior to the promulgation of these regulations, the commentators recommended that section 1374 treatment be adopted as the default treatment on a prospective basis. In accordance with these comments, the –7T regulations provide that section 1374 treatment applies unless the C corporation elects deemed sale treatment.

Anti-Stuffing Rule for Taxpayers Electing Deemed Sale Treatment

Treasury and the IRS are concerned that taxpayers electing deemed sale treatment might attempt to decrease net gains on conversion transactions by stuffing loss property into a C corporation prior to a conversion transaction. Treasury and the IRS note that sections 336 and § 1.337(d)–4 both have anti-stuffing rules. Accordingly, the –7T regulations include an anti-stuffing rule applicable to transactions taxed under the deemed sale approach. The anti-stuffing rule is similar to those contained in section 336 and § 1.337(d)–4.

Aggregate Principles to Apply to Partnership Transactions

Treasury and the IRS believe that a partnership with C corporation partners should be treated as an aggregate for purposes of applying these regulations. Accordingly, the –7T regulations provide that these regulations apply to property transferred by a partnership to a RIC or REIT to the extent of any C corporation partner's proportionate share of the transferred property. For example, if a C corporation owns a 20 percent interest in a partnership and that partnership contributes an asset to a REIT in a section 351 transaction, then the partnership shall be treated as a C corporation with respect to 20 percent of the asset contributed to the REIT. If the partnership were to elect deemed sale treatment with respect to such transfer, then any gain recognized by the partnership on the deemed sale must be specially allocated to the C corporation partner.

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. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Lisa A. Fuller of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury Department and the IRS 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 1—INCOME TAXES

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

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

Section 1.337(d)–6T also issued under 26 U.S.C. 337.

Section 1.337(d)–7T also issued under 26 U.S.C. 337. * * *

Par. 2. §1.337(d)–5T is amended by:

1. Revising the section heading.
2. Revising paragraph (d).

The revisions read as follows:

§ 1.337(d)–5T Old transitional rules imposing tax on property owned by a C corporation that becomes property of a RIC or REIT (temporary).

* * * * *

(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, and before January 2, 2002. 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, and before January 2, 2002. However, RICs and REITs that are subject to section 1374 treatment under this section may not rely on § 1.337(d)–5T(b)(1), but must apply paragraphs (c)(1)(i), (c)(2)(i), (c)(2)(ii), and (c)(3) of § 1.337(d)–6T, with respect to built-in gains and losses recognized in taxable years beginning on or after January 2, 2002. In lieu of applying this section, taxpayers may rely on § 1.337(d)–6T to determine the tax consequences (for all taxable years) of any conversion transaction. For transactions and qualifications that occur on or after January 2, 2002, see § 1.337(d)–7T.

Par. 3. Sections 1.337(d)–6T and 1.337(d)–7T are added immediately after § 1.337(d)–5T to read as follows:

§ 1.337(d)–6T New transitional rules imposing tax on property owned by a C corporation that becomes property of a RIC or REIT (temporary).

(a) *General Rule*—(1) *Property owned by a C corporation that becomes property of a RIC or REIT*. If property owned by a C corporation (as defined in paragraph (a)(2)(i) of this section) becomes the property of a RIC or REIT (the converted property) in a conversion transaction (as defined in paragraph (a)(2)(ii) of this section), then deemed sale treatment will apply as described in paragraph (b) of this section, unless the RIC or REIT elects section 1374 treatment with respect to the conversion transaction as provided in paragraph (c) of this section. See paragraph (d) of this section for exceptions to this paragraph (a).

(2) *Definitions*—(i) *C corporation*. For purposes of this section, the term C corporation has the meaning provided in section 1361(a)(2) except that the term does not include a RIC or REIT.

(ii) *Conversion transaction*. For purposes of this section, the term conversion transaction means the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT.

(b) *Deemed Sale Treatment*—(1) *In general*. If property owned by a C corporation becomes the property of a RIC or REIT in a conversion transaction, then the C corporation recognizes gain and loss as if it sold the converted property to an unrelated party at fair market value on the deemed sale date (as defined in paragraph (b)(3) of this section). This paragraph (b) does not apply if its application would result in the recognition of a net loss. For this purpose, *net loss* is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.

(2) *Basis adjustment*. If a corporation recognizes a net gain under paragraph (b)(1) of this section, then the converted property has a basis in the hands of the RIC or REIT equal to the fair market value of such property on the deemed sale date.

(3) *Deemed sale date*—(i) *RIC or REIT qualifications*. If the conversion transaction is a qualification of a C corporation as a RIC or REIT, then the deemed sale date is the end of the last day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC or REIT.

(ii) *Other conversion transactions*. If the conversion transaction is a transfer of property owned by a C corporation to a RIC or REIT, then the deemed sale date is the end of the day before the day of the transfer.

(4) *Example*. The rules of this paragraph (b) are illustrated by the following example:

Example. Deemed sale treatment on merger into RIC. (i) X, a calendar-year taxpayer, has qualified as a RIC since January 1, 1991. On May 31, 1994, Y, a C corporation and calendar-year taxpayer, transfers all of its property to X in a transaction that qualifies as a reorganization under section 368(a)(1)(C). X does not elect section 1374 treatment under paragraph (c) of this section and chooses not to rely on § 1.337(d)–5T. As a result of the transfer, Y is subject to deemed sale treatment under this paragraph (b) on its tax return for the short taxable year ending May 31, 1994. On May 31, 1994, Y's only assets are Capital Asset, which has a fair market value of $100,000 and a basis of $40,000 as of the end of May 30, 1994, and $50,000 cash. Y also has an unrestricted net operating loss carryforward of $12,000 and accumulated earnings and profits of $50,000. Y has no taxable income for the short taxable year ending May 31, 1994, other than gain recognized under this paragraph (b). In 1997, X sells Capital Asset for $110,000. Assume the applicable corporate tax rate is 35%.

(ii) Under this paragraph (b), Y is treated as if it sold the converted property (Capital Asset and $50,000 cash) at fair market value on May 30, 1994, recognizing $60,000 of gain ($150,000 amount realized - $90,000 basis). Y must report the gain on its tax return for the short taxable year ending May 31, 1994. Y may offset this gain with its $12,000 net operating loss carryforward and will pay tax of $16,800 (35% of $48,000).

(iii) Under section 381, X succeeds to Y's accumulated earnings and profits. Y's accumulated earnings and profits of $50,000 increase by $60,000 and decrease by $16,800 as a result of the deemed sale. Thus, the aggregate amount of subchapter C earnings and profits that must be distributed to satisfy section 852(a)(2)(B) is $93,200 ($50,000 + $60,000 - $16,800). X's basis in Capital Asset is $100,000. On X's sale of Capital Asset in 1997, X recognizes $10,000 of gain, which is taken into account in computing X's net capital gain for purposes of section 852(b)(3).

(c) *Election of section 1374 treatment*—(1) *In general*—(i) *Property owned by a C corporation that becomes property of a RIC or REIT*. Paragraph (b) of this section does not apply if the RIC or REIT that was formerly a C corporation or that acquired property from a C corporation makes the election described in paragraph (c)(4) of this section. A RIC or REIT that makes such an election will be subject to tax on the net built-in gain in the converted property under the rules of section 1374 and the regulations thereunder, as modified by this paragraph (c), as if the RIC or REIT were an S corporation.

(ii) *Property subject to the rules of section 1374 owned by a RIC, REIT, or S corporation that becomes property of a RIC or REIT*. If property subject to the rules of section 1374 owned by a RIC, a REIT, or an S corporation (the predecessor) becomes the property of a RIC or REIT (the successor) in a continuation transaction, the rules of section 1374 apply to the successor to the same extent that the predecessor was subject to the rules of section 1374 with respect to such property, and the 10-year recognition period of the successor with respect to such property is reduced by the portion of the 10-year recognition period of the predecessor that expired before the date of the continuation transaction. For this purpose, a continuation transaction means the qualification of the predecessor as a RIC or REIT or the transfer of property from the predecessor to the successor in a transaction in which the successor's basis in the transferred property is determined, in whole or in part, by reference to the predecessor's basis in that property.

(2) *Modification of section 1374 treatment*—(i) *Net recognized built-in gain for REITs*—(A) *Prelimitation amount*. The prelimitation amount determined as provided in § 1.1374–2(a)(1) is reduced by the portion of such amount, if any, that is

subject to tax under section 857(b)(4), (5), (6), or (7). For this purpose, the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is computed as follows:

(*1*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(A), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(2) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(2).

(*2*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(B), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(3) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(3).

(B) *Taxable income limitation*. The taxable income limitation determined as provided in §1.1374–2(a)(2) is reduced by an amount equal to the tax imposed under sections 857(b)(5), (6), and (7).

(ii) *Loss carryforwards, credits and credit carryforwards*—(A) *Loss carryforwards*. Consistent with paragraph (c)(1)(i) of this section, net operating loss carryforwards and capital loss carryforwards arising in taxable years for which the corporation that generated the loss was not subject to subchapter M of chapter 1 of the Code are allowed as a deduction against net recognized built-in gain to the extent allowed under section 1374 and the regulations thereunder. Such loss carryforwards must be used as a deduction against net recognized built-in gain for a taxable year to the greatest extent possible before such losses can be used to reduce investment company taxable income for purposes of section 852(b) or real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(B) *Credits and credit carryforwards*. Consistent with paragraph (c)(1)(i) of this section, minimum tax credits and business credit carryforwards arising in taxable years for which the corporation that generated the credit was not subject to subchapter M of chapter 1 of the Internal Revenue Code are allowed to reduce the tax imposed on net recognized built-in gain under this paragraph (c) to the extent allowed under section 1374 and the regulations thereunder. Such credits and credit carryforwards must be used to reduce the tax imposed under this paragraph (c) on net recognized built-in gain for a taxable year to the greatest extent possible before such credits and credit carryforwards can be used to reduce the tax, if any, on investment company taxable income for purposes of section 852(b) or on real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(iii) *10-year recognition period*. In the case of a conversion transaction that is a qualification of a C corporation 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 first taxable year. In the case of other conversion transactions, the 10-year recognition period begins on the day the property is acquired by the RIC or REIT.

(3) *Coordination with subchapter M rules*—(i) *Recognized built-in gains and losses subject to subchapter M*. Recognized built-in gains and losses of a RIC or REIT are included in computing investment company taxable income for purposes of section 852(b)(2), real estate investment trust taxable income for purposes of section 857(b)(2), capital gains for purposes of sections 852(b)(3) and 857(b)(3), gross income derived from sources within any foreign country or possession of the United States for purposes of section 853, and the dividends paid deduction for purposes of sections 852(b)(2)(D), 852(b)(3)(A), 857(b)(2)(B), and 857(b)(3)(A).

(ii) *Treatment of tax imposed*. The amount of tax imposed under this paragraph (c) on net recognized built-in gain for a taxable year is treated as a loss sustained by the RIC or the REIT during such taxable year. The character of the loss is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. With respect to RICs, the tax imposed under this paragraph (c) on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

(4) *Making the section 1374 election*—(i) *In general*. A RIC or REIT makes a section 1374 election with the following statement: "[Insert name and employer identification number of electing RIC or REIT] elects under § 1.337–6T(c) to be subject to the rules of section 1374 and the regulations thereunder with respect to its property that formerly was held by a C corporation, [insert name and employer identification number of the C corporation, if different from name and employer identification number of the RIC or REIT]." However, a RIC or REIT need not file an election under this paragraph (c), but will be deemed to have made such an election if it can demonstrate that it informed the IRS prior to January 2, 2002, of its intent to make a section 1374 election. An election under this paragraph (c) is irrevocable.

(ii) *Time for making the election*. An election under this paragraph (c) may be filed by the RIC or REIT with any Federal income tax return filed by the RIC or REIT on or before March 15, 2003, provided that the RIC or REIT has reported consistently with such election for all periods.

(5) *Example*. The rules of this paragraph (c) are illustrated by the following example:

Example. Section 1374 treatment on REIT election. (i) X, a C corporation that is a calendar-year taxpayer, elects to be taxed as a REIT on its 1994 tax return, which it files on March 15, 1995. As a result, X is a REIT for its 1994 taxable year and would be subject to deemed sale treatment under paragraph (b) of this section but for X's timely election of section 1374 treatment under this paragraph (c). X chooses not to rely on § 1.337(d)–5T. As of the beginning of the 1994 taxable year, X's property consisted of Real Property, which is not section

1221(a)(1) property and which had a fair market value of $100,000 and an adjusted basis of $80,000, and $25,000 cash. X also had accumulated earnings and profits of $25,000, unrestricted net operating loss carryforwards of $3,000, and unrestricted business credit carryforwards of $2,000. On July 1, 1997, X sells Real Property for $110,000. For its 1997 taxable year, X has net income other than recognized built-in gain. Assume the highest corporate tax rate is 35%.

(ii) Upon its election to be taxed as a REIT, X retains its $80,000 basis in Real Property and its $25,000 accumulated earnings and profits. X retains its $3,000 of net operating loss carryforwards and its $2,000 of business credit carryforwards. To satisfy section 857(a)(2)(B), X must distribute $25,000, an amount equal to its earnings and profits accumulated in non-REIT years, to its shareholders by the end of its 1994 taxable year.

(iii) Upon X's sale of Real Property in 1997, X recognizes gain of $30,000 ($110,000 - $80,000). X's recognized built-in gain for purposes of applying section 1374 is $20,000 ($100,000 fair market value as of the beginning of X's first taxable year as a REIT - $80,000 basis). Because X has net income other than recognized built-in gain for its 1997 taxable year, the taxable income limitation does not apply. X, therefore, has $20,000 net recognized built-in gain for the year. Assuming that X has not used its $3,000 of net operating loss carryforwards in a prior taxable year and that their use is allowed under section 1374(b)(2) and §1.1374–5, X is allowed a $3,000 deduction against the $20,000 net recognized built-in gain. X would owe tax of $5,950 (35% of $17,000) on its net recognized built-in gain, except that X may use its $2,000 of business credit carryforwards to reduce this tax, assuming that X has not used the credit carryforwards in a prior taxable year and that their use is allowed under sections 1374(b)(3) and § 1.1374–6. Thus, X owes tax of $3,950 under this paragraph (c). For purposes of subchapter M, X's earnings and profits for the year increase by $26,050 ($30,000 capital gain on the sale of Real Property - $3,950 tax under this paragraph (c)).

(iv) To compute X's net capital gain for purposes of section 857(b)(3) for the taxable year, the $20,000 of net recognized built-in gain less the $3,950 of tax imposed on that gain is added to X's capital gain (or loss), if any, that is not recognized built-in gain (or loss).

(d) *Exceptions*—(1) *Gain otherwise recognized*. Paragraph (a) of this section does not apply to any conversion transaction to the extent that gain or loss otherwise is recognized on such conversion transaction. See, for example, sections 336, 351(b), 356, 357(c), 367, and 1001.

(2) *Re-election of RIC or REIT status*—(i) *Generally*. Except as provided in paragraphs (d)(2)(ii) and (iii) of this section, paragraph (a)(1) of this section does not apply to any corporation that—

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

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

(ii) *Property acquired from another corporation while a C corporation*. The exception described in paragraph (d)(2)(i) of this section does not apply to property acquired by the corporation while it was subject to tax as a C corporation from another corporation (whether or not a C corporation) in a transaction that results in the acquirer's basis in the property being determined by reference to a C corporation's basis in the property.

(iii) *RICs and REITs previously subject to section 1374 treatment*. If the RIC or REIT had property subject to paragraph (c) of this section before the RIC or REIT became subject to tax as a C corporation as described in paragraph (d)(2)(i) of this section, then paragraph (c) of this section applies to the RIC or REIT upon its requalification as a RIC or REIT, except that the 10-year recognition period with respect to such property is reduced by the portion of the 10-year recognition period that expired before the RIC or REIT became subject to tax as a C corporation and by the period of time that the corporation was subject to tax as a C corporation.

(e) *Effective date*. This section applies to conversion transactions that occur on or after June 10, 1987, and before January 2, 2002. In lieu of applying this section, taxpayers generally may apply § 1.337(d)–5T to determine the tax consequences (for all taxable years) of any conversion transaction that occurs on or after June 10, 1987, and before January 2, 2002, except that RICs and REITs that are subject to section 1374 treatment with respect to a conversion transaction may not rely on § 1.337(d)–5T(b)(1), but must apply paragraphs (c)(1)(i), (c)(2)(i), (c)(2)(ii), and (c)(3) of this section, with respect to built-in gains and losses recognized in taxable years beginning on or after January 2, 2002. Taxpayers are not prevented from relying on § 1.337(d)–5T merely because they elect section 1374 treatment in the manner described in paragraph (c)(4) of this section instead of in the manner described in § 1.337(d)–5T(b)(3) and (c). For conversion transactions that occur on or after January 2, 2002, see §1.337(d)–7T. This section expires on December 31, 2004.

§ 1.337(d)–7T Tax on property owned by a C corporation that becomes property of a RIC or REIT (temporary).

(a) *General Rule*—(1) *Property owned by a C corporation that becomes property of a RIC or REIT*. If property owned by a C corporation (as defined in paragraph (a)(2)(i) of this section) becomes the property of a RIC or REIT (the converted property) in a conversion transaction (as defined in paragraph (a)(2)(ii) of this section), then section 1374 treatment will apply as described in paragraph (b) of this section, unless the C corporation elects deemed sale treatment with respect to the conversion transaction as provided in paragraph (c) of this section. See paragraph (d) of this section for exceptions to this paragraph (a).

(2) *Definitions*—(i) *C corporation*. For purposes of this section, the term C corporation has the meaning provided in section 1361(a)(2) except that the term does not include a RIC or REIT.

(ii) *Conversion transaction*. For purposes of this section, the term conversion transaction means the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT.

(b) *Section 1374 treatment*—(1) *In general*—(i) *Property owned by a C corporation that becomes property of a RIC or REIT*. If property owned by a C corporation becomes the property of a RIC or REIT in a conversion transaction, then the RIC or REIT will be subject to tax on the net built-in gain in the converted property under the rules of section 1374 and the regulations thereunder, as modified by this paragraph (b), as if the RIC or REIT were an S corporation.

(ii) *Property subject to the rules of section 1374 owned by a RIC, REIT, or S corporation that becomes property of a RIC or REIT*. If property subject to the rules of section 1374 owned by a RIC, a REIT, or an S corporation (the predecessor) becomes the property of a RIC or REIT (the successor) in a continuation transaction, the rules of section 1374 apply to the successor to the same extent that the predecessor was subject to the rules of section 1374 with respect to such property, and the 10-year recognition period of the successor with respect to such property is reduced by the portion of the 10-year recognition period of the predecessor that expired before the date of the continuation transaction. For this purpose, a continuation transaction means the qualification of the predecessor as a RIC or REIT or the transfer of property from the predecessor to the successor in a transaction in which the successor's basis in the transferred property is determined, in whole or in part, by reference to the predecessor's basis in that property.

(2) *Modification of section 1374 treatment*—(i) *Net recognized built-in gain for REITs*—(A) *Prelimitation amount*. The prelimitation amount determined as provided in §1.1374–2(a)(1) is reduced by the portion of such amount, if any, that is subject to tax under section 857(b)(4), (5), (6), or (7). For this purpose, the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is computed as follows:

(*1*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(A), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(2) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(2).

(*2*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(B), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(3) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(3).

(B) *Taxable income limitation*. The taxable income limitation determined as provided in § 1.1374–2(a)(2) is reduced by an amount equal to the tax imposed under sections 857(b)(5), (6), and (7).

(ii) *Loss carryforwards, credits and credit carryforwards*—(A) *Loss carryforwards*. Consistent with paragraph (b)(1)(i) of this section, net operating loss carryforwards and capital loss carryforwards arising in taxable years for which the corporation that generated the loss was not subject to subchapter M of chapter 1 of the Code are allowed as a deduction against net recognized built-in gain to the extent allowed under section 1374 and the regulations thereunder. Such loss carryforwards must be used as a deduction against net recognized built-in gain for a taxable year to the greatest extent possible before such losses can be used to reduce investment company taxable income for purposes of section 852(b) or real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(B) *Credits and credit carryforwards*. Consistent with paragraph (b)(1)(i) of this section, minimum tax credits and business credit carryforwards arising in taxable years for which the corporation that generated the credit was not subject to subchapter M of chapter 1 of the Internal Revenue Code are allowed to reduce the tax imposed on net recognized built-in gain under this paragraph (b) to the extent allowed under section 1374 and the regulations thereunder. Such credits and credit carryforwards must be used to reduce the tax imposed under this paragraph (b) on net recognized built-in gain for a taxable year to the greatest extent possible before such credits and credit carryforwards can be used to reduce the tax, if any, on investment company taxable income for purposes of section 852(b) or on real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(iii) *10-year recognition period*. In the case of a conversion transaction that is a qualification of a C corporation 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 first taxable year. In the case of other conversion transactions, the 10-year recognition period begins on the day the property is acquired by the RIC or REIT.

(3) *Coordination with subchapter M rules*—(i) *Recognized built-in gains and losses subject to subchapter M*. Recognized built-in gains and losses of a RIC or REIT are included in computing investment company taxable income for purposes of section 852(b)(2), real estate investment trust taxable income for purposes of section 857(b)(2), capital gains for purposes of sections 852(b)(3) and 857(b)(3), gross income derived from sources within any foreign country or possession of the United States for purposes of section 853, and the dividends paid deduction for purposes of sections 852(b)(2)(D), 852(b)(3)(A), 857(b)(2)(B), and 857(b)(3)(A).

(ii) *Treatment of tax imposed*. The amount of tax imposed under this paragraph (b) on net recognized built-in gain for a taxable year is treated as a loss sustained by the RIC or the REIT during such taxable year. The character of the loss is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. With respect to RICs, the tax imposed under this paragraph (b) on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

(4) *Example*. The rules of this paragraph (b) are illustrated by the following example:

Example. Section 1374 treatment on REIT election. (i) X, a C corporation that is a calendar-year taxpayer, elects to be taxed as a REIT on its 2004 tax return, which it files on March 15, 2005. As a result, X is a REIT for its 2004 taxable year and is subject to section 1374 treatment under this paragraph (b). X does not elect deemed sale treatment under paragraph (c) of this section. As of the beginning of the 2004 taxable year, X's property consisted of Real Property, which is not section 1221(a)(1) property and which had a fair market value of $100,000 and an adjusted basis of $80,000, and $25,000 cash. X also had accumulated earnings and profits of $25,000, unrestricted net operating loss carryforwards of $3,000, and unrestricted business credit carryforwards of $2,000. On July 1, 2007, X sells Real Property for $110,000. For its 1997 taxable year, X has net income other than recognized built-in gain. Assume the highest corporate tax rate is 35%.

(ii) Upon its election to be taxed as a REIT, X retains its $80,000 basis in Real Property and its $25,000 accumulated earnings and profits. X retains its $3,000 of net operating loss carryforwards and its $2,000 of business credit carryforwards. To satisfy section 857(a)(2)(B), X must distribute $25,000, an amount equal to its earnings and profits accumulated in non-REIT years, to its shareholders by the end of its 2004 taxable year.

(iii) Upon X's sale of Real Property in 2007, X recognizes gain of $30,000 ($110,000 - $80,000). X's recognized built-in gain for purposes of applying section 1374 is $20,000 ($100,000 fair market value as of the beginning of X's first taxable year as a REIT - $80,000 basis). Because X has net income other than recognized built-in gain for its 2007 taxable year, the taxable income limitation does not apply. X, therefore, has $20,000 net recognized built-in gain for the year. Assuming that X has not used its $3,000 of net operating loss carryforwards in a prior taxable year and that their use is allowed under section 1374(b)(2) and § 1.1374–5, X is allowed a $3,000 deduction against the $20,000 net recognized built-in gain. X would owe tax of $5,950 (35% of $17,000) on its net recognized built-in gain, except that X may use its $2,000 of business credit carryforwards to reduce the tax, assuming that X has not used the credit carryforwards in a prior taxable year and that their use is allowed under section 1374(b)(3) and § 1.1374–6. Thus, X owes tax of $3,950 under this paragraph (b). For purposes of subchapter M, X's earnings and profits for the year increase by $26,050 ($30,000 capital gain on the sale of Real Property - $3,950 tax under this paragraph (b)).

(iv) To compute X's net capital gain for purposes of section 857(b)(3) for the taxable year, the $20,000 of net recognized built-in gain less the $3,950 of tax imposed on that gain is added to X's capital gain (or loss), if any, that is not recognized built-in gain (or loss).

(c) *Election of deemed sale treatment*—(1) *In general*. Paragraph (b) of this section does not apply if the C corporation that qualifies as a RIC or REIT or transfers property to a RIC or REIT makes the election described in paragraph (c)(5) of this section. A C corporation that makes such an election recognizes gain and loss as if it sold the converted property to an unrelated party at fair market value on the deemed sale date (as defined in paragraph (c)(3) of this section). See paragraph (c)(4) of this section concerning limitations on the use of loss in computing gain. This paragraph (c) does not apply if its application would result in the recognition of a net loss. For this purpose, *net loss* is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.

(2) *Basis adjustment*. If a corporation recognizes a net gain under paragraph (c)(1) of this section, then the converted property has a basis in the hands of the RIC or REIT equal to the fair market value of such property on the deemed sale date.

(3) *Deemed sale date*—(i) *RIC or REIT qualifications*. If the conversion transaction is a qualification of a C corporation as a RIC or REIT, then the deemed sale date is the end of the last day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC or REIT.

(ii) *Other conversion transactions*. If the conversion transaction is a transfer of property owned by a C corporation to a RIC or REIT, then the deemed sale date is the end of the day before the day of the transfer.

(4) *Anti-stuffing rule*. A C corporation must disregard converted property in computing gain or loss recognized on the conversion transaction under this paragraph (c), if—

(i) The converted property was acquired by the C corporation in a transaction to which section 351 applied or as a contribution to capital;

(ii) Such converted property had an adjusted basis immediately after its acquisition by the C corporation in excess of its fair market value on the date of acquisition; and

(iii) The acquisition of such converted property by the C corporation was part of a plan a principal purpose of which was to reduce gain recognized by the C corporation in connection with the conversion transaction. For purposes of this paragraph (c)(4), the principles of section 336(d)(2) apply.

(5) *Making the deemed sale election*. A C corporation makes the deemed sale election with the following statement: "[Insert name and employer identification number of electing corporation] elects deemed sale treatment under § 1.337(d)–7T(c) with respect to its property that was converted to property of, or transferred to, a RIC or REIT, [insert name and employer identification number of the RIC or REIT, if different from the name and employer identification number of the C corporation]." This statement must be attached to the Federal income tax return of the C corporation for the taxable year in which the deemed sale occurs. An election under this paragraph (c) is irrevocable.

(6) *Examples*. The rules of this paragraph (c) are illustrated by the following examples:

Example 1. Deemed sale treatment on merger into RIC. (i) X, a calendar-year taxpayer, has qualified as a RIC since January 1, 2001. On May 31, 2004, Y, a C corporation and calendar-year taxpayer, transfers all of its property to X in a transaction that qualifies as a reorganization under section 368(a)(1)(C). As a result of the transfer, Y would be subject to section 1374 treatment under paragraph (b) of this section but for its timely election of deemed sale treatment under this paragraph (c). As a result of such election, Y is subject to deemed sale treatment on its tax return for the short taxable year ending May 31, 2004. On May 31, 2004, Y's only assets are Capital Asset, which has a fair market value of $100,000 and a basis of $40,000 as of the end of May 30, 2004, and $50,000 cash. Y also has an unrestricted net operating loss carryforward of $12,000 and accumulated earnings and profits of $50,000. Y has no taxable income for the short taxable year ending May 31, 2004, other than gain recognized under this paragraph (c). In 2007, X sells Capital Asset for $110,000. Assume the applicable corporate tax rate is 35%.

(ii) Under this paragraph (c), Y is treated as if it sold the converted property (Capital Asset and $50,000 cash) at fair market value on May 30, 2004, recognizing $60,000 of gain ($150,000 amount realized - $90,000 basis). Y must report the gain on its tax return for the short taxable year ending May 31, 2004. Y may offset this gain with its $12,000 net operating loss carryforward and will pay tax of $16,800 (35% of $48,000).

(iii) Under section 381, X succeeds to Y's accumulated earnings and profits. Y's accumulated earnings and profits of $50,000 increase by $60,000 and decrease by $16,800 as a result of the deemed sale. Thus, the aggregate amount of subchapter C earnings and profits that must be distributed to satisfy section 852(a)(2)(B) is $93,200 ($50,000 + $60,000 - $16,800). X's basis in Capital Asset is $100,000. On X's sale of Capital Asset in 2007, X recognizes $10,000 of gain which is taken into account in computing X's net capital gain for purposes of section 852(b)(3).

Example 2. Loss limitation. (i) Assume the facts are the same as those described in *Example 1*, but that, prior to the reorganization, a shareholder of Y contributed to Y a capital asset, Capital Asset 2, which has a fair market value of $10,000 and a basis of $20,000, in a section 351 transaction.

(ii) Assuming that Y's acquisition of Capital Asset 2 was made pursuant to a plan a principal purpose of which was to reduce the amount of gain that Y would recognize in connection with the conversion transaction, Capital Asset 2 would be disregarded in computing the amount of Y's net gain on the conversion transaction.

(d) *Exceptions*—(1) *Gain otherwise recognized*. Paragraph (a) of this section does not apply to any conversion transaction to the extent that gain or loss otherwise is recognized on such conversion transaction. See, for example, sections 336, 351(b), 356, 357(c), 367, and 1001.

(2) *Re-election of RIC or REIT status*—(i) *Generally*. Except as provided in paragraphs (d)(2)(ii) and (d)(2)(iii) of this section, paragraph (a)(1) of this section does not apply to any corporation that—

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

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

(ii) *Property acquired from another corporation while a C corporation*. The exception described in paragraph (d)(2)(i) of this section does not apply to property acquired by the corporation while it was subject to tax as a C corporation from another corporation (whether or not a C corporation) in a transaction that results in the acquirer's basis in the property being determined by reference to a C corporation's basis in the property.

(iii) *RICs and REITs previously subject to section 1374 treatment*. If the RIC or REIT had property subject to paragraph (b) of this section before the RIC or REIT became subject to tax as a C corporation as described in paragraph (d)(2)(i) of this section, then paragraph (b) of this section applies to the RIC or REIT upon its requalification as a RIC or REIT, except that the 10-year recognition period with respect to such property is reduced by the portion of the 10-year recognition period that expired before the RIC or REIT became subject to tax as a C corporation and by the period of time that the corporation was subject to tax as a C corporation.

(e) *Special rule for partnerships*. The principles of this section apply to property transferred by a partnership to a RIC or REIT to the extent of any C corporation partner's proportionate share of the transferred property. For example, if a C corporation owns a 20 percent interest in a partnership and that partnership contributes an asset to a REIT in a section 351 transaction, then the partnership shall be treated as a C corporation with respect to 20 percent of the asset contributed to the REIT. If the partnership were to elect deemed sale treatment under paragraph (c) of this section with respect to such transfer, then any gain recognized by the partnership on the deemed sale must be specially allocated to the C corporation partner.

(f) *Effective date*. This section applies to conversion transactions that occur on or after January 2, 2002. For conversion transactions that occurred on or after June 10, 1987, and before January 2, 2002, see § 1.337(d)–5T and § 1.337(d)–6T. This section expires on December 31, 2004.

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. 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) * * *

CFR Part or section where identified and described	Current OMB control No.
* * * * *	
1.337(d)–6T	1545–1672
1.337(d)–7T	1545-1672
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 20, 2001.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 31, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2002, 67 F.R. 8)

Section 408.—Individual Retirement Arrangements

26 CFR 1.408–2: Individual retirement accounts.

A revenue procedure describes the process for amending prototype and model IRAs, SEPs, and SIMPLE IRA plans. See Rev. Proc. 2002–10, page 401.

Section 408A.—Roth IRAs

26 CFR 1.408A–2: Establishing Roth IRAs.

A revenue procedure describes the process for amending prototype and model Roth IRAs. See Rev. Proc. 2002–10, page 401.

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

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

LIFO; price indexes; department stores. The November 2001 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 November 30, 2001.

Rev. Rul. 2002–4

The following Department Store Inventory Price Indexes for November 2001 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, November 30, 2001.

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	Nov. 2000	Nov. 2001	Percent Change from Nov. 2000 to Nov. 2001[1]
1. Piece Goods	499.6	492.1	-1.5
2. Domestics and Draperies	610.2	597.2	-2.1
3. Women's and Children's Shoes	664.0	659.0	-0.8
4. Men's Shoes	911.2	877.2	-3.7
5. Infants' Wear	648.0	641.4	-1.0
6. Women's Underwear	577.3	574.5	-0.5
7. Women's Hosiery	347.0	355.0	2.3
8. Women's and Girls' Accessories	555.4	562.2	1.2
9. Women's Outerwear and Girls' Wear	402.0	385.3	-4.2
10. Men's Clothing	598.8	582.7	-2.7
11. Men's Furnishings	639.2	625.4	-2.2
12. Boys' Clothing and Furnishings	501.3	490.1	-2.2
13. Jewelry	936.0	907.3	-3.1
14. Notions	798.0	806.5	1.1
15. Toilet Articles and Drugs	973.8	979.8	0.6
16. Furniture and Bedding	696.6	629.5	-9.6
17. Floor Coverings	625.6	627.3	0.3
18. Housewares	775.6	762.5	-1.7
19. Major Appliances	227.9	226.5	-0.6
20. Radio and Television	57.5	52.3	-9.0
21. Recreation and Education[2]	92.3	88.4	-4.2
22. Home Improvements[2]	129.2	124.2	-3.9
23. Auto Accessories[2]	107.6	110.4	2.6
Groups 1 — 15: Soft Goods	604.6	592.1	-2.1
Groups 16 — 20: Durable Goods	435.6	418.8	-3.9
Groups 21 — 23: Misc. Goods[2]	100.1	97.6	-2.5
Store Total[3]	541.4	528.0	-2.5

[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 Michael Burkom at the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7718 (not a toll-free call).

Section 865.—Source Rules for Personal Property Sales

26 CFR 1.865–1: Loss with respect to personal property other than stock.

T.D. 8973

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Allocation of Loss With Respect to Stock and Other Personal Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final Tax Regulations which remove temporary regulations relating to the allocation of loss recognized on the disposition of stock and other personal property. The loss allocation regulations primarily will affect taxpayers that claim the foreign tax credit and that incur losses with respect to personal property and are necessary to modify existing guidance with respect to loss allocation.

DATES: *Effective Dates*: These regulations are effective January 8, 2002.

Applicability Dates: For dates of applicability, see §§ 1.865–1(f) and 1.865–2(e).

FOR FURTHER INFORMATION CONTACT: David A. Juster (202) 622–3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1. On January 11, 1999, final regulations (T.D. 8805 (1999–1 C.B. 371) the 1999 final regulations) addressing the allocation of loss on the disposition of stock (§ 1.865–2) and amending the foreign tax credit passive limitation grouping rules under § 1.904–4(c) were published in the **Federal Register** (64 FR 1505), together with temporary regulations relating to the allocation of loss on the disposition of personal property other than stock (§ 1.865–1T) and providing a special matching rule with respect to the allocation of certain stock losses (§ 1.865–2T). A notice of proposed rulemaking (REG–106905–98, 1999–1 C.B. 768) cross-referencing the temporary regulations was published in the **Federal Register** for the same day (64 FR 1571). No public hearing was requested or held. One written comment responding to the notice of proposed rulemaking was received. After consideration of the comment, the regulations are finalized substantially as proposed, and the corresponding temporary regulations are removed. This Treasury decision also contains minor clarifying amendments to § 1.865–2 of the 1999 final regulations. The revisions are discussed below.

Explanation of Provisions

§ 1.865–1: Loss with Respect to Personal Property Other Than Stock

§ 1.865–1(a): general rules

Taxpayers have inquired whether the regulations apply to section 166 bad debt deductions. Section 1.865–1 is intended to apply to all recognized losses with respect to personal property, unless otherwise excepted, whether or not the loss results from an actual sale or disposition. Although section 166 does not use the term *loss* in the context of describing worthless debts giving rise to a deduction under the statute, worthlessness deductions reflect economically sustained losses similar to losses described in section 165(g) with respect to worthless securities. Section 1.865–1(a)(1) of the final regulations clarifies that the loss allocation rules of § 1.865–1 apply to section 166 bad debt deductions, as well as losses on property that is marked-to-market (such as under section 475) and not excluded from the scope of these regulations (as are inventory property and certain derivative contracts).

One commentator requested that the final regulations clarify the proper allocation of a loss from the disposition of a partnership interest. Treasury and the Service do not believe that a special rule is required. Instead, loss on the disposition of a partnership interest is subject to the general rule of § 1.865–1(a) that allocates loss to the class of gross income to which gain from the sale of such property would give rise in the seller's hands, *i.e.*, on a reciprocal-to-gain basis.

§ 1.865–1(b)(2): contingent payment debt instruments

Section 1.865–1(b)(2), explaining the particular application of the reciprocal-to-gain loss allocation rule to contingent payment debt instruments, provides that loss on an instrument to which § 1.1275–4(b) applies is allocated and apportioned to the class of interest income to which the instrument would give rise. The final regulation adopts the rule of the temporary regulation, reworded to clarify the interaction of this section with § 1.1275–4(b)(9)(iv)(A).

§ 1.865–1(c)(4): unamortized bond premium

Section 1.865–1(c)(4) provides an exception from the general reciprocal-to-gain rule with respect to unamortized bond premium. The final regulations modify the text and add a new *Example 3* in § 1.865–1(e) to clarify that loss on a debt instrument is allocated against interest only to the extent of the amount of bond premium that could have been, but was not, amortized by the taxpayer before the loss was recognized.

§ 1.865–1(c)(6)(iii): matching rule

For discussion of modifications to the matching rule in response to comments, see the discussion below in connection with the stock loss matching rule of § 1.865–2(b)(4)(iii).

§ 1.865–1(f): effective dates

The final regulations apply to losses recognized on or after January 8, 2002. A taxpayer may apply the regulations, however, to loss recognized in taxable years beginning on or after January 1, 1987, subject to certain conditions.

§ 1.865–2: Loss with Respect to Stock

§ 1.865–2(a)(1): general rules

A sentence is added to § 1.865–2(a)(1) to clarify that the loss allocation rules of § 1.865–2 apply to loss on stock (other than inventory) that is marked-to-market (such as under section 475).

§ 1.865–2(a)(3)(ii): bona fide residents of Puerto Rico

Under section 933, a U.S. citizen or resident alien that is a *bona fide* resident of Puerto Rico is generally exempt from U.S. tax with respect to Puerto Rican source income, but remains subject to U.S. tax with respect to income derived from other sources. Consistent with the general rule of the 1999 final regulations allocating losses against gains and taking account of the special source rule of section 865(g)(3), § 1.865–2(a)(3)(ii) provides that a loss recognized by a U.S. citizen or resident alien that is a *bona fide* resident of Puerto Rico with respect to stock of a corporation that is engaged in a trade or business within Puerto Rico shall be allocated to reduce foreign source income. The final regulation, however, did not specifically state whether the stock loss is allocated against Puerto Rican source income that is exempt from tax under section 933 or against all of the *bona fide* resident's foreign source income. Section 1.865–2(a)(3)(ii) is clarified to provide that if gain from the sale of such stock would be Puerto Rican source income that is exempt from tax under section 933, the loss with respect to such stock shall be allocated to Puerto Rican source income. Under section 933(1), a loss allocated to Puerto Rican source income that is excluded from gross income under section 933 is not allowed as a deduction. See § 1.933–1(c).

§§ 1.865–1(c)(6)(iii) and 1.865–2(b)(4)(iii): matching rule

The temporary regulations provided that, to the extent a taxpayer recognizes foreign source income for tax purposes that results in the creation of a corresponding loss with respect to stock or other personal property, as the case may be, the loss shall be allocated and apportioned against such income. The preamble to the temporary regulations explained that this rule is intended to prevent taxpayers from avoiding the dividend recapture rule of § 1.865–2(b)(1) or from accelerating foreign source income and recognizing an offsetting U.S. loss.

One commenter characterized the rule as overly broad and the examples as unrealistic. The commenter recommended that the matching rule be eliminated from the final regulations or revised to target identified abuses more narrowly.

Taking these considerations into account, §§ 1.865–1(c)(6)(iii) and 1.865–2(b)(4)(iii) are modified to provide that the matching rule will only apply if a taxpayer engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss. As an anti-abuse rule, the matching rule targets transactions that are designed to produce an artificial or accelerated recognition of income that directly results in the creation of a corresponding built-in loss. The step-down preferred transactions described in *Examples 4* and *5* of § 1.865–2T(b)(4)(iv) are transactions of this type; however, because those transactions are now expressly addressed by regulations at § 1.7701(l)–3, the final regulations omit *Examples 4* and *5*. In addition, *Example 6* of § 1.865–2T(b)(4)(iv) is revised and redesignated as *Example 6* of paragraph (b)(1)(iv) of § 1.865–2 to illustrate an amendment to the definition of the recapture period in § 1.865–2(d)(3) discussed below.

Section 1.865–2(b)(4)(iii) is also revised to clarify the interaction of the matching rule and the exceptions to the dividend recapture rule for *de minimis* or passive dividends. In the temporary regulations, the matching rule applied to amounts that otherwise were exempted from the dividend recapture rule under the passive or *de minimis* exceptions only if the taxpayer held the stock with a principal purpose of producing foreign source income and corresponding loss. Because the final regulations revise the matching rule to incorporate a principal purpose test in all instances, the specific requirement of a principal purpose to apply the matching rule to *de minimis* or passive dividends is no longer necessary.

§ 1.865–2(d)(3): recapture period

The dividend recapture period set forth in § 1.865–2(d)(3) is revised to provide that the 24-month period ends on the date on which a taxpayer recognizes a loss with respect to stock. In addition, in connection with the revisions to the matching rule discussed above, the definition of the recapture period in § 1.865–2(d)(3) is expanded to provide that the recapture period is extended if the assets of the corporation are converted to low-risk investments with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired. As noted above, *Example 6* of § 1.865–2T(b)(4)(iv) has been redesignated as *Example 6* of § 1.865–2(b)(1)(iv) and revised to illustrate the operation of this change to the definition of the recapture period. Finally, § 1.865–2(d)(3) is revised to clarify that the dividend recapture rule applies to a dividend paid after the date a loss is recognized, if the loss is incurred after the dividend was declared (*i.e.*, when the stock is sold ex-dividend).

§ 1.865–2(e): effective dates

The final regulations retain the January 11, 1999, effective date of the identical provisions of the temporary regulations and provide that the amendments made by the final regulations apply to losses recognized on or after January 8, 2002. A taxpayer may apply the regulations, however, to loss recognized in any taxable year beginning on or after January 1, 1987, subject to certain conditions.

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. A final regulatory flexibility analysis under 5 U.S.C. 604 has been prepared for the portion of this

Treasury decision with respect to regulations issued under section 865 of the Internal Revenue Code. This analysis is set forth below.

Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Small Business Administration for comment on its impact on small business.

Regulatory Flexibility Analysis

It has been determined that a final regulatory flexibility analysis is required under 5 U.S.C. 604 with respect to this Treasury decision issued under section 865 of the Internal Revenue Code. These regulations will affect small entities such as small businesses but not other small entities, such as local government or tax exempt organizations, which do not pay taxes. The IRS and Treasury Department are not aware of any federal rules that duplicate, overlap or conflict with these regulations. The final regulations address the allocation of loss with respect to stock and other personal property. These regulations are necessary primarily for the proper computation of the foreign tax credit limitation under section 904 of the Internal Revenue Code. With respect to U.S. resident taxpayers, the regulations generally allocate losses against U.S. source income. Generally, this allocation simplifies the computation of the foreign tax credit limitation. None of the significant alternatives considered in drafting the regulations would have significantly altered the economic impact of the regulations on small entities. There are no alternative rules that are less burdensome to small entities but that accomplish the purposes of the statute.

Drafting Information

Various personnel from the Office of Associate Chief Counsel (International) within the Office of Chief Counsel, the IRS and Treasury Department participated in developing these regulations.

* * * * *

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 is amended by removing the entries for "1.865–1T" and "1.865–2T", revising the entry for "1.865–2", and adding entries in numerical order to read in part as follows:

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

Section 1.861–8 also issued under 26 U.S.C. 882(c). * * *

Section 1.865–1 also issued under 26 U.S.C. 863(a) and 865(j)(1).

Section 1.865–2 also issued under 26 U.S.C. 863(a) and 865(j)(1). * * *

Par. 2. Section 1.861–8 is amended by:

1. Revising paragraphs (e)(7)(iii) and (e)(8).

2. Removing the authority citation at the end of the section.

The revisions read as follows:

§ 1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * *

(7) * * *

(iii) *Allocation of loss recognized in taxable years after 1986.* See §§ 1.865–1 and 1.865–2 for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) *Net operating loss deduction.* A net operating loss deduction allowed under section 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

* * * * *

Par. 3. Section 1.861–8T is amended as follows:

1. Paragraphs (e)(1) and (e)(3) through (e)(11) are revised.

2. Paragraph (h) is amended by removing the last sentence of the concluding text.

3. The authority citation at the end of the section is removed.

The revisions read as follows:

§ 1.861–8T Computation of taxable income from sources within the United States and for other sources and activities (temporary).

* * * * *

(e) * * *

(1) [Reserved]. For further guidance, see § 1.861–8(e)(1).

* * * * *

(3) through (11) [Reserved]. For further guidance, see §1.861–8(e)(3) through (e)(11).

* * * * *

Par. 4. Section 1.865–1 is added to read as follows:

§ 1.865–1 Loss with respect to personal property other than stock.

(a) *General rules for allocation of loss*—(1) *Allocation against gain*. Except as otherwise provided in § 1.865–2 and paragraph (c) of this section, loss recognized with respect to personal property shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain from a sale of such property would give rise in the hands of the seller. For purposes of this section, loss includes bad debt deductions under section 166 and loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. Thus, for example, loss recognized by a United States resident on the sale or worthlessness of a bond generally is allocated to reduce United States source income.

(2) *Loss attributable to foreign office*. Except as otherwise provided in § 1.865–2 and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss recognized by a United States resident with respect to property that is attributable to an office or other fixed place of business in a foreign country within the meaning of section 865(e)(3), the loss shall be allocated to reduce foreign source income if a gain on the sale of the property would have been taxable by the foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent. However, paragraph (a)(1) of this section and not this paragraph (a)(2) will apply if gain on the sale of such property would be sourced under section 865(c), (d)(1)(B), or (d)(3).

(3) *Loss recognized by United States citizen or resident alien with foreign tax home*. Except as otherwise provided in § 1.865–2 and paragraph (c) of this section, and except with respect to loss subject to paragraph (b) of this section, in the case of loss with respect to property recognized by a United States citizen or resident alien that has a tax home (as defined in section 911(d)(3)) in a foreign country, the loss shall be allocated to reduce foreign source income if a gain on the sale of such property would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

(4) *Allocation for purposes of section 904*. For purposes of section 904, loss recognized with respect to property that is allocated to foreign source income under this paragraph (a) shall be allocated to the separate category under section 904(d) to which gain on the sale of the property would have been assigned (without regard to section 904(d)(2)(A)(iii)(III)). For purposes of § 1.904–4(c)(2)(ii)(A), any such loss allocated to passive income shall be allocated (prior to the application of § 1.904–4(c)(2)(ii)(B)) to the group of passive income to which gain on a sale of the property would have been assigned had a sale of the property resulted in the recognition of a gain under the law of the relevant foreign jurisdiction or jurisdictions.

(5) *Loss recognized by partnership*. A partner's distributive share of loss recognized by a partnership with respect to personal property shall be allocated and apportioned in accordance with this section as if the partner had recognized the loss. If loss is attributable to an office or other fixed place of business of the partnership within the meaning of section 865(e)(3), such office or fixed place of business shall be considered to be an office of the partner for purposes of this section.

(b) *Special rules of application*—(1) *Depreciable property*. In the case of a loss recognized with respect to depreciable personal property, the gain referred to in paragraph (a)(1) of this section is the gain that would be sourced under section 865(c)(1) (depreciation recapture).

(2) *Contingent payment debt instrument*. Loss described in the last sentence of § 1.1275–4(b)(9)(iv)(A) that is recognized with respect to a contingent payment debt instrument to which § 1.1275–4(b) applies (instruments issued for money or publicly traded property) shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the instrument (in the amount of the loss subject to this paragraph (b)(2)) would give rise.

(c) *Exceptions*—(1) *Foreign currency and certain financial instruments*. This section does not apply to loss governed by section 988 and loss recognized with respect to options contracts or derivative financial instruments, including futures contracts, forward contracts, notional principal contracts, or evidence of an interest in any of the foregoing.

(2) *Inventory*. This section does not apply to loss recognized with respect to property described in section 1221(a)(1).

(3) *Interest equivalents and trade receivables*. Loss subject to § 1.861–9T(b) (loss equivalent to interest expense and loss on trade receivables) shall be allocated and apportioned under the rules of § 1.861–9T and not under the rules of this section.

(4) *Unamortized bond premium*. If a taxpayer recognizing loss with respect to a bond (within the meaning of § 1.171–1(b)) did not amortize bond premium to the full extent permitted by section 171 and the regulations thereunder, then, to the extent of the amount of bond premium that could have been, but was not, amortized by the taxpayer, loss recognized with respect to the bond shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the bond was assigned.

(5) *Accrued interest*. Loss attributable to accrued but unpaid interest on a debt obligation shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which interest income from the obligation was assigned. For purposes of this section, whether loss is attributable to accrued but unpaid interest (rather than to principal) shall be determined under the principles of §§ 1.61–7(d) and 1.446–2(e).

(6) *Anti-abuse rules*—(i) *Transactions involving built-in losses*. If one of the principal purposes of a transaction is to change the allocation of a built-in loss with respect to personal property by transferring the property to another person, qualified business unit, office or other fixed place of business, or branch that subsequently recognizes the loss, the loss shall be allocated by the transferee as if it were recognized by the transferor immediately prior to the transaction. If one of the principal purposes of a change of residence is to change the allocation of a built-in loss with respect to personal property, the loss shall be allocated as if the change of residence had not occurred. If one of the principal purposes of a transaction is to change the allocation of a built-in loss on the disposition of personal property by converting the original property into other property and subsequently recognizing loss with respect to such other property, the loss shall be allocated as if it were recognized with respect to the original property immediately prior to the transaction. Transactions subject to this paragraph shall include, without limitation, reorganizations within the meaning of section 368(a), liquidations under section 332, transfers to a corporation under section 351, transfers to a partnership under section 721, transfers to a trust, distributions by a partnership, distributions by a trust, transfers to or from a qualified business unit, office or other fixed place of business, or branch, or exchanges under section 1031. A person may have a principal purpose of affecting loss allocation even though this purpose is outweighed by other purposes (taken together or separately).

(ii) *Offsetting positions*. If a taxpayer recognizes loss with respect to personal property and the taxpayer (or any person described in section 267(b) (after application of section 267(c)), 267(e), 318, or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such property with a principal purpose of recognizing foreign source income and United States source loss, the loss shall be allocated and apportioned against such foreign source income. For purposes of this paragraph (c)(6)(ii), positions are offsetting if the risk of loss of holding one or more positions is substantially diminished by holding one or more other positions.

(iii) *Matching rule*. If a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss with respect to personal property (as a consequence of the rules regarding the timing of recognition of income, for example), the loss shall be allocated and apportioned against such income to the extent of the recognized foreign source income. For an example illustrating a similar rule with respect to stock loss, see § 1.865–2(b)(4)(iv) *Example 3*.

(d) *Definitions*—(1) *Contingent payment debt instrument*. A contingent payment debt instrument is any debt instrument that is subject to § 1.1275–4.

(2) *Depreciable personal property*. Depreciable personal property is any property described in section 865(c)(4)(A).

(3) *Terms defined in § 1.861–8*. See § 1.861–8 for the meaning of *class of gross income*, *statutory grouping of gross income*, and *residual grouping of gross income*.

(e) *Examples*. The application of this section may be illustrated by the following examples:

Example 1. On January 1, 2000, *A*, a domestic corporation, purchases for $1,000 a machine that produces widgets, which *A* sells in the United States and throughout the world. Throughout *A*'s holding period, the machine is located and used in Country *X*. During *A*'s holding period, *A* incurs depreciation deductions of $400 with respect to the machine. Under § 1.861–8, *A* allocates and apportions depreciation deductions of $250 against foreign source general limitation income and $150 against U.S. source income. On December 12, 2002, *A* sells the machine for $100 and recognizes a loss of $500. Because the machine was used predominantly outside the United States, under sections 865(c)(1)(B) and 865(c)(3)(B)(ii) gain on the disposition of the machine would be foreign source general limitation income to the extent of the depreciation adjustments. Therefore, under paragraph (b)(1) of this section, the entire $500 loss is allocated against foreign source general limitation income.

Example 2. On January 1, 2002, *A*, a domestic corporation, loans $2,000 to *N*, its wholly-owned controlled foreign corporation, in exchange for a contingent payment debt instrument subject to § 1.1275–4(b). During 2002 through 2004, *A* accrues and receives interest income of $630, $150 of which is foreign source general limitation income and $480 of which is foreign source passive income under section 904(d)(3). Assume there are no positive or negative adjustments pursuant to § 1.1275–4(b)(6) in 2002 through 2004. On January 1, 2005, *A* disposes of the debt instrument and recognizes a $770 loss. Under § 1.1275–4(b)(8)(ii), $630 of the loss is treated as ordinary loss and $140 is treated as capital loss. Assume that $140 of interest income earned in 2005 with respect to the debt instrument would be foreign source passive income under section 904(d)(3). Under § 1.1275–4(b)(9)(iv), $150 of the ordinary loss is allocated against foreign source general limitation income and $480 of the ordinary loss is allocated against foreign source passive income. Under paragraph (b)(2) of this section, the $140 capital loss is allocated against foreign source passive income.

Example 3. (i) On January 1, 2003, *A*, a domestic corporation, purchases for $1,200 a taxable bond maturing on December 31, 2008, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Interest payments for 2003 and 2004 are timely made. *A* does not elect to amortize its bond premium under section 171 and the regulations thereunder, which would have permitted *A* to offset the $100 of interest income by $28.72 of bond premium in 2003, and by $30.42 in 2004. On January 1, 2005, *A* sells the bond and recognizes a $100 loss. Under paragraph (c)(4) of this section, $59.14 of the loss is allocated against foreign source income. Under paragraph (a)(1) of this section, the remaining $40.86 of the loss is allocated against U.S. source income.

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that *A* made the election to amortize its bond premium effective for taxable year 2004 (see § 1.171–4(c)). Under paragraph (c)(4) of this section, $28.72 of the loss is allocated against foreign source income. Under paragraph (a)(1) of this section, the remaining $71.28 of the loss is allocated against U.S. source income.

Example 4. On January 1, 2002, *A*, a domestic corporation, purchases for $1,000 a bond maturing December 31, 2014, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. Between 2002 and 2006, *A* accrues and receives foreign source interest income of $500 with respect to the bond. On January 1, 2007, *A* sells the bond and recognizes a $500 loss. Under paragraph (a)(1) of this section, the $500 loss is allocated against U.S. source income.

Example 5. On January 1, 2002, *A*, a domestic corporation on the accrual method of accounting, purchases for $1,000 a bond maturing December 31, 2012, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $100, payable December 31 of each year. The issuer of the bond is a foreign corporation and interest on the bond is thus foreign source. On June 10, 2002, after *A* has accrued $44 of interest income, but before any interest has been paid, the issuer suddenly becomes insolvent and declares bankruptcy. *A* sells the bond (including the accrued interest) for $20. Assuming that *A* properly accrued $44 of interest income, *A* treats the $20 proceeds from the sale of the bond as payment of interest previously accrued and recognizes a $1,000 loss with respect to the bond principal and a $24 loss with respect to the accrued interest. See § 1.61–7(d). Under paragraph (a)(1) of this section, the $1,000 loss with respect to the principal is allocated against U.S. source income. Under paragraph (c)(5) of this section, the $24 loss with respect to accrued but unpaid interest is allocated against foreign source interest income.

(f) *Effective date*—(1) *In general*. Except as provided in paragraph (f)(2) of this section, this section is applicable to loss recognized on or after January 8, 2002. For purposes of this paragraph (f), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) *Application to prior periods*. A taxpayer may apply the rules of this section to losses recognized in any taxable year beginning on or after January 1, 1987, and all subsequent years, provided that—

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 2002; and

(ii) The taxpayer makes—appropriate adjustments to eliminate any double benefit arising from the application of this section to years that are not open for assessment.

(3) *Examples*. See § 1.865–2(e)(3) for examples illustrating an applicability date provision similar to the applicability date provided in this paragraph (f).

§ 1.865–1T [Removed]

Par. 5. Section 1.865–1T is removed.

Par. 6. Section 1.865–2 is amended by:

1. Adding a sentence after the first sentence of paragraph (a)(1).

2. Adding two sentences at the end of paragraph (a)(3)(ii).

3. Adding *Example 6* to paragraph (b)(1)(iv).

4. Revising paragraph (b)(4)(iii).

5. Adding *Example 3* to paragraph (b)(4)(iv).

6. Revising paragraphs (d)(3), (e)(1), and (e)(2)(i).

The revisions and additions read as follows:

§ 1.865–2 Loss with respect to stock.

(a)(1) * * * For purposes of this section, loss includes loss on property that is marked-to-market (such as under section 475) and subject to the rules of this section. * * *

(3) * * *

(ii) * * * If gain from a sale of such stock would give rise to income exempt from tax under section 933, the loss with respect to such stock shall be allocated to amounts that are excluded from gross income under section 933(1) and therefore shall not be allowed as a deduction from gross income. See section 933(1) and § 1.933–1(c).

* * * * *

(b) * * *

(1) * * *

(iv) * * *

Example 6. (i) On January 1, 1998, *P*, a domestic corporation, purchases *N*, a foreign corporation, for $1,000. On March 1, 1998, *P* causes *N* to sell its operating assets, distribute a $400 general limitation dividend to *P*, and invest its remaining $600 in short-term government securities. *P* converted the *N* assets into low-risk investments with a principal purpose of holding the *N* stock without significant risk of loss until the recapture period expired. *N* earns interest income from the securities. The income constitutes subpart *F* income that is included in *P*'s income under section 951, increasing *P*'s basis in the *N* stock under section 961(a). On March 1, 2002, *P* sells *N* and recognizes a $400 loss.

(ii) Pursuant to paragraph (d)(3) of this section, the recapture period is increased by the period in which *N*'s assets were held as low-risk investments because *P* caused *N*'s assets to be converted into and held as low-risk investments with a principal purpose of enabling *P* to hold the *N* stock without significant risk of loss. Accordingly, under paragraph (b)(1)(i) of this section the $400 loss is allocated against foreign source general limitation income.

* * * * *

(4) * * *

(iii) *Matching rule*. If a taxpayer (or a person described in section 1059(c)(3)(C) with respect to the taxpayer) engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss with respect to stock (as a consequence of the rules regarding the timing of recognition of income, for example), the loss shall be allocated and apportioned against such income to the extent of the recognized foreign source income. This paragraph (b)(4)(iii) applies to any portion of a loss that is not allocated under paragraph (b)(1)(i) of this section (dividend recapture rule), including a loss in excess of the dividend recapture amount and a loss that is related to a dividend recapture amount described in paragraph (b)(1)(ii) (*de minimis* exception) or (b)(1)(iii) (passive dividend exception) of this section.

(iv) *Examples*. * * *

* * * * *

Example 3. (i) *Facts*. On January 1, 2002, *P* and *Q*, domestic corporations, form *R*, a domestic partnership. The corporations and partnership use the calendar year as their taxable year. *P* contributes $900 to *R* in exchange for a 90–percent partnership interest and *Q* contributes $100 to *R* in exchange for a 10–percent partnership interest. *R* purchases a dance studio in country *X* for $1,000. On January 2, 2002, *R* enters into contracts to provide dance lessons in Country *X* for a 5–year period beginning January 1, 2003. These contracts are prepaid by the dance studio customers on December 31, 2002, and *R* recognizes foreign source taxable income of $500 from the prepayments (*R*'s only income in 2002). *P* takes into income its $450 distributive share of partnership taxable income. On January 1, 2003, *P*'s basis in its partnership interest is $1,350 ($900 from its contribution under section 722, increased by its $450 distributive share of partnership income under section 705). On September 22, 2003, *P* contributes its *R* partnership interest to *S*, a newly-formed domestic corporation, in exchange for all the stock of *S*. Under section 358, *P*'s basis in S is $1,350. On December 1, 2003, *P* sells *S* to an unrelated party for $1050 and recognizes a $300 loss.

(ii) *Loss allocation*. *P* recognized foreign source income for tax purposes before the income had economically accrued, and the accelerated recognition of income increased *P*'s basis in *R* without increasing its value by a corresponding amount, which resulted in the creation of a built-in loss with respect to the *S* stock. Under paragraph (b)(4)(iii) of this section the $300 loss is allocated against foreign source income if *P* had a principal purpose of recognizing foreign source income and corresponding loss.

* * * * *

(d) * * *

(3) *Recapture period*. A recapture period is the 24-month period ending on the date on which a taxpayer recognized a loss with respect to stock. For example, if a taxpayer recognizes a loss on March 15, 2002, the recapture period begins on and includes March 16, 2000, and ends on and includes March 15, 2002. A recapture period is increased by any period of time in which the taxpayer has diminished its risk of loss in a manner described in section 246(c)(4) and the regulations thereunder and by any period in which the assets of the corporation are hedged against risk of loss (or are converted into and held as low-risk investments) with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period has expired. In the case of a loss recognized after a dividend is declared but before such dividend is paid, the recapture period is extended through the date on which the dividend is paid.

* * * * *

(e) *Effective date*—(1) *In general*. This section is applicable to loss recognized on or after January 11, 1999, except that paragraphs (a)(3)(ii), (b)(1)(iv) *Example 6*, (b)(4)(iii), (b)(4)(iv) *Example 3*, and (d)(3) of this section are applicable to loss recognized on or after January 8, 2002. For purposes of this paragraph (e), loss that is recognized but deferred (for example, under section 267 or 1092) shall be treated as recognized at the time the loss is taken into account.

(2) * * *

(i) The taxpayer's tax liability as shown on an original or amended tax return is consistent with the rules of this section for each such year for which the statute of limitations does not preclude the filing of an amended return on June 30, 2002; and

* * * * *

§ 1.865–2T [Removed]

Par. 7. Section 1.865–2T is removed.

§ 1.904–4 [Amended]

Par. 8. In § 1.904–4, paragraph (c)(2)(ii)(A), remove the language "1.865–1T through 1.865–2T" at the end of the first sentence and add "1.865–1 and 1.865–2" in its place.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 19, 2001.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 27, 2001, 8:45 a.m., and published in the issue of the Federal Register for December 28, 2001, 66 F.R. 67081)

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

This notice announces that the Treasury and the Service intend to publish proposed regulations providing comprehensive guidance on the Federal tax treatment of split-dollar life insurance arrangements. In addition, this notice indicates that any regulations will not be effective until the publication date of the final regulations, and provides information on the tax treatment of split-dollar life insurance arrangements entered into prior to the effective date of final regulations. Notice 2001–10 (2001–5 I.R.B. 459) is revoked. Notwithstanding that revocation, Rev. Rul. 55–747 (1955–2 C.B. 228) remains revoked, and Rev. Rul. 64–328 (1964–2 C.B. 11) and Rev. Rul. 66–110 (1966–1 C.B. 12) remain modified to the extent that those rulings indicate that an employer's premium payments under a split-dollar life insurance arrangement may not be treated as loans. See Notice 2002–8, page 398.

Part III. Administrative, Procedural, and Miscellaneous

Split-Dollar Life Insurance Arrangements

Notice 2002–8

I. PURPOSE AND OVERVIEW

On January 29, 2001, the Treasury Department and Internal Revenue Service issued Notice 2001–10 (2001–5 I.R.B. 459) to provide interim guidance regarding the tax treatment of parties entering into split-dollar life insurance arrangements and to revise standards for valuing current life insurance protection. This Notice 2002–8:

- Revokes Notice 2001–10;
- Announces that the Treasury and the Service intend to publish proposed regulations providing comprehensive guidance regarding the Federal tax treatment of split-dollar life insurance arrangements;
- Outlines rules expected to be included in the forthcoming proposed regulations and the expected effective date of those regulations; and
- Provides guidance regarding the valuation of current life insurance protection under a split-dollar life insurance arrangement, under qualified retirement plans and under employee annuity contracts.

II. EXPECTED PROPOSED REGULATIONS

Treasury and the Service intend to issue proposed regulations requiring the taxation of parties to a split-dollar life insurance arrangement under one of two mutually exclusive regimes. Under one regime, the economic benefits of a split-dollar life insurance arrangement generally are treated as transfers to the benefited party. Under the other regime, payments by the sponsor (*i.e.*, the party providing life insurance benefits to the other party under the arrangement) pursuant to a split-dollar life insurance arrangement generally are treated as a series of loans to the benefited party.

The proposed regulations are expected to provide that, in an employment-related split-dollar life insurance arrangement, if the employer is formally designated as the owner of the life insurance contract, then the benefits provided to the employee under the arrangement are subject to tax under the first regime. Under this regime, the employer is treated for Federal tax purposes as the owner of the life insurance contract prior to termination of the arrangement, and is treated as providing current life insurance protection and other economic benefits to the employee, which are taxable under section 61 of the Internal Revenue Code. A transfer of the life insurance contract to the employee is taxed under section 83. The proposed regulations will not treat an employer as having made a transfer of a portion of the cash surrender value of a life insurance contract to an employee for purposes of section 83 solely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the employer.

The proposed regulations are expected to provide that if the employee is formally designated as the owner of the life insurance contract under a split-dollar arrangement, then the premiums paid by the employer are treated as a series of loans by the employer to the employee if the employee is obligated to repay the employer, whether out of contract proceeds or otherwise. Under this second regime, the loans are subject to the principles, where applicable, of sections 1271–1275 (regarding the taxation of original issue discount) and section 7872 (in the case of a compensation-related below-market loan, section 7872 deems an interest payment by the employee to the employer, which is funded by deemed additional compensation paid by the employer to the employee). If the employee is not obligated to repay the premiums paid by the employer, then such amounts are treated as compensation income to the employee at the time the premiums are paid by the employer.

The same principles are expected to govern the Federal tax treatment of split-dollar life insurance arrangements in other contexts, including arrangements that provide benefits in gift and corporation-shareholder contexts.

The proposed regulations addressing the Federal tax treatment of split-dollar life insurance arrangements will be effective for arrangements entered into after the date of publication of final regulations.

III. REVISED STANDARDS FOR VALUING CURRENT LIFE INSURANCE PROTECTION

Pending the consideration of comments and publication of further guidance, the following interim guidance is provided on the valuation of current life insurance protection:

1. Rev. Rul. 55–747 (1955–2 C.B. 228), remains revoked, as provided in and with the transitional relief for 2001 described in Part IV.B.1 of Notice 2001–10. Notwithstanding such revocation, for a split-dollar life insurance arrangement entered into before January 28, 2002, in which a contractual arrangement between an employer and employee provides that the P.S. 58 rates will be used to determine the value of current life insurance protection provided to the employee (or to the employee and one or more additional persons), the employer and employee may continue to use the P.S. 58 rates set forth in Rev. Rul. 55–747 to determine the value of current life insurance protection.

2. For arrangements entered into before the effective date of future guidance, taxpayers may use the premium rate table set forth at the end of this notice to determine the value of current life insurance protection on a single life that is provided under a split-dollar life insurance arrangement, in a qualified retirement plan, or under employee annuity contracts. (This table is captioned as Table 2001 and was originally published in Notice 2001–10.) Taxpayers should make appropriate adjustments to these premium rates if the life insurance protection covers more than one life.

3. For arrangements entered into before the effective date of future guidance, to the extent provided by Rev. Rul. 66–110 (1966–1 C.B. 12) as amplified by Rev. Rul. 67–154 (1967–1 C.B. 11) taxpayers may continue to determine the value of current life insurance protection by using the insurer's lower published premium rates that are available to all standard risks for initial issue one-year term insurance. However, for arrangements entered into after January 28, 2002,

and before the effective date of future guidance, for periods after December 31, 2003, the Service will not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless (i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.

IV. SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS ENTERED INTO BEFORE THE DATE OF PUBLICATION OF FINAL REGULATIONS

1. For split-dollar life insurance arrangements entered into before the date of publication of final regulations, the Service will not treat a service recipient as having made a transfer of a portion of the cash surrender value of a life insurance contract to a service provider for purposes of section 83 solely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the service recipient.

2. For split-dollar life insurance arrangements entered into before the date of publication of final regulations, in cases where the value of current life insurance protection is treated as an economic benefit provided by a sponsor to a benefited person under a split-dollar life insurance arrangement, the Service will not treat the arrangement as having been terminated (and thus will not assert that there has been a transfer of property to the benefited person by reason of termination of the arrangement) for so long as the parties to the arrangement continue to treat and report the value of the life insurance protection as an economic benefit provided to the benefited person. This treatment will be accepted without regard to the level of the remaining economic interest that the sponsor has in the life insurance contract.

3. For split-dollar life insurance arrangements entered into before the date of publication of final regulations, the parties to the arrangement may treat premium or other payments by the sponsor as loans. In such cases, the Service will not challenge reasonable efforts to comply with the requirements of sections 1271–1275 and section 7872. All payments by the sponsor from the inception of the arrangement (reduced by any repayments to the sponsor) before the first taxable year in which such payments are treated as loans for Federal tax purposes must be treated as loans entered into at the beginning of that first year in which such payments are treated as loans.

4. For split-dollar life insurance arrangements entered into before January 28, 2002, under which a sponsor has made premium or other payments under the arrangement and has received or is entitled to receive full repayment of all of its payments, the Service will not assert that there has been a taxable transfer of property to a benefited person upon termination of the arrangement if (i) the arrangement is terminated before January 1, 2004, or (ii) for all periods beginning on or after January 1, 2004, all payments by the sponsor from inception of the arrangement (reduced by any repayments to the sponsor) are treated as loans for Federal tax purposes, and the parties to the arrangement report the tax treatment in a manner consistent with this loan treatment, including sections 1271–1275 and section 7872. Any such payments by the sponsor before the first taxable year in which such payments are treated as loans for Federal tax purposes must be treated as loans entered into at the beginning of that first year in which such payments are treated as loans.

V. REQUEST FOR COMMENTS

The proposed regulations will provide an opportunity for comment. In addition, Treasury and the Service request comments on this notice, in particular on both the appropriate rates for valuing current life insurance protection and the standards that should be required for use of the insurer's published premium rates for valuing current life insurance protection. Comments are specifically invited on (i) whether one or more premium rate tables should be prescribed as the exclusive basis for valuing current life insurance protection for Federal tax purposes, and (ii) if one or more premium rate tables are prescribed for these purposes, how such tables should be determined and whether premium rates charged by life insurance companies can be used for this determination.

Written comments on this notice are requested to be submitted no later than April 28, 2002, to CC:ITA:RU (Notice 2002–8 [NOT–168656–01]), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (Notice 2002–8 [NOT–168656–01]), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or submitted electronically to: *Notice.Comments@irscounsel.treas.gov*. All comments will be available for public inspection and copying.

VI. EFFECT ON OTHER DOCUMENTS

Notice 2001–10 is revoked. Notwithstanding that revocation, Rev. Rul. 55–747 remains revoked, and Rev. Rul. 64–328 (1964–2 C.B. 11) and Rev. Rul. 66–110 remain modified to the extent that those rulings indicate that an employer's premium payments under a split-dollar life insurance arrangement may not be treated as loans.

Except for Part III (Revised Standards for Valuing Current Life Insurance Protection), no inference should be drawn from this notice regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations. However, taxpayers may rely on this notice (including a reasonable application of the rules to be proposed as described in Part II) or Notice 2001–10 for split-dollar life insurance arrangements entered into before the date of publication of final regulations.

VII. CONTACT INFORMATION

For further information regarding this notice, contact Rebecca Asta of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 622–3930, or Erinn Madden of the Office of Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622–6030 (not toll-free calls).

TABLE 2001
INTERIM TABLE OF ONE-YEAR TERM PREMIUMS
FOR $1,000 OF LIFE INSURANCE PROTECTION

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
0	$ 0.70	35	$ 0.99	70	$ 20.62
1	$ 0.41	36	$ 1.01	71	$ 22.72
2	$ 0.27	37	$ 1.04	72	$ 25.07
3	$ 0.19	38	$ 1.06	73	$ 27.57
4	$ 0.13	39	$ 1.07	74	$ 30.18
5	$ 0.13	40	$ 1.10	75	$ 33.05
6	$ 0.14	41	$ 1.13	76	$ 36.33
7	$ 0.15	42	$ 1.20	77	$ 40.17
8	$ 0.16	43	$ 1.29	78	$ 44.33
9	$ 0.16	44	$ 1.40	79	$ 49.23
10	$ 0.16	45	$ 1.53	80	$ 54.56
11	$ 0.19	46	$ 1.67	81	$ 60.51
12	$ 0.24	47	$ 1.83	82	$ 66.74
13	$ 0.28	48	$ 1.98	83	$ 73.07
14	$ 0.33	49	$ 2.13	84	$ 80.35
15	$ 0.38	50	$ 2.30	85	$ 88.76
16	$ 0.52	51	$ 2.52	86	$ 99.16
17	$ 0.57	52	$ 2.81	87	$ 110.40
18	$ 0.59	53	$ 3.20	88	$ 121.85
19	$ 0.61	54	$ 3.65	89	$ 133.40
20	$ 0.62	55	$ 4.15	90	$ 144.30
21	$ 0.62	56	$ 4.68	91	$ 155.80
22	$ 0.64	57	$ 5.20	92	$ 168.75
23	$ 0.66	58	$ 5.66	93	$ 186.44
24	$ 0.68	59	$ 6.06	94	$ 206.70
25	$ 0.71	60	$ 6.51	95	$ 228.35
26	$ 0.73	61	$ 7.11	96	$ 250.01
27	$ 0.76	62	$ 7.96	97	$ 265.09
28	$ 0.80	63	$ 9.08	98	$ 270.11
29	$ 0.83	64	$ 10.41	99	$ 281.05
30	$ 0.87	65	$ 11.90		
31	$ 0.90	66	$ 13.51		
32	$ 0.93	67	$ 15.20		
33	$ 0.96	68	$ 16.92		
34	$ 0.98	69	$ 18.70		

26 CFR 601.201: Rulings and determination letters. (Also, Part I, §§ 408, 408A.)

Rev. Proc. 2002–10

SECTION 1. PURPOSE

This revenue procedure provides (1) guidance to drafters of IRAs, SEPs and SIMPLE IRA plans; (2) guidance to users of Internal Revenue Service model IRAs and plans; and (3) transitional relief for users of IRAs and plans that have not been approved by the Service.

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Pub. L. 107–16, made several changes to the Internal Revenue Code, affecting IRAs (traditional, Roth, and SIMPLE IRAs), SEPs (including salary reduction SEPs, "SARSEPs") and SIMPLE IRA plans, that are effective beginning January 1, 2002.

.02 On January 17, 2001, proposed regulations concerning required minimum distributions from retirement plans were published in the Federal Register. These proposed regulations can be used to figure required minimum distributions from IRAs beginning with the 2001 distribution calendar year. Final regulations are expected to be issued in the near future.

.03 Rev. Proc. 87–50 (1987–2 C.B. 647) provides the procedures for a sponsoring organization or a mass submitter (a "prototype sponsor") to apply to the Service for an opinion letter on whether a prototype traditional IRA or a prototype SEP meets the requirements of § 408(a) or (b), or § 408(k), respectively. Rev. Proc. 87–50 also contains procedures for employers and employee associations to apply for a ruling on a § 408(c) IRA and for employers to apply for a ruling on whether a SEP, in combination with a terminated defined benefit plan, satisfies the requirements of § 415.

.04 Rev. Proc. 91–44 (1991–2 C.B. 733) modified Rev. Proc. 87–50 to permit prototype sponsors to apply to the service for an opinion letter on whether a prototype SARSEP meets the requirements of § 408(k)(6). The Small Business Job Protection Act of 1996 (Pub. L. 104–188) prohibited the establishment of SARSEPs after December 31, 1996.

.05 Rev. Proc. 97–29 (1997–1 C.B. 698) modified Rev. Proc. 87–50 to permit prototype sponsors to apply to the Service for an opinion letter on whether a prototype SIMPLE IRA or a SIMPLE IRA plan meets the requirements of § 408(p).

.06 Rev. Proc. 98–59 (1998–2 C.B. 727) modified Rev. Proc. 87–50 to permit prototype sponsors to apply to the Service for an opinion letter on whether a prototype Roth IRA meets the requirements of § 408A.

.07 In Announcement 2001–96 (2001–41 I.R.B. 317) (October 9, 2001), the Service announced that opinion letters would not be issued covering EGTRRA changes to SEPs and SIMPLE IRA plans until further notice.

.08 Model forms are available for taxpayers who want to use a pre-approved document to establish an IRA or a SEP or SIMPLE IRA plan without using a prototype document. The model forms referenced in the preceding sentence are: Form 5305, *Individual Retirement Trust Account*; Form 5305–A, *Individual Retirement Custodial Account*; Form 5305–R, *Roth Individual Retirement Trust Account*; Form 5305–RA, *Roth Individual Retirement Custodial Account*; Form 5305–RB, *Roth Individual Retirement Annuity Endorsement*; Form 5305–S, *SIMPLE Individual Retirement Trust Account*; Form 5305–SA, *SIMPLE Individual Retirement Custodial Account*; Form 5304–SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)* — (Not Subject to the Designated Financial Institution Rules); Form 5305–SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)* — (For Use With a Designated Financial Institution); Form 5305–SEP, *Simplified Employee Pension*; and Form 5305A-SEP, *Salary Reduction and Other Elective Simplified Employee Pension.*

SECTION 3. OPINION LETTERS FOR IRAS AND SEP AND SIMPLE IRA PLANS

.01 *Mandatory submission*. Beginning April 1, 2002, prototype sponsors can apply for opinion letters on prototype documents that incorporate EGTRRA changes and the final required minimum distribution rules. All prototype sponsors with currently approved prototype IRAs, SEPs, and SIMPLE IRA plans must amend these documents and submit an application for opinion letters on the amended documents no later than December 31, 2002, in order to remain a prototype sponsor of such documents. Drafters of § 408(c) IRAs must also amend such § 408(c) IRA documents and submit an application for opinion letters on the amended documents no later than October 1, 2002. The documents must be submitted using the appropriate application form and following the instructions on that form. Form 5306, *Application for Approval of Prototype or Employer Sponsored Individual Retirement Arrangement (IRA)*, is used for prototype IRA submissions, and Form 5306–A, *Application for Approval of Prototype Simplified Employee Pension (SEP) or Savings Incentive Match Plan for Employees of Small Employees (SIMPLE IRA plan)*, is used for prototype SEP and SIMPLE IRA plan submissions.

.02 *Sample language*. A Listing of Required Modifications, or LRMs, that the Service finds acceptable for prototype IRAs, SEPs, and SIMPLE IRA plans will be available shortly on the Service's Web Site at *www.irs.gov*. Click on "Tax Info For Business," then "Employee Plans Corner," then "Listing of Required Modifications (LRMs)." In order to receive a favorable opinion letter, prototype documents must include language that addresses every point in the LRMs, unless clearly inapplicable. Identical language is not necessary, but LRM concepts may not be abbreviated by using references to Code sections or such phrases as "in accordance with the law."

.03 *Annuities*. In the case of a prototype sponsor that is an issuer of individual retirement annuities described in § 408(b) and that must apply to one or more state insurance departments for approval of amended IRA documents, the Service will grant expedited review of Service-approved EGTRRA prototype IRA documents amended for changes required by a state insurance department, provided: (1) the Service-approved EGTRRA document is submitted to the state insurance department within 90 days of the date the Service issues a favorable EGTRRA opinion letter on the document and; (2) the prototype sponsor resubmits the document, as amended to comply with changes required by the state insurance department, to the Service within 90 days after it is approved by such state insurance department.

SECTION 4. ADOPTION OF REVISED IRAS, SEPS, AND SIMPLE IRA PLANS

.01 *Model IRAs*. The Service expects to issue revised model IRAs in early 2002 containing EGTRRA changes and required minimum distribution rules that comply with the final regulations. Existing model IRAs may not be used to establish new IRAs after June 1, 2002. An individual using an existing model IRA who wants to take advantage of the 2002 EGTRRA changes to IRAs in 2002 must adopt a revised model IRA (or an appropriate amended prototype IRA) by the end of 2002.

.02 *Prototype IRAs*. An individual using a currently approved prototype IRA must adopt either (1) the prototype sponsor's amended document within 180 days after the date the Service issues a favorable EGTRRA opinion letter on the amended document or (2) an appropriate model IRA by the end of 2002.

.03 *Section 408(c) IRAs*. An employer or employee association using a currently approved § 408(c) IRA must adopt an amended § 408(c) IRA within 30 days after the date the Service issues a favorable EGTRRA opinion letter on the amended document.

.04 *Disclosure statements*. A financial institution that serves as a trustee, issuer, or custodian for a model or prototype IRA must change the corresponding disclosure statement, required pursuant to § 408(i), to reflect the contents of the revised IRA. The financial institution must distribute the amended disclosure statement to each individual using the revised IRA.

.05 *Model SEPs and SIMPLE IRA plans*. The Service expects to issue revised model SEP and SIMPLE IRA forms, also in early 2002, containing EGTRRA changes. Existing model SEPs and SIMPLE IRA plans may not be used to establish new SEPs or SIMPLE IRA plans after June 1, 2002. An employer using an existing model SEP who wants to take advantage of the EGTRRA changes to such plans for the first plan year beginning after December 31, 2001, must adopt a revised model plan (or an appropriate amended prototype plan) by the end of such first plan year. An employer using an existing model SIMPLE IRA plan, must adopt a revised model plan (or an appropriate amended prototype plan) by the end of 2002. However, notwithstanding the preceding two sentences or otherwise applicable notice requirements, participating employees must be notified of the increased EGTRRA contribution limits by October 1, 2002.

.06 *Prototype SEPs and SIMPLE IRA plans*. An employer using a currently approved prototype SEP who wants to take advantage of the EGTRRA changes to such plans for the first plan year beginning after December 31, 2001, must adopt the prototype sponsor's amended document within 180 days after the date the Service issues a favorable opinion letter on the amended document. An employer using a currently approved prototype SIMPLE IRA plan must adopt the prototype sponsor's amended document within 180 days after the date the Service issues a favorable opinion letter on the amended document. However, notwithstanding the preceding two sentences or otherwise applicable notice requirements, participating employees must be notified of the increased EGTRRA contribution limits by October 1, 2002.

.07 *SEPs with § 415 rulings*. An employer using a SEP that has a favorable ruling because participants also participated in the employer's terminated defined benefit plan must adopt an amended SEP in accordance with section 4.05 above. Because the aggregation rules under § 415(e) have been repealed, the Service will no longer issue rulings on whether a SEP, in combination with a terminated defined benefit plan, satisfies the requirements of § 415.

SECTION 5. TRANSITIONAL RELIEF FOR PROTOTYPE ADOPTERS

.01 *IRAs*. An individual and financial institution who establish a trust, custodial account or annuity contract as an IRA after 2001 using a document that has not received an EGTRRA opinion letter are deemed to have established an IRA using an EGTRRA-approved document provided the conditions in (1) through (4) below are satisfied:

(1) The individual and financial institution used a document provided by a prototype sponsor to establish the "IRA."

(2) No later than December 31, 2002, the prototype sponsor applies to the Service for an opinion letter on the document described in section 5.01(1).

(3) The individual and financial institution adopt the approved document within 180 days after the date the Service issues a favorable opinion letter on the document to the prototype sponsor.

(4) The individual and financial institution comply in operation with applicable statutory requirements for the period beginning on the date the "IRA" was established under the original document through the date the Service-approved document is adopted.

.02 *SEPs and SIMPLE IRA plans*. An employer who establishes a plan as a SEP or SIMPLE IRA plan after 2001 using a document that has not received an EGTRRA opinion letter is deemed to have established such a plan using an EGTRRA-approved document provided the conditions in (1) through (4) below are satisfied:

(1) The employer used a document provided by a prototype sponsor to establish the "SEP" or "SIMPLE IRA plan."

(2) No later than December 31, 2002, the prototype sponsor applies to the Service for an opinion letter on the document described in section 5.02(1).

(3) Within 180 days after the Service issues a favorable opinion letter on the document to the prototype sponsor, the employer adopts the approved document.

(4) The employer complies in operation with applicable statutory requirements for the period beginning on the date the "SEP" or "SIMPLE IRA plan" was established under the original document through the date the Service-approved document is adopted.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Section 4.01 of Rev. Proc. 87–50 is modified by section 4.07 of this revenue procedure.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective on January 28, 2002.

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. section 3507) under control number 1545–1769.

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

The collections of information in this revenue procedure are in sections 4.04, 4.05, and 4.06. This information is required to inform IRA owners and plan participants of the new rules applicable to their retirement savings. The likely respondents are (1) businesses or other for-profit institutions and (2) not-for-profit institutions.

The estimated total annual reporting burden is 7,371,000 hours.

The estimated annual burden per respondent varies from 0.1 hours to 1,000 hours, depending on individual circumstances, with an estimated average of 19.5 hours. The estimated number of respondents is 378,000.

The estimated annual frequency of responses is one.

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.

DRAFTING INFORMATION

The principal author of this revenue procedure is Roger Kuehnle of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue procedure, please contact Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday.

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Credit for Increasing Research Activities

REG–112991–01

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the computation of the research credit under section 41(c) and the definition of qualified research under section 41(d). In addition, this document contains proposed regulations describing when computer software that is developed by (or for the benefit of) a taxpayer primarily for the taxpayer's internal use is excepted from the internal-use software exclusion contained in section 41(d)(4)(E). These proposed regulations reflect changes to section 41 made by the Tax Reform Act of 1986, the Revenue Reconciliation Act of 1989, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Tax and Trade Relief Extension Act of 1998, and the Tax Relief Extension Act of 1999. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments and requests to speak (with outlines of oral comments) at the public hearing scheduled for March 27, 2002, must be received no later than March 6, 2002.

ADDRESSES: Send submissions to: CC:IT&A:RU (REG–112991–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:IT&A:RU (REG–112991–01), 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 of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: *http://www.irs.gov/tax_regs/reglist.html*. The public hearing will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Lisa J. Shuman, 202–622–3120; concerning submissions of comments and the hearing, LaNita VanDyke 202–622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this proposed regulation have been previously reviewed and approved by the **Office of Management and Budget** (OMB) in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) and assigned OMB Control Number 1545–1625. 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 OMB.

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 3, 2001, Treasury and the IRS published in the **Federal Register** (66 FR 280) final regulations (T.D. 8930, 2001–5 I.R.B. *433*) relating to the computation of the credit for increasing research activities (the research credit) under section 41(c) and the definition of qualified research under section 41(d). In response to taxpayer concerns regarding T.D. 8930, on January 31, 2001, Treasury and the IRS published Notice 2001–19 (2001–10 I.R.B. 784), announcing that Treasury and the IRS would review T.D. 8930 and reconsider comments previously submitted in connection with the finalization of T.D. 8930. Comments were requested on all aspects of T.D. 8930 with specific comments requested on whether modifications should be made to the documentation requirement contained in § 1.41–4(d).

Notice 2001–19 also provided that, upon the completion of this review, Treasury and the IRS would announce changes to the regulations, if any, in the form of proposed regulations. Notice 2001–19 stated that T.D. 8930 would be revised so that the provisions of the regulations, including any changes to T.D. 8930, would be effective no earlier than the date when the completion of this review was announced, except that the provisions relating to internal-use computer software (including any revisions) generally would be applicable for taxable years beginning after December 31, 1985.

Explanation of Provisions

This document amends 26 CFR part 1 to provide additional rules under section 41. Section 41 contains the rules for the research credit. After consideration of the statute and legislative history, the court decisions, T.D. 8930 and the comments previously submitted in connection with the finalization of T.D. 8930, and the comments submitted in response to Notice 2001–19, Treasury and the IRS have revised T.D. 8930 to provide rules regarding:

(i) the requirement in section 41(d)(1)(B)(i) that qualified research be "undertaken for the purpose of discovering information which is technological in nature";

(ii) the requirement in section 41(d)(1)(C) that qualified research be research "substantially all of the activities of which constitute elements of a process of experimentation";

(iii) the type of computer software constituting software "which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" for purposes of section 41(d)(4)(E); and

(iv) the documentation required to substantiate the research credit.

These and other changes to T.D. 8930 are discussed below.

I. Research that is Undertaken for the Purpose of Discovering Information which is Technological in Nature

Section 41(d)(1)(B)(i) requires that qualified research must be "undertaken for the purpose of discovering information which is technological in nature." T.D. 8930 provided that "research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering" and that "information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science."

With respect to the phrase "undertaken for the purpose of discovering information," commentators noted that § 1.174–2(a)(1) imposes a requirement that a taxpayer's activities must be "intended to discover information" in order to give rise to research and experimental expenditures under section 174, and that section 41(d)(1)(A) incorporates this requirement because an expenditure must qualify under section 174 in order to give rise to the research credit. Commentators argued that the enactment of the section 41(d)(1)(B) "undertaken for the purpose of discovering information" language should not necessarily be viewed as imposing a different standard than that imposed under section 174 because the section 174 "intended to discover information" language was promulgated in regulations after section 41(d)(1)(B) was enacted.

Commentators also stated that the requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" reflects Congress' concern that the research credit had been claimed for non-technological research. These commentators note that in 1984 hearings to evaluate the operation of the research credit prior to the changes of the Tax Reform Act of 1986, Public Law 99–514, 100 Stat. 2085, 2186 (the 1986 Act), members of the Subcommittee on Oversight of the House Committee on Ways and Means and Treasury officials cited research credit claims by fast food restaurants, fashion designers and hair stylists as examples of activities that should not be credit eligible. These commentators argue that the 1986 Act modifications to the research credit were intended to target research that relies upon principles of the physical or biological sciences, engineering, or computer science.

Based upon their review of these comments, the statute and legislative history, Treasury and the IRS have determined that the definition of qualified research set out in T.D. 8930 does not fully address Congress' concerns regarding the importance of research activities to the U.S. economy. Accordingly, Treasury and the IRS have eliminated in these proposed regulations the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. Rather, Treasury and the IRS believe that the requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" is intended to distinguish technological research, which may qualify for the research credit, from non-technological research, which does not.

When the research credit rules were amended by the 1986 Act, Congress explained the requirement in section 41(d)(1)(B)(i) as follows:

> [t]he determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science/3/—in which case the information is deemed technological in nature—or on other principles, such as those of economics—in which case the information is not to be treated as technological in nature. For example, information relating to financial services or similar products (such as new types of variable annuities or legal forms) or advertising does not qualify as technological in nature.

H.R. Conf. Rep. No. 99–841, at II–71 (1986) (footnote omitted). This explanation of section 41(d)(1)(B)(i) focuses on the distinction between information derived from a process of experimentation that fundamentally relies on principles of physical or biological sciences, engineering, or computer science, and information derived by other means. This and other changes to the research credit by the 1986 Act were driven by Congressional concerns that the research credit had been applied "too broadly" and that "[m]any taxpayers claiming the credit were not in industries that involved high technology or its application in developing new and improved products or methods of production." H.R. Rep. No. 99–426, at 177–78; S. Rep. No. 99–313, at 694–95. The examples provided by Congress illustrate this point. Information relating to financial services, variable annuities, legal forms and advertising all involve information derived from non-technological research. This distinction between technological and non-technological research is further emphasized by other changes made to the definition of qualified research by the 1986 Act. For example, section 41(d)(4)(D) specifically excludes from the definition of qualified research certain non-technical activities including efficiency surveys, activities relating to management function or technique, market research testing, routine data collection and quality control testing. Similarly, section 41(d)(3)(B) generally provides that if the purpose of research relates to style, taste, cosmetic or seasonal design factors, then that research cannot constitute qualified research. The 1986 Act also expanded the list of social science exclusions contained in section 41(d)(4)(G).

In contrast, the 1986 legislative history does not indicate that section 41(d)(1)(B)(i) was enacted to impose a scientific discovery requirement. The legislative history does not contain a definition of the term *discovery*. The footnote 3 referenced in the above quoted legislative history does state:

> Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken to discover information that is technological in nature, however, if the research is intended to expand or refine existing principles of computer science.

H.R. Conf. Rep. No. 99–841, at II–71, n.3 (1986). This footnote, however, does not set forth a rule of general application, but instead merely illustrates a clear example of research satisfying the requirement that qualified research be technological in nature.

For all of these reasons, Treasury and the IRS have concluded that there should be no "discovery" requirement in the research credit regulations separate and apart from that already required under § 1.174–2(a)(1), which states, in part:

> Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.

Accordingly, these proposed regulations do not retain from T.D. 8930 the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. Instead, the proposed regulations repeat the requirement from § 1.174–2(a)(1) by stating that research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty, for purposes of this requirement, exists if the information available to the taxpayer does not establish the capability or method of developing or improving the business component, or the appropriate design of the business component.

These proposed regulations expand on the definition of *technological in nature* set out in T.D. 8930. As under T.D. 8930, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. As in T.D. 8930, these proposed regulations clarify the definition of technological in nature by stating that a taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

T.D. 8930 contained a patent safe harbor providing that a taxpayer is conclusively presumed to have obtained knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering, if that taxpayer was awarded a patent (other than a patent for design issued under the provisions of 35 U.S.C. 171) for the business component. These proposed regulations contain a similar rule that conforms to the underlying requirement for credit eligibility in section 41(d)(1)(B)(i) that research must be undertaken for the purpose of discovering information that is technological in nature. Accordingly, these proposed regulations provide that a taxpayer is conclusively presumed to have discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component if that taxpayer was awarded a patent (other than a patent for design issued under the provisions of 35 U.S.C. 171) for the business component.

II. Process of Experimentation

Together with the requirements of section 41(d)(1)(A) and (B), section 41(d)(1)(C) provides that qualified research means research substantially all of the activities of which constitute elements of a process of experimentation related to a new or improved function, performance, or reliability or quality. In T.D. 8930, Treasury and the IRS clarified how the process of experimentation required by section 41(d)(1)(C) differs from research and development in the experimental or laboratory sense required by § 1.174–2(a). Specifically, T.D. 8930 provided that a process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset, but does not include the evaluation of alternatives to establish the appropriate design of a business component when the capability and method for developing or improving the business component are not uncertain. Several commentators objected to any distinction regarding the design of a business component and cited examples from the legislative history which these commentators contend show that the determination of the appropriate design of a business component involved a process of experimentation.

Treasury and the IRS continue to believe that the requirements for a process of experimentation under section 41 are more stringent than the requirements for research and development in the experimental or laboratory sense under § 1.174–2(a)(1). However, Treasury and the IRS have determined that a process of experimentation may exist if a taxpayer performs research to establish the appropriate design of a business component when the capability and method for developing or improving the business component are not uncertain. As is discussed in more detail below, not all research to arrive at the appropriate design of a business component will be credit eligible.

These proposed regulations provide that a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. Whether a taxpayer has undertaken a process of experimentation is a facts and circumstances determination. The proposed regulations provide factors that are indicative of a process of experimentation. The factors listed are not exclusive, and no one factor is dispositive.

A taxpayer's activities do not constitute elements of a process of experimentation where the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are readily discernible and applicable as of the beginning of the taxpayer's research activities so that true experimentation in the scientific or laboratory sense would not have to be undertaken to test, analyze, and choose among viable alternatives. Similarly, a process of experimentation does not include merely selecting among several alternatives that are readily discernible and applicable. The fact that a taxpayer conducts only rudimentary or nontechnological testing in order to develop or improve a business component tends to indicate that the appropriate design of the business component was readily discernible and applicable at the outset within the meaning of these rules.

T.D. 8930 provided that the substantially all requirement of section 41(d)(1)(C) is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistently applied reasonable basis (and without regard to § 1.41–2(d)(2)), constitute elements of a process of experimentation for a purpose described in section 41(d)(3). The substantially all requirement is applied separately to each business component. These proposed regulations retain the same rule. Treasury and the IRS, however, request comments on the application of the substantially all rule. Treasury and the IRS are specifically interested in comments on whether research expenses incurred for non-qualified purposes are includible in the credit computation provided that substantially all of the research expenses constitute elements of a process of experimentation.

III. Internal Use Software

Section 41(d)(4)(E) provides that, except to the extent provided by regulations, research with respect to "computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" (*i.e.*, internal-use software) is excluded from the definition of qualified research. T.D. 8930 provided that the development of internal-use software constitutes qualified research only if the research satisfies both the general requirements for credit eligibility under section 41 (including that the research not be otherwise excluded) and an additional, three-part high threshold of innovation test. T.D. 8930 defined internal-use software as software that is to be used internally, such as software used in general and administrative functions of the taxpayer, or in providing noncomputer services. Noncomputer services are services offered by a taxpayer to customers who do business with the taxpayer primarily to obtain a service other than a computer service, even if such other service is enabled, supported, or facilitated by computer or software technology. T.D. 8930, however, contained an exception to this rule that provides that internal-use software does not include software that is designed to provide customers with a new feature, not available from the taxpayer's competitors, with respect to a noncomputer service and that the taxpayer reasonably anticipates will give rise to increased customer demand for the noncomputer service.

The high threshold of innovation test in T.D. 8930 generally required that (i) the internal-use software be innovative; (ii) the development of the internal-use software involve significant economic risk; and (iii) the internal-use software not be commercially available. The high threshold of innovation test, however, does not apply with respect to the development of software (i) for use in conducting qualified research; (ii) for use in a production process; (iii) for use as part of a package of hardware and software developed concurrently; and (iv) for use in providing computer services to customers. Computer services are services offered by a taxpayer to customers who do business with the taxpayer primarily for the use of the taxpayer's computer or software technology.

In response to Notice 2001–19, several commentators objected to the internal-use software provisions of T.D. 8930. After reviewing the legislative history to the 1986 Act, the Tax and Trade Relief Extension Act of 1998, Public Law 105–277, 112 Stat. 2681, 2681–888 (the 1998 Act), and the Tax Relief Extension Act of 1999, Public Law 106–170, 113 Stat. 1860, 1919, together with the comment letters, Treasury and the IRS made several changes to the internal-use software rules. These proposed regulations clarify the definition of internal-use software contained in T.D. 8930 as well as the exceptions to this definition and the types of software that are not required to satisfy the high threshold of innovation test. These changes are discussed below.

Internal-use software defined

Under these proposed regulations, software that is developed by (or for the benefit of) the taxpayer primarily to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties is not treated as internal use software. All other software is presumed to be developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use. This distinction reflects the view that software that is sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties is software that is intended to be used primarily by the customers of the taxpayer, whereas software that does not satisfy this requirement is software that is intended to be used primarily by the taxpayer for its internal use or in connection with a noncomputer service provided by the taxpayer.

These proposed regulations retain the provision in T.D. 8930 that excluded from the definition of *internal-use software* computer software and hardware developed as a single product. This rule, however, has been modified in response to a commentator's suggestion that some purchasers of combined software and hardware packages may develop their own computer software to operate the package or modify the imbedded computer software. Because the computer software is an integral part of the hardware, these commentators urged that the computer software/hardware rule should be extended to these development costs. Treasury and the IRS agree that, provided the computer software is developed to be used with hardware as a single product and the activities are otherwise credit-eligible and not excluded under another provision (*e.g.*, section 41(d)(4)(B)), the computer software/hardware rule should extend to these development costs. Thus, under these proposed regulations, internal-use software does not include a new or improved package of computer software and hardware developed together by the taxpayer as a single product (or to the costs to modify an acquired computer software and hardware package), of which the software is an integral part, that is used directly by the taxpayer in providing services in its trade or business to customers.

High threshold of innovation test

These proposed regulations retain the general rule contained in T.D. 8930 that internal-use software must satisfy the general requirements for credit eligibility (and not be excluded from the definition of qualified research under any other exclusion) and the three-part high threshold of innovation test. These proposed regulations clarify the first prong of the three-part test by providing that internal-use software is innovative if the software is intended to be unique or novel and is intended to differ in a significant and inventive way from prior software implementations or methods. This change is being proposed pursuant to the authority provided in section 41(d)(4)(E) and the legislative history thereunder in order to update the definition of innovative contained in T.D. 8930. The T.D. 8930 definition was derived from the legislative history to the 1986 Act and required that the software be intended to result in a reduction in cost, improvement in speed, or other improvement, that is substantial and economically significant. Treasury and the IRS became concerned that the elements of the T.D. 8930 definition, while perhaps reflecting innovations in computer software in the mid–1980s, did not adequately reflect the factors that indicate that software is innovative today. The proposed change, therefore, is an attempt both to update the definition of innovative, and to provide a more flexible definition with continuing application. Several examples were added to these proposed regulations to illustrate the application of this proposed rule. The second and third prongs of the high threshold of innovation test (*i.e.*, significant economic risk and commercial availability) remain unchanged from T.D. 8930.

Software not required to satisfy the high threshold of innovation test

Like T.D. 8930, these proposed regulations provide that software is not required to satisfy the high threshold of innovation test if the software was developed by the taxpayer for use in an activity that constitutes qualified research (other than the development of the internal-use software itself), a production process that meets the requirements of section 41(d)(1), or in providing computer services to customers. These proposed regulations, however, eliminate the special rule contained in T.D. 8930 for software used to deliver noncomputer services to customers with features that are not yet offered by a taxpayer's competitors. Several commentators stated that this rule is too limited and subjective in its application to have significant value to taxpayers. Due to other revisions contained in these proposed regulations, Treasury and the IRS believe that the computer software targeted by this rule generally would be credit eligible without this rule.

Several commentators objected to the distinction between computer services and noncomputer services and urged that the definition of internal-use software exclude any software used to deliver a service to customers or any software that includes an interface with customers or the public. An exclusion for software that includes an interface with customers or the public would entail substantial administrative difficulties and may inappropriately permit certain categories of costs (*e.g.*, certain web site development costs) to constitute qualified research expenses without having to satisfy the high threshold of innovation test.

With respect to software developed by a taxpayer for use in a production process satisfying the requirements of section 41(d)(1), comments from service providers urged Treasury and the IRS to give service providers the same benefits as manufacturing companies. Congress provided an explicit exclusion for software developed for use in a production process; however, it did not provide a similar exclusion for software used in the provision of noncomputer services. Therefore, Treasury and the IRS conclude that software used in the provision of noncomputer services generally should be subject to the internal-use software requirements.

Effective date

Treasury and the IRS propose the revisions to the internal-use software rules to be effective for taxable years beginning after December 31, 1985. Treasury and the IRS believe that the proposed rule is consistent with the legislative history and the legislative mandate for retroactive application of the rule. Taxpayers, however, may continue to rely on T.D. 8930 until regulations are finalized.

IV. Shrinking-back Rule

T.D. 8930 contained a special shrinking-back rule. These proposed regulations revise the shrinking-back rule to conform it to the rule in the legislative history to the 1986 Act. These proposed regulations also reiterate that the shrinking-back rule may not itself be applied as a reason to exclude research activities from credit eligibility.

V. Other Exclusions

Several commentators raised issues concerning activities excluded from the definition of qualified research. In particular, the commentators were concerned about the research after commercial production exclusion. Because the rules contained in § 1.41–4(c) of T.D. 8930 closely reflected the legislative history regarding post-research activities, these proposed regulations retain the rules contained in T.D. 8930. See H.R. Conf. Rep. No. 99–841, at II–74–75. However, new examples are included to illustrate the application of the exclusions. Treasury and the IRS request comments concerning the application of the exclusions and the extent to which additional guidance concerning the exclusions may be helpful.

VI. Gross Receipts

When Congress revised the computation of the research credit to incorporate a taxpayer's gross receipts, neither the statute nor the legislative history defined the term *gross receipts*, other than to provide that gross receipts for any taxable year are reduced by returns and allowances made during the tax year, and, in the case of a foreign corporation, that only gross receipts effectively connected with the conduct of a trade or business within the United States are taken into account. See section 41(c)(6).

T.D. 8930 adopted a broad definition of the term *gross receipts* for purposes of computing the research credit. T.D. 8930 generally defined gross receipts as the total amount derived by a taxpayer from all activities and sources. In addition, because certain extraordinary gross receipts might not be taken into account when a business determines its research budget, T.D. 8930 provided that certain items (*e.g.*, receipts from the sale or exchange of capital assets, or repayments of loans or similar instruments) would be excluded from the computation of gross receipts. Further, T.D. 8930 excluded from the definition of gross receipts any income derived by a taxpayer in a taxable year that precedes the first taxable year in which the taxpayer derives more than

$25,000 in gross receipts other than investment income.

In response to Notice 2001–19, some commentators suggested that the definition of gross receipts created an administrative burden to the extent that taxpayers would be obligated to apply the definition of the term for the four years preceding the determination years as well as to the 1984 through 1988 base years.

These proposed regulations retain the definition of gross receipts contained in T.D. 8930. Treasury and the IRS continue to believe that the definition of gross receipts should be construed broadly and that the definition of gross receipts in T.D. 8930 is appropriate for purposes of computing the research credit. Further, Treasury and the IRS believe that the administrative burden referred to by commentators is due to the incremental nature of the credit and the statutorily determined base years, and not to the definition of gross receipts.

VII. Recordkeeping for the Research Credit

Under T.D. 8930, taxpayers were required to prepare and retain written documentation before or during the early stages of the research project that describes the principal questions to be answered and the information the taxpayer seeks to obtain that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering. These proposed regulations eliminate this recordkeeping requirement.

Treasury and the IRS recognize that the research credit presents a particular burden for taxpayers because tracking eligible expenditures may necessitate taxpayers preparing and keeping records unlikely to be prepared or kept for other business purposes. The fact that the records are not prepared or kept for other business purposes has made administration of the research credit burdensome for the IRS. Moreover, section 41 often requires an allocation between qualifying and non-qualifying costs that is difficult for taxpayers to make and for the IRS to administer.

Nevertheless, when the research credit was extended in 1999, Congress made clear that the credit should not impose unreasonable recordkeeping requirements:

> The conferees also are concerned about unnecessary and costly taxpayer recordkeeping burdens and reaffirm that eligibility for the credit is not intended to be contingent on meeting unreasonable recordkeeping requirements.

H.R. Conf. Rep. No. 106–478, at 132 (1999). Treasury and the IRS have re-evaluated whether a research credit-specific documentation requirement is warranted and have concluded that the high degree of variability in the objectives and conduct of research activities in the United States compels a conclusion that taxpayers must be provided reasonable flexibility in the manner in which they substantiate their research credits. Accordingly, Treasury and the IRS have concluded that the failure to keep records in a particular manner (so long as such records are in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit) cannot serve as a basis for denying the credit. Treasury and the IRS have decided that the rules generally applicable under section 6001 provide sufficient detail about required documentary substantiation for purposes of the research credit. Consequently, no separate research credit-specific documentation requirement is included in these proposed regulations.

Section 1.6001–1 requires the keeping of records "sufficient to establish the amount of . . . credits, . . required to be shown . . . ." The consequence of failing to keep sufficient records substantiating a claimed credit may be denial of the credit. To address any ongoing recordkeeping concerns regarding the research credit, Treasury and the IRS propose to use pre-filing processes, including industry issue resolution, pre-filing agreements, determination letters, and record retention agreements, to provide certainty to taxpayers about the records that must be kept and to ensure the availability to the IRS of the records necessary to examine taxpayers' returns expeditiously. Treasury and the IRS solicit comments from taxpayers on establishing recordkeeping rules that will facilitate compliance and administration, including whether pre-filing agreements should extend to the qualification of particular cost centers or to the procedures established by the taxpayer for determining the expenditures qualifying for the credit. Treasury and the IRS also solicit comments from taxpayers on the extent to which guidelines may be developed on an industry-by-industry basis.

Proposed Effective Dates

Except as specifically provided in § 1.41–4(c)(6)(ix), the proposed amendments to § 1.41–4 are proposed to apply to taxable years ending on or after December 26, 2001. Notwithstanding this prospective effective date, Treasury and the IRS believe that these rules prescribe the proper treatment of the expenditures they address, and the IRS generally will not challenge return positions consistent with the proposed regulations. Therefore, taxpayers may rely on these proposed regulations until the date final regulations under § 1.41–4 are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. 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. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments (a signed original and eight

(8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 27, 2002, at 10 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the 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 (in the manner described in the ADDRESSES portion of this preamble) comments and an outline of the topics to be discussed and the time to be devoted to each topic by March 6, 2002.

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.

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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 continues to read in part as follows:

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

Par. 2. Section 1.41–0 is amended as follows:

1. Revising the entry for § 1.41–3.
2. Revising the entries for § 1.41–4.
3. Revising the entry for § 1.41–8.

The revisions read as follow:

§ 1.41–0 Table of contents.

* * * * *

Par. 3. Section 1.41–3 is amended by:

1. Revising the section heading.
2. Revising paragraph (e).

The revisions read as follows:

§ 1.41–3 Base amount for taxable years ending on or after December 26, 2001.

* * * * *

(e) *Effective date*. The rules of this section are applicable for taxable years ending on or after December 26, 2001.

Par. 4. Section 1.41–4 is revised to read as follows:

§ 1.41–4 Qualified research for expenditures paid or incurred in taxable years ending on or after December 26, 2001.

(a) *Qualified research*—(1) *General rule*. Research activities related to the development or improvement of a business component constitute qualified research only if the research activities meet all of the requirements of section 41(d)(1) and this section, and are not otherwise excluded under section 41(d)(3)(B) or (d)(4), or this section.

(2) *Requirements of section 41(d)(1)*. Research constitutes qualified research only if it is research—

(i) With respect to which expenditures may be treated as expenses under section 174, see § 1.174–2;

(ii) That is undertaken for the purpose of discovering information that is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and

(iii) Substantially all of the activities of which constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality.

(3) *Undertaken for the purpose of discovering information*—(i) *In general*. For purposes of section 41(d) and this section, research must be undertaken for the purpose of discovering information that is technological in nature. Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

(ii) *Application of the discovering information requirement*. A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. In addition, a determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer succeed in developing a new or improved business component.

(iii) *Patent safe harbor*. For purposes of section 41(d) and paragraph (a)(3)(i) of this section, the issuance of a patent by the Patent and Trademark Office under the provisions of 35 U.S.C. 151 (other than a patent for design issued under the provisions of 35 U.S.C. 171) is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. However, the issuance of such a patent is not a precondition for credit availability.

(4) *Technological in nature*. For purposes of section 41(d) and this section, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

(5) *Process of experimentation*—(i) *In general*. For purposes of section 41(d) and this section, a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. Thus, a taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer's research activities. However, a process of experimentation does not include the evaluation of alternatives to achieve the desired result if the capability and method of achieving the desired result, and the appropriate design of the desired result, are readily discernible and applicable as of the beginning of the taxpayer's research activities. A process of experimentation may include developing one or more hypotheses designed to achieve the desired result, designing and conducting an experiment to test and analyze those hypotheses, and refining or discarding the hypotheses as part of a design process to develop or improve the business component. For purposes of this paragraph (a)(5), factors that tend to indicate that the taxpayer has engaged in a process of experimentation are listed in paragraph (a)(5)(iv) of this section.

(ii) *Readily discernible capability, method and appropriate design*. A taxpayer's activities do not constitute elements of a process of experimentation where the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are readily discernible and applicable as of the beginning of the taxpayer's research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to test, analyze, and choose among viable alternatives. A process of experimentation does not include any activities to select among several alternatives that are readily discernible and applicable.

(iii) *Qualified purpose*. For purposes of section 41(d) and this section, a process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance, reliability or quality of the business component. Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors.

(iv) *Factors tending to indicate that the taxpayer has engaged in a process of experimentation*. For purposes of section 41(d) and this section, in determining whether a taxpayer has undertaken a process of experimentation, all facts and circumstances with respect to a taxpayer's research activities are taken into account. No one factor is dispositive in making this determination. Further, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination. Thus, no inference should be drawn from the taxpayer's failure to satisfy any or all of the factors. Among the factors that tend to indicate that the taxpayer has engaged in a process of experimentation are—

(A) The taxpayer tests and analyzes numerous alternative hypotheses to develop a new or improved business component;

(B) The taxpayer engages in extensive, comprehensive, intricate or complex scientific or laboratory testing; or

(C) The taxpayer evaluates numerous or complex specifications related to the function, performance, reliability or quality of a new or improved business component.

(6) *Substantially all requirement*—(i) *General rule*. The substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistently applied reasonable basis (and without regard to § 1.41–2(d)(2)), constitute elements of a process

of experimentation for a purpose described in section 41(d)(3). The substantially all requirement is applied separately to each business component.

(ii) *Illustrations*. [Reserved]

(7) *Use of computers and information technology*. The employment of computers or information technology, or the reliance on principles of computer science or information technology to store, collect, manipulate, translate, disseminate, produce, distribute, or process data or information, and similar uses of computers and information technology does not itself establish that qualified research has been undertaken.

(8) *Illustrations*. The following examples illustrate the application of paragraph (a)(5) of this section:

Example 1. (i) *Facts*. X is engaged in the business of developing and manufacturing widgets. X wants to change the color of its blue widget to green. X obtains from various suppliers several different shades of green paint. X paints several sample widgets, and surveys X's customers to determine which shade of green X's customers prefer.

(ii) *Conclusion*. X's activities to change the color of its blue widget to green are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section because substantially all of X's activities are not undertaken for a qualified purpose. All of X's research activities are related to style, taste, cosmetic, or seasonal design factors.

Example 2. (i) *Facts*. X is engaged in the business of manufacturing widgets and wants to change the color of its blue widget to green. X obtains samples of green paint from a supplier and determines that X must modify its painting process to accommodate the green paint because the green paint has different characteristics from other paints X has used. X obtains detailed data on the green paint from X's paint supplier. X also consults with the manufacturer of X's paint spraying machines and determines that X must acquire new nozzles that are designed to operate with paints similar to the green paint X wants to use. X installs the new nozzles on its paint spraying machines and tests the nozzles to ensure that they work as specified by the manufacturer of the paint spraying machines.

(ii) *Conclusion*. X's activities to modify its painting process is a separate business component under section 41(d)(2)(A). X's activities to modify its painting process by installing new nozzles on its paint spraying machines to change the color of its blue widget to green are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. The capability, method and appropriate design of the changes to X's painting process are readily discernible and applicable to X as of the beginning of X's activities. X's activities to test the nozzles to determine if the nozzles work as specified by the manufacturer of the paint spraying machines are not the type of testing activities that tend to indicate that a process of experimentation was undertaken.

Example 3. (i) *Facts*. X is engaged in the business of manufacturing food products and currently manufactures a large-shred version of a product. Because X's competitors manufacture both a large-shred and fine-shred version of comparable food products, X seeks to modify its current production line to permit it to manufacture both a large-shred version and fine-shred version of one of its own food products. A shredding blade capable of producing a fine-shred version of the food product is not commercially available. Thus, X must develop a new shredding blade that can be fitted onto X's current production line. X must test and analyze numerous alternative hypotheses to determine whether a new shredding blade must be constructed of a different material from that of its existing shredding blade. In addition, X must engage in comprehensive and complex scientific or laboratory testing to ensure that its modified production process, with the newly-developed shredding blade, can accommodate the manufacture of both the large-shred and fine-shred versions of X's food products.

(ii) *Conclusion*. X's activities to modify its current production line meet the requirements of qualified research as set forth in paragraph (a)(2) of this section. Substantially all of X's activities constitute elements of a process of experimentation because X must evaluate more than one alternative to achieve a result where the method and appropriate design are uncertain as of the beginning of the taxpayer's research activities. X must test and analyze numerous alternative hypotheses and engage in comprehensive and complex scientific or laboratory testing to ensure that its modified production process, with a newly-developed shredding blade, can accommodate the manufacture of both the large-shred and fine-shred versions of X's food products.

Example 4. (i) *Facts*. X operates wireless networks in several U.S. cities. X discovers in City a service problem and collects data on the nature of the problem. X analyzes the data and knows, based on its previous experience with wireless networks in other cities, that the installation of a new type of gateway will eliminate the problem. X installs the new gateway in its City network.

(ii) *Conclusion*. X's activities to determine a solution to its service problem are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. Substantially all of X's research activities do not constitute elements of a process of experimentation because the solution to the service problem is readily discernible and applicable by X as of the beginning of X's research activities.

Example 5. (i) *Facts*. X is engaged in the business of manufacturing and selling automobiles. X incorporated into one of its new vehicles a new exhaust system that it designed. After X offered the vehicle for sale, X received complaints of a rattling noise that could be heard in the passenger compartment. X's engineers determined that the cause of the noise was the exhaust system coming into contact with the undercarriage of the vehicle. Based on previous experience with similar noise problems, X's engineers knew of two safe, effective, reliable solutions that would eliminate the noise. X's engineers selected one of the solutions based on cost studies that indicated it would be the less expensive alternative.

(ii) *Conclusion*. X's activities to eliminate the rattling noise are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. Substantially all of X's research activities do not constitute elements of a process of experimentation because the solution is readily discernible and applicable to X as of the beginning of X's activities.

Example 6. (i) *Facts*. X is in the business of designing, developing, and manufacturing automobiles and decides to update one of its current model vehicles. In response to government-mandated fuel economy requirements, X undertakes to improve aerodynamics by lowering the hood of the current model vehicle. X determines that lowering the hood changes the air flow under the hood, which changes the rate at which air enters the engine through the air intake system, and which reduces the functionality of the cooling system. X designs, models, tests, refines, and re-tests proposed modifications to both the air intake system and cooling system until modifications are developed that meet X's requirements. X then integrates the modified air intake and cooling systems into a current model vehicle with a lower hood, modifying in the process the new air intake and cooling systems as well as the underhood wiring, brake lines and fuel line. X conducts extensive and complex scientific or laboratory testing to determine if the current model vehicle meets X's requirements. X conducts extensive and complex scientific or laboratory testing (including simulations and crash tests) to determine if the current model vehicle meets X's requirements.

(ii) *Conclusion*. X's activities to update its vehicle meet the requirements of qualified research as set forth in paragraph (a)(2) of this section. X must test and analyze numerous alternative hypotheses, engage in extensive testing and analysis, and evaluate complex specifications related to the functionality of several of the vehicle's underhood systems and to the vehicle's overall performance. These activities indicate that X undertook a process of experimentation to achieve the appropriate design of the updated vehicle.

(b) *Application of requirements for qualified research*—(1) *In general*. The requirements for qualified research in section 41(d)(1) and paragraph (a) of this section, must be applied separately to each business component, as defined in section 41(d)(2)(B). In cases involving development of both a product and a manufacturing or other commercial production process for the product, research activities relating to development of the process are not qualified research unless the requirements of section 41(d) and this section are met for the research activities relating to the process without taking into account the research activities relating to development of the product. Similarly, research activities relating to development of the product are not qualified research unless the requirements of section 41(d) and this section are met for the research activities relating to the product without taking into account the research activities relating to development of the manufacturing or other commercial production process.

(2) *Shrinking-back rule*. The requirements of section 41(d) and paragraph (a) of this section are to be applied first at the level of the discrete business component, that is, the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. If the requirements for credit eligibility are met at that first level, then some or all of the taxpayer's qualified research expenses are eligible for the credit. If all aspects of such requirements are not met at that level, the test applies at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This shrinking back of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test. This shrinking-back rule is applied only if a taxpayer does not satisfy the requirements of section 41(d)(1) and paragraph (a)(2) of this section with respect to the overall business component. The shrinking-back rule is not itself applied as a reason to exclude research activities from credit eligibility.

(3) *Illustration*. The following example illustrates the application of this paragraph (b):

Example. X, a motorcycle engine builder, develops a new carburetor for use in a motorcycle engine. X also modifies an existing engine design for use with the new carburetor. Under the shrinking-back rule, the requirements of section 41(d)(1) and paragraph (a) of this section are applied first to the engine. If the modifications to the engine when viewed as a whole, including the development of the new carburetor, do not satisfy the requirements of section 41(d)(1) and paragraph (a) of this section, those requirements are applied to the next most significant subset of elements of the business component. Assuming that the next most significant subset of elements of the engine is the carburetor, the research activities in developing the new carburetor may constitute qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section.

(c) *Excluded activities*—(1) *In general*. Qualified research does not include any activity described in section 41(d)(4) and paragraph (c) of this section.

(2) *Research after commercial production*—(i) *In general*. Activities conducted after the beginning of commercial production of a business component are not qualified research. Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use.

(ii) *Certain additional activities related to the business component*. The following activities are deemed to occur after the beginning of commercial production of a business component—

(A) Preproduction planning for a finished business component;

(B) Tooling-up for production;

(C) Trial production runs;

(D) Trouble shooting involving detecting faults in production equipment or processes;

(E) Accumulating data relating to production processes; and

(F) Debugging flaws in a business component.

(iii) *Activities related to production process or technique*. In cases involving development of both a product and a manufacturing or other commercial production process for the product, the exclusion described in section 41(d)(4)(A) and paragraphs (c)(2)(i) and (ii) of this section applies separately for the activities relating to the development of the product and the activities relating to the development of the process. For example, even after a product meets the taxpayer's basic functional and economic requirements, activities relating to the development of the manufacturing process still may constitute qualified research, provided that the development of the process itself separately satisfies the requirements of section 41(d) and this section, and the activities are conducted before the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use.

(iv) *Clinical testing*. Clinical testing of a pharmaceutical product prior to its commercial production in the United States is not treated as occurring after the beginning of commercial production even if the product is commercially available in other countries. Additional clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the Food and Drug Administration and is ready for commercial production and sale is not treated as occurring after the beginning of commercial production if such clinical testing is undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product. A functional use, characteristic, indication, combination, dosage, or delivery form shall be considered new only if such functional use, characteristic, indication, combination, dosage, or delivery form must be approved by the Food and Drug Administration.

(3) *Adaptation of existing business components*. Activities relating to adapting an existing business component to a particular customer's requirement or need are not qualified research. This exclusion does not apply merely because a business component is intended for a specific customer.

(4) *Duplication of existing business component*. Activities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component are not qualified research. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.

(5) *Surveys, studies, research relating to management functions, etc*. Qualified research does not include activities relating to—

(i) Efficiency surveys;

(ii) Management functions or techniques, including such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line);

(iii) Market research, testing, or development (including advertising or promotions);

(iv) Routine data collections; or

(v) Routine or ordinary testing or inspections for quality control.

(6) *Internal use software for taxable years beginning on or after the December 31, 1985*—(i) *General rule*. Research with respect to computer software that is

developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if the software satisfies the requirements of paragraph (c)(6)(ii) of this section.

(ii) *Requirements*. The requirements of this paragraph (c)(6)(ii) are—

(A) The software satisfies the requirements of section 41(d)(1);

(B) The software is not otherwise excluded under section 41(d)(4) (other than section 41(d)(4)(E)); and

(C) One of the following conditions is met—

(*1*) The taxpayer develops the software for use in an activity that constitutes qualified research (other than the development of the internal-use software itself);

(*2*) The taxpayer develops the software for use in a production process that satisfies the requirements of section 41(d)(1);

(*3*) The taxpayer develops the software for use in providing computer services to customers; or

(*4*) The software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section.

(iii) *Computer software and hardware developed as a single product*. This paragraph (c)(6) does not apply to the development costs of a new or improved package of computer software and hardware developed together by the taxpayer as a single product (or to the costs to modify an acquired computer software and hardware package), of which the software is an integral part, that is used directly by the taxpayer in providing services in its trade or business to customers. In these cases, eligibility for the research credit is to be determined by examining the combined software-hardware product as a single product.

(iv) *Primarily for internal use*. Unless computer software is developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties, computer software is presumed developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use. For example, the computer software may serve general and administrative functions of the taxpayer, or may be used in providing a noncomputer service. General and administrative functions include, but are not limited to, functions such as payroll, bookkeeping, financial management, financial reporting, personnel management, sales and marketing, fixed asset accounting, inventory management, and cost accounting. Computer software that is developed to be commercially sold, leased, licensed or otherwise marketed, for separately stated consideration to unrelated third parties is not developed primarily for the taxpayer's internal use. The requirements of this paragraph (c)(6) apply to computer software that is developed primarily for the taxpayer's internal use even though the taxpayer subsequently sells, leases, licenses, or otherwise markets the computer software for separately stated consideration to unrelated third parties.

(v) *Software used in the provision of services*—(A) *Computer services*. For purposes of this section, a computer service is a service offered by a taxpayer to customers who conduct business with the taxpayer primarily for the use of the taxpayer's computer or software technology. A taxpayer does not provide a computer service merely because customers interact with the taxpayer's software.

(B) *Noncomputer services*. For purposes of this section, a noncomputer service is a service offered by a taxpayer to customers who conduct business with the taxpayer primarily to obtain a service other than a computer service, even if such other service is enabled, supported, or facilitated by computer or software technology.

(vi) *High threshold of innovation test*. Computer software satisfies this paragraph (c)(6)(vi) only if the taxpayer can establish that—

(A) The software is innovative in that the software is intended to be unique or novel and is intended to differ in a significant and inventive way from prior software implementations or methods;

(B) The software development involves significant economic risk in that the taxpayer commits substantial resources to the development and there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period; and

(C) The software is not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the requirements of paragraphs (c)(6)(v)(A) and (B) of this section.

(vii) *Application of high threshold of innovation test*. The costs of developing internal use software are eligible for the research credit only if the software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section. This test takes into account only the results attributable to the development of the new or improved software independent of the effect of any modifications to related hardware or other software.

(viii) *Illustrations*. The following examples illustrate provisions contained in this paragraph (c)(6) of this section. No inference should be drawn from these examples concerning the application of section 41(d)(1) and paragraph (a) of this section to these facts. The examples are as follows:

Example 1. (i) *Facts*. X, an insurance company, has increased its number of insurance policies in force. In recent years, regulatory and financial accounting rules for computing actuarial reserves on these insurance policies have changed several times. In order to compute actuarial reserves in a more timely and cost-effective manner, X undertakes to create an improved reserve valuation software that will generate data for regulatory and financial accounting purposes.

(ii) *Conclusion*. The improved reserve valuation software created by X is internal use software because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. The improved reserve valuation software was developed by X to serve X's general and administrative functions. X's costs of developing the reserve valuation software are eligible for the research credit only if the software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section.

Example 2. (i) *Facts*. Assume the same facts as in *Example 1*. Also assume that in order to create an improved reserve valuation software, X purchases updated hardware with a new operating system to build the new software system. Several other insurance companies using the same updated hardware and new operating system have in place software systems that can handle the volume of transactions that X seeks to handle, provide reserve computations within a similar time frame, and accommodate the most current regulatory and financial accounting requirements.

(ii) *Conclusion*. X's reserve valuation software system is internal use software that does not satisfy the high threshold of innovation test of paragraph (c)(6)(vi) of this section. The software is not intended to be unique or novel in that it is intended to be merely comparable to software developed by other insurance companies. The software does not differ in a significant or inventive way from prior software implementations because X's reserve valuation software system was developed using the same technologies and methods that were employed by other insurance companies. Further, X's reserve valuation software is not excluded from the application of paragraph (c)(6) of this section by the rule of paragraph (c)(6)(iii) of this section.

Example 3. (i) *Facts*. In 1986, X, a large regional bank with hundreds of branch offices, maintained separate software systems for each of its customer's accounts, including checking, deposit, loan, lease, and trust. X determined that improved customer service could be achieved by redesigning its disparate systems into one customer-centric system. X also determined that commercially available database management systems did not meet all of the critical requirements of the proposed system. Specifically, available relational database management systems were well suited for the proposed system's data modeling requirements but not the data integrity and transaction throughput (transactions-per-second) requirements. Rather than waiting several years for vendor offerings to mature and become viable for its purpose, X decided to embark upon the project utilizing older technology that satisfied the data integrity and transaction throughput requirements but that was severely challenged with respect to the data modeling capabilities. X commits substantial resources to this project and, because of technical risk, X cannot determine if it will recover its resources in a reasonable period. Early in the course of the project, industry analysts observed that the project appeared highly ambitious and risky. The limitations of the technology X was attempting to utilize required that X develop a new database architecture that could accommodate transaction volumes unheard-of in the industry. X was unable to successfully develop the system and X abandoned the project.

(ii) *Conclusion*. X intended to develop a computer software system primarily for X's internal use because X did not intend to commercially sell, lease, license, or otherwise market the software, for separately stated consideration to unrelated third parties, and X intended to use the software in providing noncomputer services to its customers. X's software development activities satisfy the high threshold of innovation test of paragraph (c)(6)(vi) of this section because the system was intended to be innovative in that it was intended to be novel and it was intended to differ in a significant and inventive way from prior software implementations. In addition, X's development activities involved significant economic risk in that X committed substantial resources to the development and there was substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the system, software meeting X's requirements was not commercially available for use by X.

Example 4. (i) *Facts*. X wishes to improve upon its capabilities in the area of insurance fraud prevention, detection and control. X believes that it can exceed the capabilities of current commercial offerings in this area by developing and applying pattern matching algorithms that are not implemented in current vendor offerings. X has determined that many insurance fraud perpetrators can evade detection because its current system relies too heavily on exact matches and scrubbed data. Because a computer software system that will accomplish these objectives is not commercially available, X undertakes to develop and implement advanced pattern matching algorithms that would significantly improve upon the capabilities currently available from vendors. X commits substantial resources to the development of the software system and cannot determine, because of technical risk, if it will recover its investment within a reasonable period.

(ii) *Conclusion*. X's computer software system is developed primarily for X's internal use because X did not intend to sell, lease, license or otherwise market the software, for separately stated consideration to unrelated third parties. X's software development activities satisfy the high threshold of innovation test of paragraph (c)(6)(vi) of this section because the software system is innovative in that it was intended to be novel and it was intended to differ in a significant and inventive way from prior software implementations. In addition, X's development activities involved significant economic risk in that X committed substantial resources to the development and there was substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the software, software satisfying X's requirements was not commercially available for use by X.

Example 5. (i) *Facts*. X is engaged in the business of designing, manufacturing, and selling widgets. X delivers its widgets in the same manner and time as its competitors. To improve customer service, X undertakes to develop computer software that will monitor the progress of the manufacture and delivery of X's widgets to enable X's customers to track their widget orders from origination to delivery, whether by air, land or ship. In addition, at the request of a customer, X will be able to intercept and return or reroute packages prior to delivery. At the time X undertakes its software development activities, X is uncertain whether it can develop the real-time communication software necessary to achieve its objective. None of X's competitors have a comparable tracking system. X commits substantial resources to the development of the system and, because of technical risk, X cannot determine if it will recover its investment within a reasonable period.

(ii) *Conclusion*. X's computer software is developed primarily for X's internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's computer software was developed to be used by X in providing noncomputer services to its customers. X's software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section because, at the time the research is undertaken, X's software is designed to provide a new tracking capability that is novel in that none of X's competitors have such a capability. Further, the new capability differs in a significant and inventive way from prior software implementations. In addition, X's development activities involved significant economic risk in that X committed substantial resources to the development and there was substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the software, software satisfying X's requirements was not commercially available for use by X.

Example 6. (i) *Facts*. X, a multinational chemical manufacturer with different business and financial systems in each of its divisions, undertakes a software development project aimed at integrating the majority of the functional areas of its major software systems into a single enterprise resource management system supporting centralized financial systems, inventory, and management reporting. This project involves the detailed analysis of X's (as well as each of X's divisions') legacy systems to understand the actual current business processes and data requirements. X also has to develop programs to fill in the gaps between the software features and X's system requirements. X hires Y, a systems consulting firm to assist with this development effort. Y has experience in developing similar systems. X, working jointly with Y, evaluates its needs, establishes goals for the new system, re-engineers the business processes that will be made concurrently with the implementation of the new system, and chooses and purchases a software system upon which to base its enterprise-wide system.

(ii) *Conclusion*. X's enterprise-wide computer software is developed primarily for internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's computer software was developed to be used by X to serve X's general and administrative functions. However, the development of X's enterprise management system does not satisfy the high threshold of innovation test of paragraph (c)(6)(vi) of this section because the system that X is seeking to develop is not intended to be unique or novel. Further, the software does not differ in a significant or inventive way from software implemented by other manufacturers.

Example 7. (i) *Facts*. X, a financial services company specializing in commercial mortgages, decides to support its ongoing expansion by upgrading its information technology infrastructure. In order to accommodate its expanding efforts to acquire and maintain corporate borrowers and draw securitized loan investors, X builds a scalable and modular enterprise network to run its latest business applications, including web-based portfolio access for investors and staff, document imaging for customer service personnel, desktop access to information services for in-house securities traders and multimedia on-line training and corporate information delivery for all company personnel. As a result, X is able to access market information faster and function more efficiently and effectively than before. The new network is based on a faster local area network technology which is better able to meet the higher bandwidth requirements of X's current multimedia applications.

(ii) *Conclusion*. X's software is software developed primarily for X's internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's software development activities do not meet the high threshold of innovation test of paragraph (c)(6)(vi) of this section because the system is not intended to be unique or novel. Further, the software does not differ in a significant or inventive way from other existing software implementations.

Example 8. (i) *Facts*. X, a corporation, undertook a software project to rewrite a legacy mainframe application using an object-oriented programming language, and to move the new application off the mainframe to a client/server environment. Both the object-oriented language and client/server technologies were new to X. This project was undertaken to develop a more maintainable application, and to be able to implement new features more quickly. X had to perform a detailed analysis of the old legacy application in order to determine the requirements of the rewritten application. To accomplish this task, X had to train the legacy mainframe programmers in the new object-oriented and client/server technologies that they would have to utilize. Several of X's competitors had successfully implemented similar systems using object-oriented programming language and client/server technologies.

(ii) *Conclusion*. X's software is developed primarily for internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's activities to rewrite a legacy mainframe application using an object-oriented programming language, and to move the application from X's mainframe to a client/server environment do not satisfy the high threshold of innovation test of paragraph (c)(6)(vi) of this section. The software developed is not intended to be either unique or novel and is not intended to differ in a significant and inventive way from prior software implementations or methods.

Example 9. (i) *Facts*. X, a retail and distribution company, wants to upgrade its warehouse management software. Therefore, X performs an analysis of the warehouse management products and vendors in the marketplace. X selects vendor V's software and, in turn, develops the software interfaces between X's legacy systems and V's warehouse management software in order to integrate the new warehouse management system with X's financial and inventory systems. The development of these interfaces requires a detailed understanding of all the input and output fields and their data formats, and how they map from the old system to the new system and vice-versa. Once X develops the interfaces, X has to perform extensive testing and validation work to ensure that the interfaces work correctly and accurately.

(ii) *Conclusion*. X's software is developed primarily for internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's software development activities do not satisfy the high threshold of innovation test of paragraph (c)(6)(vi) of this section because the software development does not involve significant economic risk in that there is no substantial uncertainty, because of technical risk, that such resources will be recovered within a reasonable period.

Example 10. (i) *Facts*. X, a credit card company, knows that its customers are not comfortable with purchasing products over the Internet because they feel the Web is not secure. X decides to build a payment system that provides customers with a single use, automatically generated, short-term time-based, transaction number. This single-use transaction number has a short expiration period that is just long enough to allow a merchant to process and fill the customer's order. Thus, when a customer wishes to make a purchase over the Internet, the customer requests X to generate automatically a single-use transaction number that merchant systems will accept as a legitimate card number. All purchases using single-use transaction numbers are automatically linked back to the customer's credit card account. X commits substantial resources to the development of the system and X cannot determine, because of technical risk, if it will recover its investment within a reasonable period. At the time of this project, nothing exists in the market that has these capabilities.

(ii) *Conclusion*. X's software is developed primarily for internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's computer software is developed primarily for X's internal use because it was intended to be used by X in providing noncomputer services to its customers. X's software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section because the system is a novel way to solve the security issue of making purchases over the Internet. Further, because of the secure payment capability, the software differs in a significant and inventive way from prior software implementations. In addition, X's development activities involved significant economic risk in that X committed substantial resources to the development and there was substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the software, software satisfying X's requirements was not commercially available for use by X.

Example 11. (i) *Facts*. X, a corporation, wants to expand its internal computing power, and is aware that its PCs and workstations are idle at night, on the weekends, and for a significant part of any business day. Because the corporate computations that X needs to make could be done on workstations as well as PCs, X develops a screen-saver like application that runs on employee computers. When employees' computers have been idle for an amount of time set by each employee, the "screen-saver" starts to execute. However, instead of displaying moving lines, like the typical screen-saver, X's application goes back to a central server to get a new job to execute. This job will execute on the idle employee's computer until it has either finished, or the employee resumes working on his computer. X wants to ensure that it can manage all of the computation jobs distributed across its thousands of PCs and workstations. In addition, X wants to ensure that the additional load on its network caused by downloading the jobs and uploading the results, as well as in monitoring and managing the jobs, does not adversely impact the corporate computing infrastructure. At the time X undertook this software development project, X was uncertain, because of technical risk, it could develop a server application that could schedule and distribute the jobs across thousands of PCs and workstations, as well as handle all the error conditions that occur on a user's machine. Also, at the time X undertook this project, there was no commercial application available with such a capability.

(ii) *Conclusion*. X's computer software is developed primarily for internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's computer software was developed to be used by X to serve X's general and administrative functions. X's software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section because making use of idle corporate computing resources through what is ostensibly a screen-saver, was a novel approach to solving X's need for more computer intensive processing time. In addition, X's software development involves significant economic risk in that there was substantial uncertainty, because of technical risk, that the server application that schedules and distributes the jobs across thousands of PCs and workstations, as well as handles all the error conditions that can occur on a user's machine, amounts to developing a new operating system with new capabilities. Finally, at the time X undertook the development of the software, software satisfying X's requirements was not commercially available for use by X.

Example 12. (i) *Facts*. (A) X, a corporation, wants to protect its internal documents without building a large public key infrastructure. In addition, X needs to implement a new highly secure encryption algorithm that has a "back-door" such that X can decrypt and read any document, even when the employee is on vacation or leaves the company. X wants to develop a new encryption algorithm that is both secure, easy to use, and difficult to break. Current commercial encryption/decryption products are too slow for high-level secure encryption processing. Furthermore, no commercial product exists that provides the capability of having a secure back-door key to decrypt files when the owner is unavailable.

(B) The development of the encryption/decryption software requires specialized knowledge of cryptography and computational methods. Due to the secret nature of X's work, the encryption algorithm has to be unbreakable, yet recoverable should the employee forget his key. X commits substantial resources to the development of the system and, because of technical risk, cannot estimate whether it will recover its investment within a reasonable period.

(ii) *Conclusion*. X's back-door file encryption software is developed primarily for internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's back-door file encryption software was developed to be used by X to serve X's general and administrative functions. X's encryption software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section because, at the time the research is undertaken, X's software is designed to provide encryption and back-door decryption capabilities that are unique in that no other product has these capabilities, which indicates the software encryption system differs in a significant way from prior software implementations. Further, the encryption and back-door decryption capabilities indicate that the software differs in a significant and inventive way from prior software implementations. In addition, X's development activities involved significant economic risk in that X committed substantial resources to the development and there was substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the software, software satisfying X's requirements was not commercially available for use by X.

Example 13. (i) *Facts*. X, a large regional telephone company, is experiencing rapidly increasing customer demand. X would like to determine whether evolutionary algorithms such as genetic algorithms may improve its ability to design cost-effective networks and extend existing networks. X would also like to determine whether such adaptive algorithms may be used to optimize the routing of call traffic across existing networks in order to use efficiently the resources available without causing congestion. X first explores the use of evolutionary algorithms for the call routing task, because X determines that this type of complex, unpredictable problem is most appropriate for an adaptive algorithm solution. X develops and tests genetic algorithms until it determines that it has developed a software system it can test on a pilot basis on its existing networks. X commits substantial resources to the project, and cannot predict, because of technical risk, whether it will recover its resources within a reasonable period. Finally, at the time X undertook the development of the software, software satisfying X's requirements was not commercially available for use by X.

(ii) *Conclusion*. X's software is developed primarily for internal use because the software is not developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties. X's computer software is intended to be used by X in providing non-computer services to its customers. X's software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section because the software is intended to be novel and is intended to differ in a significant and inventive way from other existing software implementations. In addition, X's development activities involved significant economic risk in that X committed substantial resources to the development and there was substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the software, software satisfying X's requirements was not commercially available.

(ix) *Effective date*. This paragraph (c)(6) is applicable for taxable years beginning after December 31, 1985.

(7) *Activities outside the United States, Puerto Rico, and other possessions*—(i) *In general*. Research conducted outside the United States, as defined in section 7701(a)(9), the Commonwealth of Puerto Rico and other possessions of the United States does not constitute qualified research.

(ii) *Apportionment of in-house research expenses*. In-house research expenses paid or incurred for qualified services performed both in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States must be apportioned between the services performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and the services performed outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States. Only those in-house research expenses apportioned to the services performed within the United States, the Commonwealth of Puerto Rico and other possessions of the United States are eligible to be treated as qualified research expenses, unless the in-house research expenses are wages and the 80 percent rule of § 1.41–2(d)(2) applies.

(iii) *Apportionment of contract research expenses*. If contract research is performed partly in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and partly outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States, only 65 percent (or 75 percent in the case of amounts paid to qualified research consortia) of the portion of the contract amount that is attributable to the research activity performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States may qualify as a contract research expense (even if 80 percent or more of the contract amount is for research performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States).

(8) *Research in the social sciences, etc*. Qualified research does not include research in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities.

(9) *Research funded by any grant, contract, or otherwise*. Qualified research does not include any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity). To determine the extent to which research is so funded, § 1.41–4A(d) applies.

(10) *Illustrations*. The following examples illustrate provisions contained in paragraphs (c)(1) through (9) (excepting (c)(6)) of this section. No inference should be drawn from these examples concerning the application of section 41(d)(1) and paragraph (a) of this section to these facts. The examples are as follows:

Example 1. (i) *Facts*. X, a tire manufacturer, develops a new material to use in its tires. X conducts research to determine the changes that will be necessary for X to modify its existing manufacturing processes to manufacture the new tire. X determines that the new material retains heat for a longer period of time than the materials X currently uses and, as a result, adheres to the manufacturing equipment during tread cooling. X evaluates numerous options for processing the treads at cooler temperatures. X designs, develops, and conducts sophisticated tests on the numerous options for a new type of belt to be used in tread cooling. X then manufactures a set of belts for its production equipment, installs the belts, and tests the belts to make sure they were manufactured correctly.

(ii) *Conclusion*. X's research with respect to the design of the new belts to be used in its manufacturing of the new tire may be qualified research under section 41(d)(1) and paragraph (a) of this section. However, X's expenses to implement the design, including the costs to manufacture, install, and test the belts were incurred after the belts met the taxpayer's functional and economic requirements and are excluded as research after commercial production under section 41(d)(4)(A) and paragraph (c)(2) of this section. In addition, amounts expended on component materials of the production belts and the costs of labor or other elements involved in the manufacture and installation of the production belts are not qualified research expenses. These expenses are not for expenditures that may be treated as expenses under section 174 and thus are not qualified research under section 41(d)(1)(A) and paragraph (a)(2)(i) of this section. See section 174(c) and § 1.174–2(b). Further, testing or inspection to determine whether the production belts were manufactured correctly is quality control testing under § 1.174–2(a)(4) and thus is not qualified research under section 41(d)(1)(A) and paragraph (a)(2)(i) of this section.

Example 2. (i) *Facts*. For several years, X has manufactured and sold a particular kind of widget. X initiates a new research project to develop a new or improved widget.

(ii) *Conclusion*. X's activities to develop a new or improved widget are not excluded from the definition of qualified research under section 41(d)(4)(A) and paragraph (c)(2) of this section. X's activities relating to the development of a new or improved widget constitute a new research project to develop a new business component. X's research activities relating to the development of the new or improved widget, a new business component, are not considered to be activities conducted after the beginning of commercial production under section 41(d)(4)(A) and paragraph (c)(2) of this section.

Example 3. (i) *Facts*. X, a computer software development firm, owns all substantial rights in a general ledger accounting software core program that X markets and licenses to customers. X incurs expenditures in adapting the core software program to the requirements of C, one of X's customers.

(ii) *Conclusion*. Because X's activities represent activities to adapt an existing software program to a particular customer's requirement or need, X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section.

Example 4. (i) *Facts*. The facts are the same as in *example 3*, except that C pays X to adapt the core software program to C's requirements.

(ii) *Conclusion*. Because X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, C's payments to X are not for qualified research and are not considered to be contract research expenses under section 41(b)(3)(A).

Example 5. (i) *Facts*. The facts are the same as in *example 3*, except that C's own employees adapt the core software program to C's requirements.

(ii) *Conclusion*. Because C's employees' activities to adapt the core software program to C's requirements are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, the wages C paid to its employees do not constitute in-house research expenses under section 41(b)(2)(A).

Example 6. (i) *Facts*. X manufacturers and sells rail cars. Because rail cars have numerous specifications related to performance, reliability and quality, rail car designs are subject to extensive, complex testing in the scientific or laboratory sense. B orders passenger rail cars from X. B's rail car requirements differ from those of X's other customers in that B wants fewer seats in its passenger cars and a higher quality seating material and carpet. X manufactures rail cars meeting B's requirements. X does not conduct complex testing in the scientific or laboratory sense on the rail cars manufactured for B.

(ii) *Conclusion*. X's activities to manufacture rail cars for B are excluded from the definition of qualified research. The rail cars designed for B were not subject to the type of complex testing that is indicative of a process of experimentation. Further, the rail car sold to B was not a new business component, but merely an adaptation of an existing business component. Thus, X's activities to manufacture rail cars for B are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section because X's activities represent activities to adapt an existing business component to a particular customer's requirement or need.

Example 7. (i) *Facts*. X, a manufacturer, undertakes to create a manufacturing process for a new valve design. X determines that it requires a specialized type of robotic equipment to use in the manufacturing process for its new valves. X is unable to locate robotic equipment that meets X's precise specifications, and, therefore, purchases the existing robotic equipment for the purpose of modifying it to meet its needs. X's engineers conduct experiments using modeling and simulation in modifying the robotic equipment and conduct extensive scientific and laboratory testing of design alternatives. As a result of this process, X's engineers develop a design for the robotic equipment that meets X's specifications. X constructs and installs the modified robotic equipment on its manufacturing process.

(ii) *Conclusion*. X's research activities to determine how to modify X's robotic equipment for its manufacturing process are not excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section.

Example 8. (i) *Facts*. An existing gasoline additive is manufactured by Y using three ingredients, A, B, and C. X seeks to develop and manufacture its own gasoline additive that appears and functions in a manner similar to Y's additive. To develop its own additive, X first inspects the composition of Y's additive, and uses knowledge gained from the inspection to reproduce A and B in the laboratory. Any differences between ingredients A and B that are used in Y's additive and those reproduced by X are insignificant and are not material to the viability, effectiveness, or cost of A and B. X desires to use with A and B an ingredient that has a materially lower cost than ingredient C. Accordingly, X engages in a process of experimentation to develop, analyze and test potential alternative formulations of the additive.

(ii) *Conclusion*. X's activities in analyzing and reproducing ingredients A and B involve duplication of existing business components and are excluded from the definition of qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section. X's experimentation activities to develop potential alternative formulations of the additive do not involve duplication of an existing business component and are not excluded from the definition of qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section.

Example 9. (i) *Facts*. X, a manufacturing corporation, undertakes to restructure its manufacturing organization. X organizes a team to design an organizational structure that will improve X's business operations. The team includes X's employees as well as outside management consultants. The team studies current operations, interviews X's employees, and studies the structure of other manufacturing facilities to determine appropriate modifications to X's current business operations. The team develops a recommendation of proposed modifications which it presents to X's management. X's management approves the team's recommendation and begins to implement the proposed modifications.

(ii) *Conclusion*. X's activities in developing and implementing the new management structure are excluded from the definition of qualified research under section 41(d)(4)(D) and paragraph (c)(5) of this section. Qualified research does not include activities relating to management functions or techniques including management organization plans and management-based changes in production processes.

Example 10. (i) *Facts*. X, an insurance company, develops a new life insurance product. In the course of developing the product, X engages in research with respect to the effect of pricing and tax consequences on demand for the product, the expected volatility of interest rates, and the expected mortality rates (based on published data and prior insurance claims).

(ii) *Conclusion*. X's activities related to the new product represent research in the social sciences (including economics and business management) and are thus excluded from the definition of qualified research under section 41(d)(4)(G) and paragraph (c)(8) of this section.

(d) *Recordkeeping for the research credit*. A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see § 1.6001–1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits.

(e) *Effective dates*. In general, the rules of this section are applicable for taxable years ending on or after December 26, 2001.

Par. 5. Section 1.41–8 is amended by:

1. Revising the section heading.

2. Revising paragraph (b)(4).

The revisions read as follows:

§ 1.41–8 Special rules for taxable years ending on or after December 26, 2001.

* * * * *

(b) * * *

(4) *Effective date*. Paragraphs (b)(2) and (3) of this section are applicable for taxable years ending on or after December 26, 2001.

Charles O. Rossotti,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 21, 2001, 8:45 a.m., and published in the issue of the Federal Register for December 26, 2001, 66 F.R. 66362)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Certain Transfers of Property to Regulated Investment Companies and Real Estate Investment Trusts

REG–142299–01, REG–209135–88

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that apply to certain transactions or events that result in a Regulated Investment Company [RIC] or

Real Estate Investment Trust [REIT] owning property that has a basis determined by reference to a C corporation's basis in the property. The text of the temporary regulations published in this issue of the Bulletin serves as the text of this proposed regulation.

DATES: Written or electronic comments must be received by April 2, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU [REG–142299–01], 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:ITA:RU [REG–142299–01], Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. or sent to the IRS Internet site at: *http://www.irs.gov/tax_regs/reglist.html*.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Lisa A. Fuller (202) 622–7750; concerning submissions of comments, Donna Poindexter (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 **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR: MP:FP:S:O, Washington, DC 20224. Comments on the collection of information should be received by March 4, 2002. 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)–6T and 1.337(d)–7T. This information is necessary for the IRS to determine whether section 1374 treatment or deemed sale 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 section 1374 treatment in lieu of deemed sale treatment in § 1.337(d)–6T, or to elect deemed sale treatment in lieu of section 1374 treatment in § 1.337(d)–7T. The likely respondents for deemed sale elections are C corporations. The likely respondents for section 1374 elections are RICs and REITs.

Section 1.337(d)–6T provides that a section 1374 election is made by filing a statement and attaching it to any Federal income tax return filed by the RIC or REIT on or before March 15, 2003, provided that the RIC or REIT has reported consistently with such election for all periods. Alternatively, a RIC or REIT can also make a section 1374 election by informing the IRS prior to January 2, 2002, of its intent to make a section 1374 election. Section 1.337(d)–7T provides that a deemed sale election is made by filing a statement and attaching it to the C corporation's Federal income tax return for the taxable year in which the deemed sale occurs.

Estimated total annual reporting burden: 70 hours.

Estimated average annual burden per respondent: 30 minutes.

Estimated number of respondents: 140.

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. 6103.

Background

Temporary regulations (T.D. 8975) in this issue of the Bulletin revise and add the Income Tax Regulations (26 CFR part 1) relating to section 337(d). The temporary regulations generally provide that, if property owned by a C corporation or property subject to section 1374 owned by a RIC, a REIT, or an S corporation becomes the property of a RIC or REIT by (1) the qualification of the C corporation as a RIC or REIT, or (2) certain transfers of property to a RIC or REIT, then the RIC or REIT will be subject either to section 1374 treatment or the C corporation will be subject to deemed sale treatment. 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 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. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the 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) or electronic comments 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 may be scheduled. When 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 Lisa A. Fuller of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury and the IRS 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

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

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

Section 1.337(d)–6 also issued under 26 U.S.C. 337.

Section 1.337(d)–7 also issued under 26 U.S.C. 337. * * *

Par. 2. Sections 1.337(d)–6 and 1.337(d)–7 are added to read as follows:

§ 1.337(d)–6 New transitional rules imposing tax on property owned by a C corporation that becomes property of a RIC or REIT.

[The text of proposed § 1.337(d)–6 is the same as the text of § 1.337(d)–6T published elsewhere in this issue of the **Federal Register**.]

§ 1.337(d)–7 Tax on property owned by a C corporation that becomes property of a RIC or REIT.

[The text of proposed §1.337(d)–7 is the same as the text of §1.337(d)–7T published elsewhere in this issue of the **Federal Register**.]

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 31, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2002, 67 F.R. 48)

Inflation Adjusted Items for 2001

Announcement 2002–5

This announcement reflects the correction of an error in Rev. Proc. 2001–13 (2001–3 I.R.B. 337) which sets forth inflation adjusted items for 2001. In section 2.15, regarding expatriation to avoid tax, the average annual net income tax figure of $115,000 is changed to $116,000, and the net worth figure of $579,000 is changed to $580,000.

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 Contributions 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.—Intemal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.