

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 96-19, page 24.

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

T.D. 8657, page 4.

INTL-0054-95, page 39.

Final, temporary, and proposed regulations under sections 864 and 884 of the Code relating to the determination of effectively connected income and the branch profits tax. A public hearing on the proposed regulations will be held on June 6, 1996.

T.D. 8658, page 13.

INTL-0054-95, page 39.

Final and proposed regulations under section 882 of the Code relating to the determination of the interest expense deduction of foreign corporations engaged in a trade or business within the United States.

ADMINISTRATIVE

Notice 96-18, page 27.

Interest netting study. This notice invites public comment in connection with the Internal Revenue Service and Treasury study of interest netting. This study was initially described in Announcement 96-5, 1996-4 I.R.B. 99 (Jan. 22, 1996).

Notice 96-19, page 28.

Joint return study. This notice invites public comment in connection with the Internal Revenue Service and Treasury study of certain joint return and community property issues, particularly as they affect divorced or

separated taxpayers. This study was initially described in Announcement 96-5, 1996-4 I.R.B. 99 (Jan. 22, 1996).

Notice 96-20, page 30.

Rev. Proc. 96-11, 1996-2 I.R.B. 18 relating to Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Magnetically or Electronically, is corrected.

Notice 96-21, page 30.

T.D. 8636, 1996-4 I.R.B. 64, relating to the time for furnishing wage statements to employees and for filing wage statements with the Social Security Administration on termination of an employer's operations, is corrected.

Notice 96-22, page 30.

T.D. 8630, 1996-3 I.R.B. 19, relating to income, estate, and gift tax regulations regarding exceptions to the use of valuation tables, is corrected.

Rev. Proc. 96-28, page 31.

Per diem allowances. This procedure provides rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meals, and/or incidental expenses incurred while away from home will be deemed substantiated when a payor provides a reimbursement or other expense allowance to pay for such expenses. It also provides an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. Rev. Proc. 94-77 is superseded.

Finding Lists begins on page 46.

Announcement of Disbarments and Suspensions begins on page 43.

Quarterly Index for January, February and March begins on page 48.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the

quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

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

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

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

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

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and 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.

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

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

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

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

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

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62-2: Reimbursements and other expense allowance arrangements.

Rules are set forth under which a reimbursement or other expense allowance arrangement for the cost of lodging, meal, and/or incidental expenses incurred by an employee while traveling away from home will satisfy the requirements of § 62(c) of the Code as to substantiation of the amount of expenses. See Rev. Proc. 96-28, 1996-14 I.R.B. page 31.

Section 162.—Trade or Business Expense

26 CFR 1.162-17: Reporting and substantiation of certain business expenses of employees.

The rules for substantiating the amount of a deduction or expense for lodging, meal, and/or incidental expenses incurred while traveling away from home that most nearly represents current costs are set forth. See Rev. Proc. 96-28, 1996-14 I.R.B. page 31.

Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

26 CFR 1.267(a)-1: Deductions disallowed.

When a payor provides a per diem allowance to an employee who is a related party, the rules set forth for the deemed substantiation to the payor of the amount of the employee's ordinary and necessary business expenses for lodging, meal, and/or incidental expenses incurred while traveling away from home do not apply. See Rev. Proc. 96-28, 1996-14 I.R.B. page 31.

Section 274.—Disallowance of Certain Entertainment, etc., Expenses

26 CFR 1.274(d)-1(a): Substantiation requirements.

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meal, and/or incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such

expenses. See Rev. Proc. 96-28, 1996-14 I.R.B. page 31.

26 CFR 1.274-5T: Substantiation requirements (temporary).

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meal, and/or incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Rules are also set forth for an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. See Rev. Proc. 96-28, 1996-14 I.R.B. page 31.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

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

The adjusted federal long-term rate is set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

Section 864.—Definitions and Special Rules

26 CFR 1.864-4: U.S. source income effectively connected with U.S. business.

T.D. 8657

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

Regulations on Effectively Connected Income and the Branch Profits Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the determination of effectively connected income under section 864 and final and temporary Income Tax Regulations relating to the branch profits tax and branch-level interest tax under section 884 of the Internal Revenue Code of 1986 (Code). Section 884 was added to the Code by section 1241 of the Tax Reform Act of 1986. This document also contains conforming changes to sections 861, 871 and 897.

EFFECTIVE DATE: June 6, 1996.

FOR FURTHER INFORMATION CONTACT: Gwendolyn A. Stanley, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1070.

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

The estimated annual burden per respondent is .25 hours.

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

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

Background

On September 2, 1988, proposed and temporary regulations (TD 8223 and INTL-934-86 [1988-2 C.B. 825]) under section 884 were published in the Federal Register (53 FR 34045). Written comments were received on the proposed amendments. On September 11, 1992, temporary regulations under § 1.884-2T were amended and final regulations (1992 final regulations) (TD 8432 [1992-2 C.B. 157]) under section 884 of the Code were published in the Federal Register (57 FR 41644). Proposed amendments (1992 proposed regulations) (INTL-0003-92 [1992-2 C.B.

752]) to the Income Tax Regulations (26 CFR part 1) under sections 864 and 884 of the Internal Revenue Code were published in the Federal Register (57 FR 41707) on the same day. Written comments were received on the proposed amendments. After consideration of all the comments, § 1.884-2(a)(2)(ii) and § 1.884-2(c)(2)(iii) of the 1988 proposed regulations and the 1992 proposed regulations are adopted as final regulations as amended by this Treasury decision. The revisions and conforming changes are discussed below.

Explanation of the Provisions

I. Section 864 stock rule.

The proposed regulations under section 864 provided that stock of a corporation shall not be treated as an asset used in, or held for use in, the conduct of a U.S. trade or business. Accordingly, the regulations proposed to delete the example of stock acquired and held to assure a constant source of supply as an asset that satisfies the asset-use test under § 1.864-4(c)(2). Commenters criticized this rule and cited to the legislative history to the Foreign Investors Tax Act of 1966 as contemplating that stock may satisfy the asset-use test. The IRS and Treasury continue to believe, however, that stock does not satisfy the asset-use test. Therefore § 1.864-4(c)(2)(iii) adopts the rule contained in the proposed regulations.

In response to our request for comments on whether insurance companies require an exception to the stock rule for their portfolio stock, one commenter suggested that foreign life insurance companies be permitted to refer to the National Association of Insurance Commissioners (NAIC) Annual Statement to determine whether their assets are used in, or held for use in, the conduct of a U.S. trade or business. The IRS and Treasury will continue to consider whether modifications to the regulations under section 864 are appropriate for foreign insurance companies and reserve on the treatment of stock held by a foreign insurance company.

Conforming changes have been made to regulations under section 864, as well as regulations under sections 871 and 897 to reflect the clarification of § 1.864-4(c)(2). The effective date of

the changes to sections 871 and 897 corresponds to the effective date of the changes to section 864.

II. Branch profits tax.

A. Interest in a partnership. Currently, a foreign corporation engaged in a U.S. trade or business through a partnership applies different rules to determine its U.S. assets depending on whether the determination is for purposes of section 884 or § 1.882-5. For purposes of computing its interest expense under § 1.882-5, the rules of § 1.861-9T(e)(7) apply. Therefore a foreign corporation takes into account either its pro rata share of partnership assets and liabilities or applies the rules of § 1.882-5 as if the partnership were a foreign corporation, depending on the nature of its interest in the partnership. In contrast, for purposes of section 884, a foreign corporation generally takes into account its adjusted basis in its partnership interest as a starting point for determining its U.S. assets.

Final regulations under section 882 published elsewhere in this issue of the Federal Register remove the temporary regulations under § 1.861-9T(e)(7)(i). These final regulations provide a new U.S. asset rule for partnership interests for purposes of determining the U.S. assets of a foreign corporate partner under sections 882 and 884. The final regulations under § 1.882-5 contain a corresponding rule to determine the value of a partnership interest held by a foreign corporation for purposes of computing its worldwide assets.

In the event that a partnership derives any income that is not effectively connected with a U.S. trade or business, or otherwise holds non-U.S. assets, the rules in § 1.884-1(d)(3) continue to provide a rule that allocates the basis in the partnership interest between U.S. and non-U.S. assets. However, the allocation rule is more flexible than the rule contained in either the 1992 final regulations or the proposed regulations under section 884. The rule allows a foreign corporation to use either an income method or an asset method to determine the proportionate share of its partnership interest that is a U.S. asset, regardless of its ownership interest in the partnership. This is a change from the previous 1992 final regulations, which required all foreign corporate partners to use an income method, and from the 1992

proposed regulations, which required more than 10% partners to use the asset method.

Based on commenters' suggestions, other clarifying changes have been made to the asset method. For example, the final regulations clarify that the adjusted bases of partnership assets reflect any adjustment under section 754 with respect to a foreign corporate partner.

B. Interest in a trust or estate. The rules applicable to interests in a trust or estate in § 1.884-1(d)(4) are finalized as proposed.

C. Nonrecourse indebtedness and integrated financial transactions. Because the final regulations under § 1.882-5 incorporate the special allocation rules of § 1.861-10T, certain changes to the final regulations under § 1.884-1(e) are needed to maintain the proper U.S. net equity of a foreign corporation that elects to directly allocate any portion of its interest expense. These regulations include a conforming change that provides that liabilities giving rise to such interest will be considered U.S. liabilities for purposes of section 884, notwithstanding that such liabilities are not taken into account in Step 2 of § 1.882-5.

In addition, a new provision has been added in § 1.884-4(b) so that branch interest continues to include interest paid with respect to liabilities that are subject to the special allocation rules, notwithstanding that such liabilities are not considered U.S. booked liabilities for purposes of Step 3 of the § 1.882-5 calculation.

D. Structural changes to conform branch interest rules to final regulations under § 1.882-5. These regulations adopt the changes made by the 1992 proposed regulations under § 1.884-4(b), and thus incorporate the rules in § 1.882-5(d)(2) (relating to U.S. booked liabilities) in defining the term branch interest of a foreign corporation. Although certain changes were made to the definition of U.S. booked liabilities in the final regulations under § 1.882-5, the manner in which a foreign corporation computes its branch interest and excess interest remains substantially unchanged.

E. Excess interest—definition of a foreign bank. A foreign corporation

that is a foreign bank may treat a minimum of 85% of its excess interest as interest on deposits, regardless of its actual ratio of deposits to interest bearing liabilities. The IRS and Treasury believe this rule should be applicable only to a foreign bank engaging in substantial deposit-taking activities, taking into account its activities in the United States as well as other countries in which it operates. The definition used in the 1992 final regulations did not clearly convey this limitation. Thus, § 1.884-4(a)(2)(iii) now defines a foreign bank by reference to section 585(a)(2)(B) of the Code, but also requires that a substantial part of its business consists of receiving deposits and making loans and discounts.

III. Complete termination rules.

The rules in § 1.884-2T(a)(5), applicable to a foreign corporation whose beneficial interest in a trust terminates, are finalized as proposed by the 1992 regulations. In addition the waiver provisions contained in § 1.884-2 of the 1988 proposed regulations are finalized as amended by this Treasury decision.

Special Analyses

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

Drafting Information

The principal author of these regulations is Gwendolyn A. Stanley, Office of Associate Chief Counsel (International), within the Office of Chief Counsel, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of amendments to the Regulations

Accordingly, 26 CFR parts 1 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 as follows:

Authority: 26 U.S.C. 7805.

Section 1.884-2 also issued under 26 U.S.C. 884(g)

Par. 2. Section 1.864-4 is amended as follows:

1. The third sentence in paragraph (c)(2)(i) is revised.

2. Paragraph (c)(2)(ii) is revised.

3. Paragraphs (c)(2)(iii) and (c)(2)(iv) are redesignated as (c)(2)(iv) and (c)(2)(v) respectively.

4. New paragraph (c)(2)(iii) is added.

5. Newly designated paragraph (c)(2)(v) is amended by:

a. Revising the introductory text.

b. Removing *Example (2)* through *Example (4)*.

c. Redesignating “*Example (5)*” as “*Example (2)*”.

d. Amending newly designated *Example (2)* by:

i. Revising the fifth and sixth sentences.

ii. Removing the date “1968” and adding the date “1997” where it appears in the second, third, and eighth sentences.

6. The last sentence of paragraph (c)(6)(i) is removed.

7. Paragraph (c)(7) is added.

The additions and revisions read as follows:

§ 1.864-4 U.S. source income effectively connected with U.S. business.

* * * * *

(c) * * *

(2) * * *

(i) * * * The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the

business of manufacturing or selling goods in the United States. * * *

(ii) *Cases where applicable.* Ordinarily, an asset shall be treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is—

(a) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or

(b) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or

(c) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

(iii) *Application of asset-use test to stock—(a) In general.* Except as provided in paragraph (c)(2)(iii)(b) of this section, stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use in, the conduct of a trade or business in the United States.

(b) *Stock held by foreign insurance companies.* [Reserved] * * * * *

(v) *Illustration.* The application of paragraph (iv) may be illustrated by the following examples:

* * * * *

Example (2). * * * During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(b) of this section to be held in a direct relationship to that business. * * *

* * * * *

(7) *Effective date.* Paragraphs (c)(2) and (c)(6)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

* * * * *

Par. 3. In § 1.871–12, paragraph (d) is amended by:

1. Revising the paragraph heading and introductory text.

- 2. Removing *Example 1*.
- 3. Removing the designation “(2)” in *Example (2)*.

The revision reads as follows:

§ 1.871–12 *Determination of tax on treaty income.*

* * * * *

(d) *Illustration.* The application of this section may be illustrated by the following example:

* * * * *

Par. 4. Section 1.884–0(b) is amended by revising the entries for §§ 1.884–1(d)(4), 1.884–2T(a)(5), 1.884–4(b)(1), and 1.884–4(b)(2) and adding entries for §§ 1.884–1(i)(4), 1.884–2T(a)(6), 1.884–4(e)(1) and 1.884–4(e)(2) to read as follows:

§ 1.884–0 *Overview of regulation provisions for section 884.*

* * * * *

- (b) * * *

§ 1.884–1 *Branch profits tax.*

* * * * *

- (d) * * *
- (4) Interest in a trust or estate.

* * * * *

- (i) * * *
- (4) Special rule for certain U.S. assets and liabilities.

§ 1.884–2T *Special Rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (temporary).*

- (a) * * *
- (5) Special rule if a foreign corporation terminates an interest in a trust. [Reserved]

(6) Coordination with second-level withholding tax.

* * * * *

§ 1.884–4 *Branch-level interest tax.*

* * * * *

- (b) * * *

- (1) Definition of branch interest.
- (2) [Reserved]
- (3) * * *
- (4) [Reserved]

* * * * *

- (e) * * *
- (1) General rule.
- (2) Special rule.

* * * * *

Par. 5. Section 1.884–1 is amended as follows:

1. Paragraph (c)(2) is amended as follows:

a. The text of paragraph (c)(2) is redesignated as paragraph (c)(2)(i) and a paragraph heading for (c)(2)(i) is added.

b. New paragraph (c)(2)(ii) is added.

2. In paragraph (d)(2)(xi), *Example 2* through *Example 4* are redesignated *Example 3* through *Example 5*, respectively, and new *Example 2* is added.

3. Paragraph (d)(3) is revised.

4. The text of paragraph (d)(4) is added.

5. Paragraph (d)(5)(iii) is revised.

6. In Paragraph (d)(6)(iii) the reference to “(d)(3)(iv)” is removed and “(d)(3)(vi)” is added in its place.

7. Paragraph (d)(6)(v) is redesignated as paragraph (d)(6)(vi).

8. New paragraph (d)(6)(v) is added and reserved.

9. Paragraph (e)(2) is amended as follows:

a. The paragraph heading and text of paragraph (e)(2) are redesignated as paragraph (e)(2)(i).

b. In newly designated paragraph (e)(2)(i) the language “(e)(2)” is removed and “(e)(2)(i)” is added in its place.

c. A new paragraph heading for paragraph (e)(2) is added.

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

10. Paragraph (e)(3)(ii) is revised.

11. Paragraph (e)(5) is amended as follows:

a. The second sentence in *Example 1* is revised.

b. In the list below, for each sentence in *Example 1* indicated in the left column, remove the language in the middle column and add the language in the right column:

| <i>sentence</i> | <i>Remove</i> | <i>Add</i> |
|---------------------------|-----------------|-----------------|
| first and third sentence | 1993 | 1997 |
| first sentence | § 1.882-5(b) | § 1.882-5(c) |
| fourth and fifth sentence | § 1.882-5(b)(2) | § 1.882-5(c)(2) |
| seventh sentence | amount | value |
| seventh sentence | § 1.882-5(b)(1) | § 1.882-5(b)(2) |

c. The second sentence in paragraph (i) of *Example 2* is revised.

d. In the list below, for each paragraph in *Example 2* indicated in the left column, remove the language in the middle column and add the language in the right column:

| <i>Paragraph</i> | <i>Remove</i> | <i>Add</i> |
|--|---------------|------------|
| (i) first sentence | 1993 | 1997 |
| (i) third and fifth sentence | 1994 | 1998 |
| (ii) first, second, and third sentence | 1995 | 1999 |
| (ii) second sentence | 1994 | 1998 |
| (iii) first sentence | 1995 | 1999 |
| (iii) last sentence | 1994 | 1998 |

12. Paragraph (i)(4) is added.

The additions and revisions read as follows:

§ 1.884-1 *Branch profits tax.*

* * * * *

(c) * * *

(2) * * * (i) *In general.* * * *

(ii) *Bad debt reserves.* A bank described in section 585(a)(2)(B) (without regard to the second sentence thereof) that uses the reserve method of accounting for bad debts for U.S. federal income tax purposes shall decrease the amount of loans that qualify as U.S. assets by any reserve that is permitted under section 585.

(d) * * *

(2) * * *

(xi) * * *

Example 2. U.S. real property interest connected to a U.S. business. FC is a foreign corporation that is a bank, within the meaning of section 585(a)(2)(B) (without regard to the second sentence thereof), and is engaged in the business of taking deposits and making loans through its branch in the United States. In 1996, FC makes a loan in the ordinary course of its lending business in the United States, securing the loan with a mortgage on the U.S. real property being financed by the borrower. In 1997, after the borrower has defaulted on the loan, FC takes title to the real property that secures the loan. On December 31, 1997, FC continues to hold the property, classifying it on its financial statement as *Other Real Estate Owned*. Because all income and gain from the property would be ECI to FC under the principles of section 864(c)(2), the U.S. real property constitutes a U.S. asset within the meaning of paragraph (d) of this section.

* * * * *

(3) *Interest in a partnership*—(i) *In general.* A foreign corporation that is a partner in a partnership must take into account its interest in the partnership (and not the partnership assets) in determining its U.S. assets. For purposes of determining the proportion of the partnership interest that is a U.S. asset, a foreign corporation may elect to use either the asset method described in paragraph (d)(3)(ii) of this section or the income method described in paragraph (d)(3)(iii) of this section.

(ii) *Asset method*—(A) *In general.* A partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date, to the extent that the assets would be treated as U.S. assets if the partnership were a foreign corporation, bears to the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date. Generally a partner's proportionate share of a partnership asset is the same as its proportionate share of all items of income, gain, loss, and deduction that may be generated by the asset.

(B) *Non-uniform proportionate shares.* If a partner's proportionate share of all items of income, gain, loss, and deduction that may be generated by a single asset of the partnership throughout the period that includes the taxable year of the partner is not uniform, then, for purposes of determining the partner's proportionate

share of the adjusted basis of that asset, a partner must take into account the portion of the adjusted basis of the asset that reflects the partner's economic interest in that asset. A partner's economic interest in an asset of the partnership must be determined by applying the following presumptions. These presumptions may, however, be rebutted if the partner or the Internal Revenue Service shows that the presumption is inconsistent with the partner's true economic interest in the asset during the corporation's taxable year.

(1) If a partnership asset ordinarily generates directly identifiable income, a partner's economic interest in the asset is determined by reference to its proportionate share of income that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(2) If a partnership asset ordinarily generates current deductions and ordinarily generates no directly identifiable income, for example because the asset contributes equally to the generation of all the income of the partnership (such as an asset used in general and administrative functions), a partner's economic interest in the asset is determined by reference to its proportionate share of the total deductions that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.

(3) For other partnership assets not described in paragraph (d)(3)(ii)(B)(1) or (2) of this section, a partner's economic interest in the asset is deter-

mined by reference to its proportionate share of the total gain or loss to which it would be entitled if the asset were sold at a gain or loss in the partnership's taxable year ending with or within the partner's taxable year.

(C) *Partnership election under section 754.* If a partnership files an election in accordance with section 754, then for purposes of this paragraph (d)(3)(ii), the basis of partnership property shall reflect adjustments made pursuant to sections 734 (relating to distributions of property to a partner) and 743 (relating to the transfer of an interest in a partnership). However, adjustments made pursuant to section 743 may be made with respect to a transferee partner only.

(iii) *Income method.* Under the income method, a partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that its distributive share of partnership ECI for the partnership's taxable year that ends with or within the partner's taxable year bears to its distributive share of all partnership income for that taxable year.

(iv) *Manner of election—(A) In general.* In determining the proportion of a foreign corporation's interest in a partnership that is a U.S. asset, a foreign corporation must elect one of the methods described in paragraph (d)(3) of this section on a timely filed return for the first taxable year beginning on or after the effective date of this section. An amended return does not qualify for this purpose, nor shall the provisions of § 301.9100-1 of this chapter and any guidance promulgated thereunder apply. An election shall be made by the foreign corporation calculating its U.S. assets in accordance with the method elected. An elected method must be used for a minimum period of five years before the foreign corporation may elect a different method. To change an election before the end of the requisite five-year period, a foreign corporation must obtain the consent of the Commissioner or her delegate. The Commissioner or her delegate will generally consent to a foreign corporation's request to change its election only in rare and unusual circumstances. A foreign corporation that is a partner in more than one partnership is not required to elect to use the same method for each partnership interest.

(B) *Elections with tiered partnerships.* If a foreign corporation elects to

use the asset method with respect to an interest in a partnership, and that partnership is a partner in a lower-tier partnership, the foreign corporation may apply either the asset method or the income method to determine the proportion of the upper-tier partnership's interest in the lower-tier partnership that is a U.S. asset.

(v) *Failure to make proper election.* If a foreign corporation, for any reason, fails to make an election to use one of the methods required by paragraph (d)(3) of this section in a timely fashion, the district director or the Assistant Commissioner (International) may make the election on behalf of the foreign corporation and such election shall be binding as if made by that corporation.

(vi) *Special rule for determining a partner's adjusted basis in a partnership interest.* For purposes of paragraphs (d)(3) and (6) of this section, a partner's adjusted basis in a partnership interest shall be the partner's basis in such interest (determined under section 705) reduced by the partner's share of the liabilities of the partnership determined under section 752 and increased by a proportionate share of each liability of the partnership equal to the partner's proportionate share of the expense, for income tax purposes, attributable to such liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *E&P basis of a partnership interest.* See paragraph (d)(6)(iii) of this section for special rules governing the calculation of a foreign corporation's E&P basis in a partnership interest.

(viii) The application of this paragraph (d)(3) is illustrated by the following examples:

Example 1. General rule—(i) Facts. Foreign corporation, FC, is a partner in partnership ABC, which is engaged in a trade or business within the United States. FC and ABC are both calendar year taxpayers. ABC owns and manages two office buildings located in the United States, each with an adjusted basis of \$50. ABC also owns a non-U.S. asset with an adjusted basis of \$100. ABC has no liabilities. Under the partnership agreement, FC has a 50 percent interest in the capital of ABC and a 50 percent interest in all items of income, gain, loss, and deduction that may be generated by the partnership's assets. FC's adjusted basis in ABC is \$100. In determining the proportion of its interest in ABC that is a U.S. asset, FC elects to use the asset method described in paragraph (d)(3)(ii) of this section.

(ii) *Analysis.* FC's interest in ABC is treated as a U.S. asset in the same proportion that the

sum of FC's proportionate share of the adjusted bases of all ABC's U.S. assets (50% of \$100), bears to the sum of FC's proportionate share of the adjusted bases of all of ABC's assets (50% of \$200). Under the asset method, the amount of FC's interest in ABC that is a U.S. asset is \$50 ($\$100 \times \$50/\100).

Example 2. Special allocation of gain with respect to real property—(i) Facts. The facts are the same as in *Example 1*, except that under the partnership agreement, FC is allocated 20 percent of the income from the partnership property but 80 percent of the gain on disposition of the partnership property.

(ii) *Analysis.* Assuming that the buildings ordinarily generate directly identifiable income, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(1) of this section that FC's proportionate share of the adjusted basis of the buildings is FC's proportionate share of the income generated by the buildings (20%) rather than the total gain that it would be entitled to under the partnership agreement (80%) if the buildings were sold at a gain on the determination date. Thus, the sum of FC's proportionate share of the adjusted bases in ABC's U.S. assets (the buildings) is presumed to be \$20 [(20% of \$50) + (20% of \$50)]. Assuming that the non-U.S. asset is not income-producing and does not generate current deductions, there is a rebuttable presumption under paragraph (d)(3)(ii)(B)(3) of this section that FC's proportionate share of the adjusted basis of that asset is FC's interest in the gain on the disposition of the asset (80%) rather than its proportionate share of the income that may be generated by the asset (20%). Thus, FC's proportionate share of the adjusted basis of ABC's non-U.S. asset is presumed to be \$80 (80% of \$100). FC's proportionate share of the adjusted bases of all of the assets of ABC is \$100 (\$20 + \$80). The amount of FC's interest in ABC that is a U.S. asset is \$20 ($\$100 \times \$20/\100).

Example 3. Tiered partnerships (asset method)—(i) Facts. The facts are the same as in *Example 1*, except that FC's adjusted basis in ABC is \$175 and ABC also has a 50 percent interest in the capital of partnership DEF. DEF owns and operates a commercial shopping center in the United States with an adjusted basis of \$200 and also owns non-U.S. assets with an adjusted basis of \$100. DEF has no liabilities. ABC's adjusted basis in its interest in DEF is \$150 and ABC has a 50 percent interest in all the items of income, gain, loss and deduction that may be generated by the assets of DEF.

(ii) *Analysis.* Because FC has elected to use the asset method described in paragraph (d)(3)(ii) of this section, it must determine what proportion of ABC's partnership interest in DEF is a U.S. asset. As permitted by paragraph (d)(3)(iv)(B) of this section, FC also elects to use the asset method with respect to ABC's interest in DEF. ABC's interest in DEF is treated as a U.S. asset in the same proportion that the sum of ABC's proportionate share of the adjusted bases of all DEF's U.S. assets (50% of \$200), bears to the sum of ABC's proportionate share of the adjusted bases of all of DEF's assets (50% of \$300). Thus, the amount of ABC's interest in DEF that is a U.S. asset is \$100 ($\$150 \times \$100/\150). FC must then apply the rules of paragraph (d)(3)(ii) of this section to all the assets of ABC, including ABC's interest in DEF that is treated in part as a U.S. asset (\$100) and in part as a non-U.S. asset (\$50). FC's interest in ABC is treated as a U.S. asset in the same

proportion that the sum of FC's proportionate share of the adjusted bases of the U.S. assets of ABC (including ABC's interest in DEF), bears to the sum of FC's proportionate share of the adjusted bases of all ABC's assets (including ABC's interest in DEF). Thus, the amount of FC's interest in ABC that is a U.S. asset is \$100 (FC's adjusted basis in ABC (\$175) multiplied by FC's proportionate share of the sum of the adjusted bases of ABC's U.S. assets (\$100)) over FC's proportionate share of the sum of the adjusted bases of ABC's assets (\$175)).

Example 4. Tiered partnerships (income method)—(i) *Facts.* The facts are the same as in *Example 3*, except that FC has elected to use the income method described in paragraph (d)(3)(iii) of this section to determine the proportion of its interest in ABC that is a U.S. asset. The two office buildings located in the United States generate \$60 of income that is ECI for the taxable year. The non-U.S. asset is not-income producing. In addition ABC's distributive share of income from DEF consists of \$40 of income that is ECI and \$140 of income that is not ECI.

(ii) *Analysis.* Because FC has elected to use the income method it does need to determine what proportion of ABC's partnership interest in DEF is a U.S. asset. FC's interest in ABC is treated as a U.S. asset in the same proportion that its distributive share of ABC's income for the taxable year that is ECI (\$50) (\$30 earned directly by ABC + \$20 distributive share from DEF) bears to its distributive share of all ABC's income for the taxable year (\$55) (\$30 earned directly by ABC + \$25 distributive share from DEF). Thus, FC's interest in ABC that is a U.S. asset is \$159 (\$175 × \$50/\$55).

(4) *Interest in a trust or estate*—(i) *Estates and non-grantor trusts.* A foreign corporation that is a beneficiary of a trust or estate shall not be treated as having a U.S. asset by virtue of its interest in the trust or estate.

(ii) *Grantor trusts.* If, under sections 671 through 678, a foreign corporation is treated as owning a portion of a trust that includes all the income and gain that may be generated by a trust asset (or pro rata portion of a trust asset), the foreign corporation will be treated as owning the trust asset (or pro rata portion thereof) for purposes of determining its U.S. assets under this section.

(5) * * *

(iii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset.

(6) * * *

(v) *Computation of E&P basis of financial instruments.* [Reserved]

* * * * *

(e) * * *

(2) *Additional liabilities*—(i) * * *

(ii) *Liabilities described in § 1.882-5(a)(1)(ii).* The amount of liabilities

determined under this paragraph (e)(2)(ii) is the amount (as of the determination date) of liabilities described in § 1.882-5(a)(1)(ii) (relating to liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset).

(3) * * *

(ii) *Limitation.* For any taxable year, a foreign corporation may elect to reduce the amount of its liabilities determined under paragraph (e)(1) of this section by an amount that does not exceed the excess, if any, of the amount of liabilities in paragraph (e)(1) of this section over the amount, as of the determination date, of U.S. booked liabilities (determined under § 1.882-5(d)(2)) and liabilities described in paragraph (e)(2) of this section.

* * * * *

(5) * * *

Example 1. * * * For purposes of computing its U.S.-connected liabilities under § 1.882-5(c), A must determine the average total value of its assets that are U.S. assets. * * *

Example 2. * * * A has \$800 of liabilities under paragraph (e)(1) of this section and \$300 of liabilities properly reflected on the books of its U.S. trade or business under § 1.882-5(d)(2). * * *

* * * * *

(i) * * *

(4) *Special rules for certain U.S. assets and liabilities.* Paragraphs (c)(2)(i) and (ii), (d)(3), (d)(4), (d)(5)(iii), (d)(6)(iii), (d)(6)(vi), (e)(2), and (e)(3)(ii), of this section are effective for taxable years beginning on or after June 6, 1996.

Par. 6. § 1.884-2 is added to read as follows:

§ 1.884-2 *Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.*

(a) through (a)(2)(i) [Reserved] For further information, see § 1.884-2T(a) through (a)(2)(ii).

(a)(2)(ii) *Waiver of period of limitations.* The waiver referred to in § 1.884-2T(a)(2)(i)(D) shall be executed on Form 8848, or substitute form, and shall extend the period for assessment of the branch profits tax for the year of complete termination to a date not earlier than the close of the sixth taxable year following that tax-

able year. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign the income tax returns for the foreign corporation (including an agent authorized to do so under a general or specific power of attorney). The waiver must be filed on or before the date (including extensions) prescribed for filing the foreign corporation's income tax return for the year of complete termination. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996, a foreign corporation may also satisfy the requirements of this paragraph (a)(2)(ii) by applying § 1.884-2T(a)(2)(ii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (a)(2)(ii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d) of this chapter.

(a)(3) through (a)(4) [Reserved] For further information, see § 1.884-2T(a)(3) through (a)(4).

(a)(5) *Special rule if a foreign corporation terminates an interest in a trust.* A foreign corporation whose beneficial interest in a trust terminates (by disposition or otherwise) in any taxable year shall be subject to the branch profits tax on ECEP attributable to amounts (including distributions of accumulated income or gain) treated as ECI to such beneficiary in such taxable year notwithstanding any other provision of § 1.884-2T(a).

(b) through (c)(2)(ii) [Reserved] For further information, see § 1.884-2T(b) through (c)(2)(ii).

(c)(2)(iii) *Waiver of period of limitations and transferee agreement.* In the case of a transferee that is a domestic corporation, the provisions of § 1.884-2T(c)(2)(i) shall not apply unless, as part of the section 381(a) transaction, the transferee executes a Form 2045 (Transferee Agreement) and a waiver of period of limitations as described in this paragraph (c)(2)(iii), and files both documents with its timely filed (including extensions) income tax return for the taxable year in which the section 381(a) transaction occurs. The waiver shall be executed on Form 8848, or substitute form, and shall extend the

period for assessment of any additional branch profits tax for the taxable year in which the section 381(a) transaction occurs to a date not earlier than the close of the sixth taxable year following the taxable year in which such transaction occurs. This form shall include such information as is required by the form and accompanying instructions. The waiver must be signed by the person authorized to sign Form 2045. With respect to a complete termination occurring in a taxable year ending prior to June 6, 1996, a foreign corporation may also satisfy the requirements of this paragraph (c)(2)(iii) by applying § 1.884-2T(c)(2)(iii) of the temporary regulations (as contained in the CFR edition revised as of April 1, 1995). A properly executed Form 8848, substitute form, or other form of waiver authorized by this paragraph (c)(2)(iii) shall be deemed to be consented to and signed by a Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d) of this chapter.

(c)(3) through (f) [Reserved] For further information, see § 1.884-2T(c)(3) through (f).

(g) *Effective dates.* Paragraphs (a)(2)(ii) and (c)(2)(iii) of this section are effective for taxable years begin-

ning after December 31, 1986. Paragraph (a)(5) of this section is effective for taxable years beginning on or after June 6, 1996.

Par. 7. Section 1.884-2T is amended as follows:

1. Paragraph (a)(2)(ii) is revised.
2. Paragraph (a)(5) is redesignated as (a)(6).
3. New paragraph (a)(5) is added.
4. Paragraph (c)(2)(iii) is revised.

The additions and revisions read as follows:

§ 1.884-2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (Temporary).

(a) * * *

(2) * * *

(ii) *Waiver of period of limitations.* [Reserved] See § 1.884-2(a)(2)(ii) for rules relating to this paragraph.

* * * * *

(5) *Special rule if a foreign corporation terminates an interest in a trust.* [Reserved] See § 1.884-2(a)(5) for

rules relating to this paragraph.

* * * * *

(c) * * *

(2) * * *

(iii) *Waiver of period of limitations and transferee agreement.* [Reserved] See § 1.884-2(c)(2)(iii) for rules relating to this paragraph.

Par. 8. Section 1.884-4 is amended as follows:

1. In paragraph (a)(1), the fifth sentence is revised.

2. Paragraph (a)(2)(iii) is revised.

3. Paragraph (b)(1) is revised and paragraph (b)(2) is removed and reserved.

4. Paragraph (b)(3) is amended by:

a. Removing the reference “(b)(1)(v)” and adding the language “(b)(1)(ii)” in the following:

i. Paragraph (b)(3)(i), first sentence.

ii. Paragraph (b)(3)(ii), introductory text.

iii. Paragraph (b)(3)(iii), heading and introductory text.

b. Adding a sentence at the end of paragraph (b)(3)(i).

5. Paragraph (b)(4) is removed and reserved.

6. In the list below, for each paragraph indicated in the left column, remove the language in the middle column and add the language in the right column:

| <i>Paragraph</i> | <i>Remove</i> | <i>Add</i> |
|--|---|--------------------------|
| (a)(2)(i)(A) | apportioned | allocated or apportioned |
| (a)(4) <i>Example 1</i> first sentence | (b)(2) | (a)(2)(iii) |
| (a)(4) <i>Example 1</i> first and seventh sentence | apportioned | allocated or apportioned |
| (a)(4) <i>Example 1</i> first, second, and eighth sentence | 1993 | 1997 |
| (a)(4) <i>Example 2</i> first sentence | (b)(2) | (a)(2)(iii) |
| (a)(4) <i>Example 2</i> second and third sentence | 1993 | 1997 |
| (b)(5)(i) last sentence | apportioned | allocated or apportioned |
| (b)(5)(ii) <i>Example</i> first, fifth, and last sentence | apportioned | allocated or apportioned |
| (b)(6) paragraph heading | apportioned | allocated or apportioned |
| (b)(6)(i) first and last sentence | apportioned | allocated or apportioned |
| (b)(6)(i) second sentence | (b)(1)(v) | (b)(1)(ii) |
| (b)(6)(ii) first and second sentence | (b)(1)(v) | (b)(1)(ii) |
| (b)(6)(ii) first and second sentence | paragraphs (b)(1)(i) through (b)(i)(iv) | paragraph (b)(1)(i) |

| <i>Paragraph</i> | <i>Remove</i> | <i>Add</i> |
|--|---------------|--------------------------|
| (b)(6)(iv) <i>Example 1</i> introductory text, paragraphs (i), (iii), and (iv), flush language first, fourth, and seventh sentence | 1993 | 1997 |
| (b)(6)(iv) <i>Example 1</i> paragraph (ii) | 1992 | 1996 |
| (b)(6)(iv) <i>Example 1</i> flush language second, and sixth sentence | (b)(1)(v) | (b)(1)(ii) |
| (c)(1)(iv) <i>Example 1</i> first sentence | apportioned | allocated or apportioned |
| (c)(1)(iv) <i>Example 1</i> first, second, third, fifth, sixth, and seventh sentence | 1993 | 1997 |
| (c)(1)(iv) <i>Example 1</i> third, fourth, and seventh sentence | 1994 | 1998 |
| (c)(1)(iv) <i>Example 2</i> second sentence | apportioned | allocated or apportioned |
| (c)(1)(iv) <i>Example 2</i> first, second, third, and last sentence | 1993 | 1997 |
| (c)(1)(iv) <i>Example 2</i> second and last sentence | 1994 | 1998 |
| (c)(2)(i) first sentence | apportioned | allocated or apportioned |
| (c)(4) <i>Example</i> third, fourth, fifth, sixth, and eighth sentence | 1993 | 1997 |
| (c)(4) <i>Example</i> fifth sentence | allocated | allocated or apportioned |

7. Paragraph (e) is amended as follows:

a. The text of paragraph (e) is redesignated as paragraph (e)(1) and a paragraph heading for (e)(1) is added.

b. The first sentence of newly designated paragraph (e)(1) is revised.

8. Paragraph (e)(2) is added.

The revisions and additions read as follows:

§ 1.884-4 Branch-level interest tax.

(a) * * * (1) * * * For purposes of this section, a foreign corporation also shall be treated as engaged in trade or business in the United States if, at any time during the taxable year, it owns an asset taken into account under § 1.882-5(a)(1)(ii) or (b)(1) for purposes of determining the amount of the foreign corporation's interest expense allocated or apportioned to ECI. * * *

(2) * * *

(iii) *Treatment of a portion of the excess interest of banks as interest on deposits.* A portion of the excess interest of a foreign corporation that is a bank (as defined in section 585(a)(2)(B) without regard to the second sentence thereof) provided that a substantial part of its business in the United States, as well as all other countries in which it operates, consists of receiving deposits and making loans and discounts, shall be treated as interest on deposits (as described in

section 871(i)(3)), and shall be exempt from the tax imposed by section 881(a) as provided in such section. The portion of the excess interest of the foreign corporation that is treated as interest on deposits shall equal the product of the foreign corporation's excess interest and the greater of—

(A) The ratio of the amount of interest bearing deposits, within the meaning of section 871(i)(3)(A), of the foreign corporation as of the close of the taxable year to the amount of all interest bearing liabilities of the foreign corporation on such date; or

(B) 85 percent.

* * * * *

(b) *Branch interest—(1) Definition of branch interest.* For purposes of this section, the term “branch interest” means interest that is —

(i) Paid by a foreign corporation with respect to a liability that is—

(A) A U.S. booked liability within the meaning of § 1.882-5(d)(2) (other than a U.S. booked liability of a partner within the meaning of § 1.882-5(d)(2)(vii)); or

(B) Described in § 1.884-1(e)(2) (relating to insurance liabilities on U.S. business and liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset); or

(ii) In the case of a foreign corporation other than a corporation described

in paragraph (a)(2)(iii) of this section, a liability specifically identified (as provided in paragraph (b)(3)(i) of this section) as a liability of a U.S. trade or business of the foreign corporation on or before the earlier of the date on which the first payment of interest is made with respect to the liability or the due date (including extensions) of the foreign corporation's income tax return for the taxable year, provided that—

(A) The amount of such interest does not exceed 85 percent of the amount of interest of the foreign corporation that would be excess interest before taking into account interest treated as branch interest by reason of this paragraph (b)(1)(ii);

(B) The requirements of paragraph (b)(3)(ii) of this section (relating to notification of recipient of interest) are satisfied; and

(C) The liability is not described in paragraph (b)(3)(iii) of this section (relating to liabilities incurred in the ordinary course of a foreign business or secured by foreign assets) or paragraph (b)(1)(i) of this section.

(2) [Reserved]

(3)(i) * * * A foreign corporation that is subject to this section may identify a liability under paragraph (b)(1)(ii) of this section whether or not it is actually engaged in the conduct of a trade or business in the United States. * * *

* * * * *

(4) [Reserved]

* * * * *

(e) *Effective dates*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, this section is effective for taxable years beginning October 13, 1992, and for payments of interest described in section 884(f)(1)(A) made (or treated as made under paragraph (b)(7) of this section) during taxable years of the payor beginning after such date. * * *

(2) *Special rule.* Paragraphs (a)(1), (a)(2)(i)(A), (a)(2)(iii), (b)(1), (b)(3), (b)(5)(i), (b)(6)(i), (b)(6)(ii), and (c)(2)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

Par. 9. In section 1.884-5, paragraphs (e)(4)(ii) and (g) are revised to read as follows:

§ 1.884-5 *Qualified resident*

* * * * *

(e) * * *

(4) * * *

(ii) *Presumption for banks.* A U.S. trade or business of a foreign corporation that is described in § 1.884-4(a)(2)(iii) shall be presumed to be an integral part of an active banking business conducted by the foreign country in its country of residence provided that a substantial part of the business of the foreign corporation in both its country of residence and the United States consists of receiving deposits and making loans and discounts. This paragraph shall be effective for taxable years beginning on or after June 6, 1996.

* * * * *

(g) * * * Except as provided in paragraph (e)(4)(ii) of this section, this section is effective for taxable years beginning on or after October 13, 1992. * * *

* * * * *

Par. 10. Section 1.897-1 is amended as follows:

1. In paragraph (f)(1)(iii) the language “stock,” is removed.

2. Paragraph (f)(2)(i) is revised to read as follows:

§ 1.897-1 *Taxation of foreign investments in United States real property interests, definition of terms.*

* * * * *

(f) * * *

(2) * * *

(i) Held for the principal purpose of promoting the present conduct of the trade or business,

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

Par. 12. In § 602.101, the table in paragraph (c) is amended by adding in numerical order “§ 1.884-2 ... 1545-1070”.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved February 28, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 5, 1996, 8:45 a.m., and published in the issue of the Federal Register for March 8, 1996, 61 F.R. 9336)

Section 882.—Tax on Income of Foreign Corporations Connected With United States Business

26 CFR 1.882-5: *Determination of interest deduction.*

T.D. 8658

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Determination of Interest Expense Deduction of Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains Income Tax Regulations relating to the determination of the interest expense deduction of foreign corporations and applies to foreign corporations engaged in a trade or business within the United States. This action is necessary because

of changes to the applicable tax law made by the Tax Reform Act of 1986, and because of changes in international financial markets.

EFFECTIVE DATE: June 6, 1996.

FOR FURTHER INFORMATION CONTACT: Ahmad Pirasteh or Richard Hoge, (202) 622-3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On April 24, 1992, the IRS published proposed amendments (INTL-309-88, 1992-1 C.B. 1157) to the Income Tax Regulations (26 CFR parts 1) under section 882 of the Internal Revenue Code in the Federal Register (57 FR 15308). A public hearing was held on October 30, 1992. Numerous written comments were received. After consideration of all of the comments, the regulations proposed by INTL-309-88 are adopted as amended by this Treasury decision, and the prior regulations are withdrawn. The revisions are discussed below.

Discussion of Major Comments and Changes to the Regulations.

1. *Introduction.*

Section 882(c) of the Internal Revenue Code provides that a foreign corporation is allowed a deduction only to the extent that the expense is connected with income that is effectively connected with the conduct of a U.S. trade or business within the United States (ECI), and that the proper allocation is to be determined as provided in regulations. The proposed § 1.882-5 regulations that were issued in 1992 generally followed the approach adopted in the 1981 final regulations, with various changes intended to clarify and update the regulations.

The proposed regulations attracted a substantial number of comments, addressing both general and specific aspects of the regulations. In response to these comments, the Treasury Department and the IRS simplified the regulations, coordinated them more closely with other regulations, and generally responded to the concerns of

foreign corporations doing business in the United States. For example, U.S. assets are defined in the first step of the three-step formula to coincide closely with the definition of a U.S. asset used for purposes of section 884. The computation of the actual ratio in Step 2 has been simplified considerably, minimizing both the number and the frequency of required computations. In Step 3, consistent with the emphasis in the regulations on the use of actual ratios and rates rather than prescribed ones whenever possible, the final regulations allow taxpayers to use either their actual interest rate on U.S. dollar liabilities, or, if they elect, to use their actual rates on liabilities denominated in each of the currencies in which their U.S. assets are denominated. The Treasury and the IRS believe that the final regulations strike a reasonable balance between the concerns of foreign corporate taxpayers and the interests of the United States government.

2. § 1.882-5(a): Rules of general application.

Section 1.882-5(a) provides general rules for determining a foreign corporation's interest expense allocable to ECI. The final regulations specify that the provisions of § 1.882-5 constitute the exclusive rules for allocating interest expense to the income from the U.S. trade or business of all foreign corporations, including foreign corporations that are residents of countries with which the United States has an income tax treaty. In general, this requires all foreign corporations to use the three-step methodology described in the final regulations. In response to commenters' questions, however, § 1.882-5(a)(1)(ii) now provides that a foreign corporation that is engaged in a U.S. trade or business, either directly or through a partnership, and that satisfies certain requirements may allocate interest expense directly to income generated by a particular asset to the same extent that a U.S. corporation is permitted to directly allocate interest expense under the rules of § 1.861-10T. When a foreign corporation directly allocates interest expense under this rule, the final regulations require adjustments to all three steps of the calculation to avoid double counting of assets and liabilities.

Numerous commenters questioned whether a taxpayer that is entitled to the benefits of a U.S. income tax treaty

should be required to use the rules of § 1.882-5 for purposes of determining the amount of interest expense allocable to the foreign corporation's income attributable to its U.S. permanent establishment. The IRS and the Treasury Department believe that the methodology provided in these regulations is fully consistent with all of the United States's treaty obligations, including the Business Profits article of our tax treaties. Generally, the Business Profits article requires that, in determining the business profits of a permanent establishment, there shall be allowed as deductions expenses that are incurred for the purposes of the permanent establishment, including interest expense. Section 1.882-5(a)(2) of the final regulations is a reasonable method of implementing that general directive, as our treaties do not compel the use of any particular method.

Most of the other changes to the general rules of § 1.882-5(a) are clarifications in response to commenters' questions. For example, the final regulations clarify certain aspects of the rules that limit a foreign corporation's allocable interest expense to the amount actually paid or accrued by the corporation in a taxable year, and the rules that coordinate the provisions of § 1.882-5 with any other section that disallows, defers, or capitalizes interest expense, and include examples that illustrate how § 1.882-5 applies to an asset that produces income exempt from U.S. taxation.

Many commenters requested that the regulations clarify how and when to make the various elections allowed under § 1.882-5. The final regulations provide uniform rules for changing any election prescribed under § 1.882-5, and give all taxpayers an opportunity to make new elections, if desired, for the first taxable year beginning after the effective date of these regulations. The regulations provide that, once a method is elected, a taxpayer must use the method for five years, unless the Commissioner or her delegate consents to an earlier change based on extenuating circumstances. The final regulations reflect the current practice of the IRS by providing that if the taxpayer fails to make a timely election, the district director or the Assistant Commissioner (International) may make any and all elections on the taxpayer's behalf.

Several commenters asked that the final regulations allow taxpayers to make correlative adjustments to their

§ 1.882-5 calculations in cases where, under the authority of § 1.881-3, the district director has determined that a taxpayer has acted as a conduit entity in a conduit financing arrangement. The IRS and Treasury do not believe that it is appropriate in this regulation to alleviate the consequences of § 1.881-3 if a taxpayer has engaged in a transaction one of the principal purposes of which is to avoid U.S. withholding tax. Allowing such correlative adjustments in this regulation would prevent § 1.881-3 from serving its function as an anti-abuse rule.

3. § 1.882-5(b): Determination of total amount of U.S. assets for the taxable year (Step 1).

As in the proposed regulations, the final regulations provide that the classification of an item as a U.S. asset under § 1.884-1(d) generally governs its classification as a U.S. asset for purposes of § 1.882-5. Under the rules of § 1.884-1(d), an item generally is treated as a U.S. asset if all of the income it generates (or would generate) and all of the gains that it would generate (if sold at a gain) are ECI. Since the proposed § 1.882-5 regulations were issued in 1992, the regulations under § 1.884-1 were amended and released in final form. In light of those new regulations, the inclusions and exclusions enumerated in the proposed regulations were largely eliminated, so that the final § 1.882-5 regulations now closely conform to the § 1.884-1(d) definition of a U.S. asset.

Section 1.882-5(b)(3) of the final regulations continues the requirement that a foreign corporation must value its U.S. assets at the most frequent, regular intervals for which data are reasonably available. However, the rule is applied separately with respect to each U.S. asset. Paragraph (b)(3) specifies that the value of a U.S. asset must be computed at least monthly by a large bank and at least semi-annually by other taxpayers.

Many questions have been raised about how § 1.882-5 applies to partnership interests held by foreign corporations. With the elimination of § 1.861-9T(e)(7)(i) by these regulations, § 1.884-1(d)(3) and § 1.882-5 now provide the exclusive rules for determining a foreign corporation's interest expense allocable to an interest in a partnership. The new regulations

under § 1.884-1(d)(3) provide that a foreign corporation determines its U.S. assets by reference to its basis in the partnership, and expand the methods available for determining the portion of its partnership basis that is a U.S. asset.

Numerous commenters were concerned that the provisions of the proposed regulations relating to real estate would treat international banks unfairly, since banks frequently acquire real estate through foreclosure, or own the buildings in which their offices are located. Commenters stated that it is unclear whether such real estate would qualify as a U.S. asset. Commenters also objected to the rule in the proposed regulations that provides that an interest in a U.S. real property holding company, which is not treated as a U.S. asset under § 1.884-1(d), would be treated as a U.S. asset only in the year of disposition. Commenters argued that banks frequently hold property acquired by foreclosure in special purpose subsidiaries in order to limit their exposure to environmental or other liabilities. However, such banks must service the debt they incurred to acquire the real property throughout the period they hold the stock, not merely upon disposition.

In response to these comments, an example is added under § 1.884-1(d)(2) to clarify that U.S. real estate acquired as a result of foreclosure by a bank acting in the ordinary course of its business is generally a U.S. asset, because the property would produce ECI to the bank under section 864(c)(2). Similarly, the building in which a bank's offices are located generally qualifies as a U.S. asset, because gain from the sale of the building generally would constitute effectively connected income under the asset-use test of § 1.864-4(c)(2). In addition, the final regulations specify that a taxpayer may achieve the same result under § 1.882-5 whether it holds foreclosure property or the office building it occupies directly or indirectly through a corporation. Section 1.882-5(b)(1)(iii)(A) provides a look-through rule that treats such real property as a U.S. asset for purposes of § 1.882-5 to the extent that it would have qualified as a U.S. asset if held directly by the taxpayer.

Commenters noted that the rule in the proposed regulations that reduces the value of shares of stock claimed as a U.S. asset by a percentage of the dividends received deduction had the

effect of treating all stock as debt-financed under the principles of section 246A. This stock cut-back rule is eliminated from the final § 1.882-5 regulations. The elimination of the rule, however, will affect only those taxpayers whose stock satisfies the business-activities test or the banking, financing or similar-business test of § 1.864-4(c). This is because the final regulations under § 1.864-4, which are being issued contemporaneously with these regulations elsewhere in this issue of the Bulletin, generally eliminate any inference that stock can produce effectively connected income under the asset-use test of § 1.864-4(c)(2).

The final regulations add an anti-abuse rule similar to the rule in § 1.884-1(d)(5)(ii) to prevent taxpayers from artificially increasing the amount of their U.S. assets.

4. § 1.882-5(c): Determination of total amount of U.S. liabilities for the taxable year (Step 2).

Commenters objected to many of the requirements in Step 2 of the proposed regulations on the grounds that the rules effectively prevented foreign banks from using their actual ratio of liabilities to assets by imposing excessive administrative burdens and capping the actual ratio at 96%. Because the IRS and Treasury believe that a taxpayer's interest deduction should be based on the taxpayer's actual ratio of liabilities to assets whenever possible, the final regulations adopt rules that are intended to encourage taxpayers to use their actual ratio. Accordingly, the final regulations drop the 96% cap on the actual ratio that was in the proposed regulations. The final regulations also substantially ease the administrative burden associated with computing the actual ratio.

Many commenters objected to the requirement in the proposed regulations that a taxpayer's worldwide liabilities to assets ratio be computed strictly in accordance with U.S. tax principles, citing the substantial burden that such a calculation would entail. In light of these comments, the final regulations require that only the classification of assets and liabilities must be strictly in accordance with U.S. tax principles. The value of worldwide assets and the amount of worldwide liabilities need only be substantially in accordance with U.S. tax principles. Examples of

how these requirements apply are provided. With regard to material items, however, the final regulations specify that a foreign corporation must compute the value of U.S. assets and the amount of worldwide liabilities in Steps 1 and 2 in a consistent manner.

The proposed regulations would have required that a foreign bank compute its actual ratio monthly. Commenters were concerned that the burden of this rule would be excessive. In response, the final regulations decrease the required frequency of the computations of the actual ratio to semi-annually for large banks, and to annually for other taxpayers.

Commenters also were concerned that the rules in the proposed regulation requiring basis adjustments for 20% owned subsidiaries would be too burdensome. These rules, which serve a somewhat different purpose in section 864(e)(4), have been removed from the final regulations.

Commenters pointed out that the election provided by the proposed regulations to compute the actual ratio of a bank on the basis of a hypothetical tax year ending six months prior to the beginning of the actual year does not serve its intended purpose. The six month lagging ratio election has therefore been eliminated.

Section 1.882-5(c)(3) of the final regulations provides that the district director or the Assistant Commissioner (International) may make appropriate adjustments to prevent the artificial increase of a corporation's actual ratio. This rule, in conjunction with more specific anti-abuse rules in Steps 1 and 3, replaces the general anti-abuse rule in § 1.882-5(e) of the proposed regulations.

Commenters criticized the 93% fixed ratio for banks as too low, and disagreed with the reasons provided in the preamble to the proposed regulations supporting the 93% ratio. The final regulations, however, retain the elective fixed ratio at 93%. In conjunction with the more relaxed rules regarding the computation of a foreign corporation's actual ratio, Treasury believes that a 93% fixed ratio, which remains purely elective, represents an appropriate safe harbor for banks.

Section 1.882-5(c)(4) also modifies the definition of a bank for these purposes to clarify the previous definition and to limit the 93% fixed ratio to the intended class of businesses.

5. § 1.882-5(d): *Determination of amount of interest expense allocable to ECI (Step 3).*

Commenters were concerned that Step 3 of the proposed regulations failed to reflect business realities, increased administrative costs and created uncertainty. In particular, they objected to the rules that eliminated certain high interest rate liabilities and certain liabilities denominated in a non-functional currency from the definition of *booked liabilities*, and the rules that prescribed an interest rate applicable to the extent that a taxpayer's U.S.-connected liabilities exceed booked liabilities (*excess liabilities*).

As noted above, the IRS and Treasury believe that the calculation of a taxpayer's interest deduction should reflect, to the greatest extent possible, the taxpayer's economic interest expense. Accordingly, these comments have been largely accepted.

The final regulations eliminate the fixed interest rates assigned to excess liabilities, and instead require that taxpayers compute their actual interest rate outside the United States. The IRS anticipates issuing regulations under section 6038C describing the records needed to verify the taxpayer's actual interest rate, among other things.

The final regulations also respond to commenters' requests for simplification and clarification in the Step 3 calculation. Under § 1.882-5(d)(2), a liability is a U.S. booked liability if the liability is properly reflected on the books of the U.S. trade or business. The final regulations set out two standards, one for non-banks and another for banks, to determine whether a liability is properly reflected on the foreign corporation's U.S. books. In general, the final regulations use a facts and circumstances test to determine whether a liability is properly booked in the United States. In response to requests from commenters for additional guidance on the requirement that the booking of a liability be "reasonably contemporaneous" with the time that the liability is incurred, the regulations specify that a bank is generally required to book a liability before the end of the day in which the liability is incurred. Section 1.882-5(d)(2)(iii)(B) provides a relief rule, however, for a situation where, due to inadvertent error, a bank fails to book a liability that otherwise would meet the criteria

for a booked liability. The special rules for banks in the proposed regulations have otherwise been eliminated.

In response to comments, the computation of the scaling ratio that applies to taxpayers with excess liabilities has also been simplified, and its application has been reduced in scope. Under the final regulations, the scaling ratio is computed by simply dividing U.S.-connected liabilities by U.S. booked liabilities, and multiplying that fraction by the interest paid or accrued by the foreign corporation. The final regulations also delete the provision in the proposed regulations that applied the scaling ratio to section 988 exchange gain or loss from an unhedged liability. The amount and source of exchange gain or loss from a section 988 transaction will therefore continue to be determined under section 988, without any reduction as a result of the scaling ratio in § 1.882-5.

The rules in the proposed regulations relating to high interest rate liabilities and nonfunctional currency liabilities have been replaced in the final regulations by a simpler anti-abuse rule that provides that U.S. booked liabilities will not include a liability if one of the principal purposes of incurring or holding the liability is to increase artificially the interest expense on U.S. booked liabilities. Factors relevant to that determination are whether the interest rate on a liability is excessive and whether, from an economic standpoint, the currency denomination of U.S. booked liabilities matches the currency denomination of U.S. assets.

6. § 1.882-5(e): *Separate currency pools method.*

Most commenters argued for retaining the separate currency pools method, which was deleted from Step 3 in the proposed regulations. After considering the comments, the IRS and Treasury agree that taxpayers should be permitted to use a methodology that looks to worldwide interest rates in all relevant currencies. Because the separate currency pools rate in the 1981 regulations ignored the currency denomination of U.S. assets and was based instead on the currency denomination of U.S. booked liabilities, however, it was subject to manipulation. The new separate currency pools method in § 1.882-5(e) of the final regulations allows taxpayers to treat their U.S. assets in

each currency as funded by the worldwide liabilities of the taxpayer in that same currency. This new separate currency pools method, which is elective, is an alternative to the Step 3 approach based on U.S. booked liabilities in § 1.882-5(d). To prevent distortions, taxpayers that have more than 10% of their U.S. assets denominated in a hyperinflationary currency are precluded from using the separate currency pools method.

The anti-abuse rule of proposed regulation § 1.882-5(e) has been replaced by three separate rules that appear under each of the three steps of this section.

Special Analyses

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

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury Department participated in drafting these regulations.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.882-5 also issued under 26 U.S.C. 882, 26 U.S.C. 864(e), 26

§ 1.861-9T [Amended]

Par. 2. Section 1.861-9T, paragraph (e)(7) is amended as follows:

1. Paragraph (e)(7)(i) is removed.
2. The heading in paragraph (e)(7)(ii) is removed.
3. Paragraph (e)(7)(ii) is redesignated as the text of paragraph (e)(7).

Par. 3. Sections 1.882-0 is added to read as follows:

§ 1.882-0 Table of contents.

This section lists captions contained in §§ 1.882-1, 1.882-2, 1.882-3, 1.882-4 and 1.882-5.

§ 1.882-1 Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.

- (a) Segregation of income.
- (b) Imposition of tax.
 - (1) Income not effectively connected with the conduct of a trade or business in the United States.
 - (2) Income effectively connected with the conduct of a trade or business in the United States.
 - (i) In general.
 - (ii) Determination of taxable income.
 - (iii) Cross references.
- (c) Change in trade or business status.
- (d) Credits against tax.
- (e) Payment of estimated tax.
- (f) Effective date.

§ 1.882-2 Income of foreign corporation treated as effectively connected with U.S. business.

- (a) Election as to real property income.
- (b) Interest on U.S. obligations received by banks organized in possessions.
- (c) Treatment of income.
- (d) Effective date.

§ 1.882-3 Gross income of a foreign corporation.

- (a) In general.

- (1) Inclusions.
- (2) Exchange transactions.
- (3) Exclusions.
- (b) Foreign corporations not engaged in U.S. business.
- (c) Foreign corporations engaged in U.S. business.
- (d) Effective date.

§ 1.882-4 Allowance of deductions and credits to foreign corporations.

- (a) Foreign corporations.
 - (1) In general.
 - (2) Return necessary.
 - (3) Filing deadline for return.
 - (4) Return by Internal Revenue Service.
- (b) Allowed deductions and credits.
 - (1) In general.
 - (2) Verification.

§ 1.882-5 Determination of interest deduction.

- (a) Rules of general application.
 - (1) Overview.
 - (i) In general.
 - (ii) Direct allocations.
 - (A) In general.
 - (B) Partnership interest.
 - (2) Coordination with tax treaties.
 - (3) Limitation on interest expense.
 - (4) Translation convention for foreign currency.
 - (5) Coordination with other sections.
 - (6) Special rule for foreign governments.
 - (7) Elections under § 1.882-5.
 - (i) In general.
 - (ii) Failure to make the proper election.
 - (8) Examples.
- (b) Step 1: Determination of total value of U.S. assets for the taxable year.
 - (1) Classification of an asset as a U.S. asset.
 - (i) General rule.
 - (ii) Items excluded from the definition of U.S. asset.
 - (iii) Items included in the definition of U.S. asset.
 - (iv) Interbranch transactions.
 - (v) Assets acquired to increase U.S. assets artificially.

- (2) Determination of the value of a U.S. asset.
 - (i) General rule.
 - (ii) Fair-market value election.
 - (A) In general.
 - (B) Adjustment to partnership basis.
 - (iii) Reduction of total value of U.S. assets by amount of bad debt reserves under section 585.
 - (A) In general.
 - (B) Example.
 - (iv) Adjustment to basis of financial instruments.
- (3) Computation of total value of U.S. assets.
- (c) Step 2: Determination of total amount of U.S.-connected liabilities for the taxable year.
 - (1) General rule.
 - (2) Computation of the actual ratio.
 - (i) In general.
 - (ii) Classification of items.
 - (iii) Determination of amount of worldwide liabilities.
 - (iv) Determination of value of worldwide assets.
 - (v) Hedging transactions.
 - (vi) Treatment of partnership interests and liabilities.
 - (vii) Computation of actual ratio of insurance companies.
 - (viii) Interbranch transactions.
 - (ix) Amounts must be expressed in a single currency.
- (3) Adjustments.
- (4) Elective fixed ratio method of determining U.S. liabilities.
- (5) Examples.
- (d) Step 3: Determination of amount of interest expense allocable to ECI under the adjusted U.S. booked liabilities method.
 - (1) General rule.
 - (2) U.S. booked liabilities.
 - (i) In general.
 - (ii) Properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank.

- (A) In general.
- (B) Identified liabilities not properly reflected.
- (iii) Properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank.
 - (A) In general.
 - (B) Inadvertent error.
- (iv) Liabilities of insurance companies.
- (v) Liabilities used to increase artificially interest expense on U.S. booked liabilities.
- (vi) Hedging transactions.
- (vii) Amount of U.S. booked liabilities of a partner.
- (viii) Interbranch transactions.
- (3) Average total amount of U.S. booked liabilities.
- (4) Interest expense where U.S. booked liabilities equal or exceed U.S. liabilities.
 - (i) In general.
 - (ii) Scaling ratio.
 - (iii) Special rules for insurance companies.
- (5) U.S.-connected interest rate where U.S. booked liabilities are less than U.S.-connected liabilities.
 - (i) In general.
 - (ii) Interest rate on excess U.S.-connected liabilities.
- (6) Examples.
- (e) Separate currency pools method.
 - (1) General rule.
 - (i) Determine the value of U.S. assets in each currency pool.
 - (ii) Determine the U.S.-connected liabilities in each currency pool.
 - (iii) Determine the interest expense attributable to each currency pool.
 - (2) Prescribed interest rate.
 - (3) Hedging transactions.
 - (4) Election not available if excessive hyperinflationary assets.
 - (5) Examples.

- (f) Effective date.
 - (1) General rule.
 - (2) Special rules for financial products.

Par. 4. Section 1.882-5 is revised to read as follows:

§ 1.882-5 Determination of interest deduction.

(a) *Rules of general application*—(1) *Overview*—(i) *In general.* The amount of interest expense of a foreign corporation that is allocable under section 882(c) to income which is (or is treated as) effectively connected with the conduct of a trade or business within the United States (ECI) is the sum of the interest paid or accrued by the foreign corporation on its liabilities booked in the United States, as adjusted under the three-step process set forth in paragraphs (b), (c) and (d) of this section and the specially allocated interest expense determined under section (a)(1)(ii) of this section. The provisions of this section provide the exclusive rules for allocating interest expense to the ECI of a foreign corporation. Under the three-step process, the total value of the U.S. assets of a foreign corporation is first determined under paragraph (b) of this section (Step 1). Next, the amount of U.S.-connected liabilities is determined under paragraph (c) of this section (Step 2). Finally, the amount of interest paid or accrued on liabilities booked in the United States, as determined under paragraph (d)(2) of this section, is adjusted for interest expense attributable to the difference between U.S.-connected liabilities and U.S. booked liabilities (Step 3). Alternatively, a foreign corporation may elect to determine its interest rate on U.S.-connected liabilities by reference to its U.S. assets, using the separate currency pools method described in paragraph (e) of this section.

(ii) *Direct allocations*—(A) *In general.* A foreign corporation that has a U.S. asset and indebtedness that meet the requirements of § 1.861-10T(b) and (c), as limited by § 1.861-10T(d)(1), may directly allocate interest expense from such indebtedness to income from such asset in the manner and to the extent provided in § 1.861-10T. For purposes of paragraphs (b)(1) or (c)(2) of this section, a foreign corporation that allocates its interest expense under the direct allocation rule of this para-

graph (a)(1)(ii)(A) shall reduce the basis of the asset that meets the requirements of § 1.861-10T(b) and (c) by the principal amount of the indebtedness that meets the requirements of § 1.861-10T(b) and (c). The foreign corporation shall also disregard any indebtedness that meets the requirements of § 1.861-10T(b) and (c) in determining the amount of the foreign corporation's liabilities under paragraphs (c)(2) and (d)(2) of this section, and shall not take into account any interest expense paid or accrued with respect to such a liability for purposes of paragraphs (d) or (e) of this section.

(B) *Partnership interest.* A foreign corporation that is a partner in a partnership that has a U.S. asset and indebtedness that meet the requirements of § 1.861-10T(b) and (c), as limited by § 1.861-10T(d)(1), may directly allocate its distributive share of interest expense from that indebtedness to its distributive share of income from that asset in the manner and to the extent provided in § 1.861-10T. A foreign corporation that allocates its distributive share of interest expense under the direct allocation rule of this paragraph (a)(1)(ii)(B) shall disregard any partnership indebtedness that meets the requirements of § 1.861-10T(b) and (c) in determining the amount of its distributive share of partnership liabilities for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) of this section, and shall not take into account any partnership interest expense paid or accrued with respect to such a liability for purposes of paragraph (d) or (e) of this section. For purposes of paragraph (b)(1) of this section, a foreign corporation that directly allocates its distributive share of interest expense under this paragraph (a)(1)(ii)(B) shall—

(1) Reduce the partnership's basis in such asset by the amount of such indebtedness in allocating its basis in the partnership under § 1.884-1(d)(3)(ii); or

(2) Reduce the partnership's income from such asset by the partnership's interest expense from such indebtedness under § 1.884-1(d)(3)(iii).

(2) *Coordination with tax treaties.* The provisions of this section provide the exclusive rules for determining the interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty.

(3) *Limitation on interest expense.* In no event may the amount of interest expense computed under this section exceed the amount of interest on indebtedness paid or accrued by the taxpayer within the taxable year (translated into U.S. dollars at the weighted average exchange rate for each currency prescribed by § 1.989(b)-1 for the taxable year).

(4) *Translation convention for foreign currency.* For each computation required by this section, the taxpayer shall translate values and amounts into the relevant currency at a spot rate or a weighted average exchange rate consistent with the method such taxpayer uses for financial reporting purposes, provided such method is applied consistently from year to year. Interest expense paid or accrued, however, shall be translated under the rules of § 1.988-2. The district director or the Assistant Commissioner (International) may require that any or all computations required by this section be made in U.S. dollars if the functional currency of the taxpayer's home office is a hyperinflationary currency, as defined in § 1.985-1, and the computation in U.S. dollars is necessary to prevent distortions.

(5) *Coordination with other sections.* Any provision that disallows, defers, or capitalizes interest expense applies after determining the amount of interest expense allocated to ECI under this section. For example, in determining the amount of interest expense that is disallowed as a deduction under section 265 or 163(j), deferred under section 163(e)(3) or 267(a)(3), or capitalized under section 263A with respect to a United States trade or business, a taxpayer takes into account only the amount of interest expense allocable to ECI under this section.

(6) *Special rule for foreign governments.* The amount of interest expense of a foreign government, as defined in § 1.892-2T(a), that is allocable to ECI is the total amount of interest paid or accrued within the taxable year by the United States trade or business on U.S. booked liabilities (as defined in paragraph (d)(2) of this section). Interest expense of a foreign government, however, is not allocable to ECI to the extent that it is incurred with respect to U.S. booked liabilities that exceed 80 percent of the total value of U.S. assets for the taxable year (determined under paragraph (b) of this section). This paragraph (a)(6) does not apply to

controlled commercial entities within the meaning of § 1.892-5T.

(7) *Elections under § 1.882-5—(i) In general.* A corporation must make each election provided in this section on the corporation's federal income tax return for the first taxable year beginning on or after the effective date of this section. An amended return does not qualify for this purpose, nor shall the provisions of § 301.9100-1 of this chapter and any guidance promulgated thereunder apply. Each election under this section, whether an election for the first taxable year or a subsequent change of election, shall be made by the corporation calculating its interest expense deduction in accordance with the methods elected. An elected method must be used for a minimum period of five years before the taxpayer may elect a different method. To change an election before the end of the requisite five-year period, a taxpayer must obtain the consent of the Commissioner or her delegate. The Commissioner or her delegate will generally consent to a taxpayer's request to change its election only in rare and unusual circumstances.

(ii) *Failure to make the proper election.* If a taxpayer, for any reason, fails to make an election provided in this section in a timely fashion, the district director or the Assistant Commissioner (International) may make any or all of the elections provided in this section on behalf of the taxpayer, and such elections shall be binding as if made by the taxpayer.

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

Example 1. Direct allocations. (i) *Facts:* FC is a foreign corporation that conducts business through a branch, B, in the United States. Among B's U.S. assets is an interest in a partnership, P, that is engaged in airplane leasing solely in the U.S. FC contributes 200× in exchange for its partnership interest. P incurs qualified non-recourse indebtedness within the meaning of § 1.861-10T to purchase an airplane. FC's share of the liability of P, as determined under section 752, is 800×.

(ii) *Analysis:* Pursuant to paragraph (a)(1)(ii)(B) of this section, FC is permitted to directly allocate its distributive share of the interest incurred with respect to the qualified nonrecourse indebtedness to FC's distributive share of the rental income generated by the airplane. A liability the interest on which is allocated directly to the income from a particular asset under paragraph (a)(1)(ii)(B) of this section is disregarded for purposes of paragraphs (b)(1), (c)(2)(vi), and (d)(2)(vii) or (e)(1)(ii) this section. Consequently, for purposes of determining

the value of FC's assets under paragraphs (b)(1) and (c)(2)(vi) of this section, FC's basis in P is reduced by the 800× liability as determined under section 752, but is not increased by the 800x liability that is directly allocated under paragraph (a)(1)(ii)(B) of this section. Similarly, pursuant to paragraph (a)(1)(ii)(B) of this section, the 800x liability is disregarded for purposes of determining FC's liabilities under paragraphs (c)(2)(vi) and (d)(2)(vii) of this section.

Example 2. Limitation on interest expense—(i) FC is a foreign corporation that conducts a real estate business in the United States. In its 1997 tax year, FC has no outstanding indebtedness, and therefore incurs no interest expense. FC elects to use the 50% fixed ratio under paragraph (c)(4) of this section.

(ii) Under paragraph (a)(3) of this section, FC is not allowed to deduct any interest expense that exceeds the amount of interest on indebtedness paid or accrued in that taxable year. Since FC incurred no interest expense in taxable year 1997, FC will not be entitled to any interest deduction for that year under § 1.882-5, notwithstanding the fact that FC has elected to use the 50% fixed ratio.

Example 3. Coordination with other sections—(i) FC is a foreign corporation that is a bank under section 585(a)(2) and a financial institution under section 265(b)(5). FC is a calendar year taxpayer, and operates a U.S. branch, B. Throughout its taxable year 1997, B holds only two assets that are U.S. assets within the meaning of paragraph (b)(1) of this section. FC does not make a fair-market value election under paragraph (b)(2)(ii) of this section, and, therefore, values its U.S. assets according to their bases under paragraph (b)(2)(i) of this section. The first asset is a taxable security with an adjusted basis of \$100. The second asset is an obligation the interest on which is exempt from federal taxation under section 103, with an adjusted basis of \$50. The tax-exempt obligation is not a qualified tax-exempt obligation as defined by section 265(b)(3)(B).

(ii) FC calculates its interest expense under § 1.882-5 to be \$12. Under paragraph (a)(5) of this section, however, a portion of the interest expense that is allocated to FC's effectively connected income under § 1.882-5 is disallowed in accordance with the provisions of section 265(b). Using the methodology prescribed under section 265, the amount of disallowed interest expense is \$4, calculated as follows:

$$\$12 \times \frac{\$50 \text{ Tax-exempt U.S. assets}}{\$150 \text{ Total U.S. assets}} = \$4$$

(iii) Therefore, FC deducts a total of \$8 (\$12 — \$4) of interest expense attributable to its effectively connected income in 1997.

Example 4. Treaty exempt asset—(i) FC is a foreign corporation, resident in Country X, that is actively engaged in the banking business in the United States through a permanent establishment, B. The income tax treaty in effect between Country X and the United States provides that FC is not taxable on foreign source income earned by its U.S. permanent establishment. In its 1997 tax year, B earns \$90 of U.S. source income from U.S. assets with an adjusted tax basis of \$900, and \$12 of foreign source interest income from U.S. assets with an adjusted tax basis of \$100. FC's U.S. interest expense deduction, computed in accordance with § 1.882-5, is \$500.

(ii) Under paragraph (a)(5) of this section, *FC* is required to apply any provision that disallows, defers, or capitalizes interest expense after determining the interest expense allocated to *ECI* under § 1.882-5. Section 265(a)(2) disallows interest expense that is allocable to one or more classes of income that are wholly exempt from taxation under subtitle A of the Internal Revenue Code. Section 1.265-1(b) provides that income wholly exempt from taxes includes both income excluded from tax under any provision of subtitle A and income wholly exempt from taxes under any other law. Section 894 specifies that the provisions of subtitle A are applied with due regard to any relevant treaty obligation of the United States. Because the treaty between the United States and Country X exempts foreign source income earned by *B* from U.S. tax, *FC* has assets that produce income wholly exempt from taxes under subtitle A, and must therefore allocate a portion of its § 1.882-5 interest expense to its exempt income. Using the methodology prescribed under section 265, the amount of disallowed interest expense is \$50, calculated as follows:

$$\$500 \times \frac{\$100 \text{ Treaty-exempt U.S. assets}}{\$1000 \text{ Total U.S. assets}} = \$50$$

(iii) Therefore, *FC* deducts a total of \$450 (\$500 — \$50) of interest expense attributable to its effectively connected income in 1997.

(b) *Step 1: Determination of total value of U.S. assets for the taxable year*—(1) *Classification of an asset as a U.S. asset*—(i) *General rule*. Except as otherwise provided in this paragraph (b)(1), an asset is a U.S. asset for purposes of this section to the extent that it is a U.S. asset under § 1.884-1(d). For purposes of this section, the term *determination date*, as used in § 1.884-1(d), means each day for which the total value of U.S. assets is computed under paragraph (b)(3) of this section.

(ii) *Items excluded from the definition of U.S. asset*. For purposes of this section, the term *U.S. asset* excludes an asset to the extent it produces income or gain described in sections 883(a)(3) and (b).

(iii) *Items included in the definition of U.S. asset*. For purposes of this section, the term *U.S. asset* includes—

(A) U.S. real property held in a wholly-owned domestic subsidiary of a foreign corporation that qualifies as a bank under section 585(a)(2)(B) (without regard to the second sentence thereof), provided that the real property would qualify as used in the foreign corporation's trade or business within the meaning of § 1.864-4(c)(2) or (3) if held directly by the foreign corporation and either was initially acquired through foreclosure or similar proceed-

ings or is U.S. real property occupied by the foreign corporation (the value of which shall be adjusted by the amount of any indebtedness that is reflected in the value of the property);

(B) An asset that produces income treated as *ECI* under section 921(d) or 926(b) (relating to certain income of a *FSC* and certain dividends paid by a *FSC* to a foreign corporation);

(C) An asset that produces income treated as *ECI* under section 953(c)(3)(C) (relating to certain income of a captive insurance company that a corporation elects to treat as *ECI*) that is not otherwise *ECI*; and

(D) An asset that produces income treated as *ECI* under section 882(e) (relating to certain interest income of possessions banks).

(iv) *Interbranch transactions*. A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset.

(v) *Assets acquired to increase U.S. assets artificially*. An asset shall not be treated as a U.S. asset if one of the principal purposes for acquiring or using that asset is to increase artificially the U.S. assets of a foreign corporation on the determination date. Whether an asset is acquired or used for such purpose will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using an asset is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on or around the determination date. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(2) *Determination of the value of a U.S. asset*—(i) *General rule*. The value of a U.S. asset is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that item, further adjusted as provided in paragraph (b)(2)(iii) of this section.

(ii) *Fair-market value election*—(A) *In general*. A taxpayer may elect to value all of its U.S. assets on the basis of fair market value, subject to the requirements of § 1.861-9T(g)(1)(iii), and provided the taxpayer uses the

methodology prescribed in § 1.861-9T(h). Once elected, the fair market value must be used by the taxpayer for both Step 1 and Step 2 described in paragraphs (b) and (c) of this section, and must be used in all subsequent taxable years unless the Commissioner or her delegate consents to a change.

(B) *Adjustment to partnership basis*. If a partner makes a fair market value election under paragraph (b)(2)(ii) of this section, the value of the partner's interest in a partnership that is treated as an asset shall be the fair market value of his partnership interest, increased by the fair market value of the partner's share of the liabilities determined under paragraph (c)(2)(vi) of this section. See § 1.884-1(d)(3).

(iii) *Reduction of total value of U.S. assets by amount of bad debt reserves under section 585*—(A) *In general*. The total value of loans that qualify as U.S. assets shall be reduced by the amount of any reserve for bad debts additions to which are allowed as deductions under section 585.

(B) *Example*. The following example illustrates the provisions of paragraph (b)(2)(iii)(A) of this section:

Example. Foreign banks; bad debt reserves. *FC* is a foreign corporation that qualifies as a bank under section 585(a)(2)(B) (without regard to the second sentence thereof), but is not a large bank as defined in section 585(c)(2). *FC* conducts business through a branch, *B*, in the United States. Among *B*'s U.S. assets are a portfolio of loans with an adjusted basis of \$500. *FC* accounts for its bad debts for U.S. federal income tax purposes under the reserve method, and *B* maintains a deductible reserve for bad debts of \$50. Under paragraph (b)(2)(iii) of this section, the total value of *FC*'s portfolio of loans is \$450 (\$500 — \$50).

(iv) *Adjustment to basis of financial instruments*. [Reserved]

(3) *Computation of total value of U.S. assets*. The total value of U.S. assets for the taxable year is the average of the sums of the values (determined under paragraph (b)(2) of this section) of U.S. assets. For each U.S. asset, value shall be computed at the most frequent, regular intervals for which data are reasonably available. In no event shall the value of any U.S. asset be computed less frequently than monthly by a large bank (as defined in section 585(c)(2)) and semi-annually by any other taxpayer.

(c) *Step 2: Determination of total amount of U.S.-connected liabilities for the taxable year*—(1) *General rule*.

The amount of U.S.-connected liabilities for the taxable year equals the total value of U.S. assets for the taxable year (as determined under paragraph (b)(3) of this section) multiplied by the actual ratio for the taxable year (as determined under paragraph (c)(2) of this section) or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

(2) *Computation of the actual ratio*—(i) *In general.* A taxpayer's actual ratio for the taxable year is the total amount of its worldwide liabilities for the taxable year divided by the total value of its worldwide assets for the taxable year. The total amount of worldwide liabilities and the total value of worldwide assets for the taxable year is the average of the sums of the amounts of the taxpayer's worldwide liabilities and the values of its worldwide assets (determined under paragraphs (c)(2)(iii) and (iv) of this section). In each case, the sums must be computed semi-annually by a large bank (as defined in section 585(c)(2)) and annually by any other taxpayer.

(ii) *Classification of items.* The classification of an item as a liability or an asset must be consistent from year to year and in accordance with U.S. tax principles.

(iii) *Determination of amount of worldwide liabilities.* The amount of a liability must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the amount of a liability must not differ from U.S. tax principles to a degree that will materially affect the value of taxpayer's worldwide liabilities or the taxpayer's actual ratio.

(iv) *Determination of value of worldwide assets.* The value of an asset must be determined consistently from year to year and must be substantially in accordance with U.S. tax principles. To be substantially in accordance with U.S. tax principles, the principles used to determine the value of an asset must not differ from U.S. tax principles to a degree that will materially affect the value of the taxpayer's worldwide assets or the taxpayer's actual ratio. The value of an asset is the adjusted basis of that asset for determining the gain or loss from the sale or other disposition of that asset, adjusted in the

same manner as the basis of U.S. assets are adjusted under paragraphs (b)(2)(ii) through (iv) of this section.

(v) *Hedging transactions.* [Reserved]

(vi) *Treatment of partnership interests and liabilities.* For purposes of computing the actual ratio, the value of a partner's interest in a partnership that will be treated as an asset is the partner's adjusted basis in its partnership interest, reduced by the partner's share of liabilities of the partnership as determined under section 752 and increased by the partner's share of liabilities determined under this paragraph (c)(2)(vi). If the partner has made a fair market value election under paragraph (b)(2)(ii) of this section, the value of its interest in the partnership shall be increased by the fair market value of the partner's share of the liabilities determined under this paragraph (c)(2)(vi). For purposes of this section a partner shares in any liability of a partnership in the same proportion that it shares, for income tax purposes, in the expense attributable to that liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

(vii) *Computation of actual ratio of insurance companies.* [Reserved]

(viii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not create an asset or a liability.

(ix) *Amounts must be expressed in a single currency.* The actual ratio must be computed in either U.S. dollars or the functional currency of the home office of the taxpayer, and that currency must be used consistently from year to year. For example, a taxpayer that determines the actual ratio annually using British pounds converted at the spot rate for financial reporting purposes must translate the U.S. dollar values of assets and amounts of liabilities of the U.S. trade or business into pounds using the spot rate on the last day of its taxable year. The district director or the Assistant Commissioner (International) may require that the actual ratio be computed in dollars if the functional currency of the taxpayer's home office is a hyperinflationary currency, as defined in § 1.985-1, that materially distorts the actual ratio.

(3) *Adjustments.* The District Director or the Assistant Commissioner (International) may make appropriate adjustments to prevent a foreign corpo-

ration from intentionally and artificially increasing its actual ratio. For example, the District Director or the Assistant Commissioner (International) may offset a loan made from or to one person with a loan made to or from another person if any of the parties to the loans are related persons, within the meaning of section 267(b) or 707(b)(1), and one of the principal purposes for entering into the loans was to increase artificially the actual ratio of a foreign corporation. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(4) *Elective fixed ratio method of determining U.S. liabilities.* A taxpayer that is a bank as defined in section 585(a)(2)(B) (without regard to the second sentence thereof) may elect to use a fixed ratio of 93 percent in lieu of the actual ratio. A taxpayer that is neither a bank nor an insurance company may elect to use a fixed ratio of 50 percent in lieu of the actual ratio.

(5) *Examples.* The following examples illustrate the application of paragraph (c) of this section:

Example 1. Classification of item not in accordance with U.S. tax principles. Bank Z, a resident of country X, has a branch in the United States through which it conducts its banking business. In preparing its financial statements in country X, Z treats an instrument documented as perpetual subordinated debt as a liability. Under U.S. tax principles, however, this instrument is treated as equity. Consequently, the classification of this instrument as a liability for purposes of paragraph (c)(2)(iii) of this section is not in accordance with U.S. tax principles.

Example 2. Valuation of item not substantially in accordance with U.S. tax principles. Bank Z, a resident of country X, has a branch in the United States through which it conducts its banking business. Bank Z is a large bank as defined in section 585(c)(2). The tax rules of country X allow Bank Z to take deductions for additions to certain reserves. Bank Z decreases the value of the assets on its financial statements by the amounts of the reserves. The additions to the reserves under country X tax rules cause the value of Bank Z's assets to differ from the value of those assets determined under U.S. tax principles to a degree that materially affects the value of taxpayer's worldwide assets. Consequently, the valuation of Bank Z's worldwide assets under country X tax principles is not substantially in accordance with U.S. tax principles. Bank Z must increase the value of its worldwide assets under paragraph (c)(2)(iii) of this section by the amount of its country X reserves.

Example 3. Valuation of item substantially in accordance with U.S. tax principles. Bank Z, a resident of country X, has a branch in the United States through which it conducts its banking business. In determining the value of its worldwide assets, Bank Z computes the adjusted basis

of certain non-U.S. assets according to the depreciation methodology provided under country X tax laws, which is different than the depreciation methodology provided under U.S. tax law. If the depreciation methodology provided under country X tax laws does not differ from U.S. tax principles to a degree that materially affects the value of Bank Z's worldwide assets or Bank Z's actual ratio as computed under paragraph (c)(2) of this section, then the valuation of Bank Z's worldwide assets under paragraph (c)(2)(iv) of this section is substantially in accordance with U.S. tax principles.

Example 4. [Reserved]

Example 5. Adjustments. FC is a foreign corporation engaged in the active conduct of a banking business through a branch, B, in the United States. P, an unrelated foreign corporation, deposits \$100,000 in the home office of FC. Shortly thereafter, in a transaction arranged by the home office of FC, B lends \$80,000 bearing interest at an arm's length rate to S, a wholly owned U.S. subsidiary of P. The district director or the Assistant Commissioner (International) determines that one of the principal purposes for making and incurring such loans is to increase FC's actual ratio. For purposes of this section, therefore, P is treated as having directly lent \$80,000 to S. Thus, for purposes of paragraph (c) of this section (Step 2), the District Director or the Assistant Commissioner (International) may offset FC's liability and asset arising from this transaction, resulting in a net liability of \$20,000 that is not a booked liability of B. Because the loan to S from B was initiated and arranged by the home office of FC, with no material participation by B, the loan to S will not be treated as a U.S. asset.

(d) *Step 3: Determination of amount of interest expense allocable to ECI under the adjusted U.S. booked liabilities method*—(1) *General rule.* The adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined by comparing the amount of U.S.-connected liabilities for the taxable year, as determined under paragraph (c) of this section, with the average total amount of U.S. booked liabilities, as determined under paragraphs (d)(2) and (3) of this section. If the average total amount of U.S. booked liabilities equals or exceeds the amount of U.S.-connected liabilities, the adjustment to the interest expense on U.S. booked liabilities is determined under paragraph (d)(4) of this section. If the amount of U.S.-connected liabilities exceeds the average total amount of U.S. booked liabilities, the adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined under paragraph (d)(5) of this section.

(2) *U.S. booked liabilities*—(i) *In general.* A liability is a U.S. booked liability if it is properly reflected on the books of the U.S. trade or business,

within the meaning of paragraph (d)(2)(ii) or (iii) of this section.

(ii) *Properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank*—(A) *In general.* A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if—

(1) The liability is secured predominantly by a U.S. asset of the foreign corporation;

(2) The foreign corporation enters the liability on a set of books relating to an activity that produces ECI at a time reasonably contemporaneous with the time at which the liability is incurred; or

(3) The foreign corporation maintains a set of books and records relating to an activity that produces ECI and the District Director or Assistant Commissioner (International) determines that there is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(B) *Identified liabilities not properly reflected.* A liability is not properly reflected on the books of the U.S. trade or business merely because a foreign corporation identifies the liability pursuant to § 1.884-4(b)(1)(ii) and (b)(3).

(iii) *Properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank*—(A) *In general.* A liability, whether interest bearing or non-interest bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is a bank as described in section 585(a)(2)(B) (without regard to the second sentence thereof) if—

(1) The bank enters the liability on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred; and

(2) There is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

(B) *Inadvertent error.* If a bank fails to enter a liability in the books of the activity that produces ECI before the close of the day on which the liability was incurred, the liability may be treated as a U.S. booked liability only if, under the facts and circumstances, the taxpayer demonstrates a direct connection or relationship between the liability and the activity that produces ECI and the failure to enter the liability in those books was due to inadvertent error.

(iv) *Liabilities of insurance companies.* [Reserved]

(v) *Liabilities used to increase artificially interest expense on U.S. booked liabilities.* U.S. booked liabilities shall not include a liability if one of the principal purposes for incurring or holding the liability is to increase artificially the interest expense on the U.S. booked liabilities of a foreign corporation. Whether a liability is incurred or held for the purpose of artificially increasing interest expense will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for incurring or holding a liability is to increase artificially the interest expense on U.S. booked liabilities of a foreign corporation include whether the interest expense on the liability is excessive when compared to other liabilities of the foreign corporation denominated in the same currency and whether the currency denomination of the liabilities of the U.S. branch substantially matches the currency denomination of the U.S. branch's assets. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(vi) *Hedging transactions.* [Reserved]

(vii) *Amount of U.S. booked liabilities of a partner.* A partner's share of liabilities of a partnership is considered a booked liability of the partner provided that it is properly reflected on the books (within the meaning of paragraph (d)(2)(ii) of this section) of the U.S. trade or business of the partnership.

(viii) *Interbranch transactions.* A transaction of any type between separate offices or branches of the same taxpayer does not result in the creation of a liability.

(3) *Average total amount of U.S. booked liabilities.* The average total

amount of U.S. booked liabilities for the taxable year is the average of the sums of the amounts (determined under paragraph (d)(2) of this section) of U.S. booked liabilities. The amount of U.S. booked liabilities shall be computed at the most frequent, regular intervals for which data are reasonably available. In no event shall the amount of U.S. booked liabilities be computed less frequently than monthly by a large bank (as defined in section 585(c)(2)) and semi-annually by any other taxpayer.

(4) *Interest expense where U.S. booked liabilities equal or exceed U.S. liabilities*—(i) *In general.* If the average total amount of U.S. booked liabilities (as determined in paragraphs (d)(2) and (3) of this section) exceeds the amount of U.S.-connected liabilities (as determined under paragraph (c) of this section (Step 2)), the interest expense allocable to ECI is the product of the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities and the scaling ratio set out in paragraph (d)(4)(ii) of this section. For purposes of this section, the reduction resulting from the application of the scaling ratio is applied pro-rata to all interest expense paid or accrued by the foreign corporation. A similar reduction in income, expense, gain, or loss from a hedging transaction (as described in paragraph (d)(2)(vi) of this section) must also be determined by multiplying such income, expense, gain, or loss by the scaling ratio. If the average total amount of U.S. booked liabilities (as determined in paragraph (d)(3) of this section) equals the amount of U.S.-connected liabilities (as determined under Step 2), the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities.

(ii) *Scaling ratio.* For purposes of this section, the scaling ratio is a fraction the numerator of which is the amount of U.S.-connected liabilities and the denominator of which is the average total amount of U.S. booked liabilities.

(iii) *Special rules for insurance companies.* [Reserved]

(5) *U.S.-connected interest rate where U.S. booked liabilities are less than U.S.-connected liabilities*—(i) *In general.* If the amount of U.S.-

connected liabilities (as determined under paragraph (c) of this section (Step 2)) exceeds the average total amount of U.S. booked liabilities, the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S. booked liabilities, plus the excess of the amount of U.S.-connected liabilities over the average total amount of U.S. booked liabilities multiplied by the interest rate determined under paragraph (d)(5)(ii) of this section.

(ii) *Interest rate on excess U.S.-connected liabilities.* The applicable interest rate on excess U.S.-connected liabilities is determined by dividing the total interest expense paid or accrued for the taxable year on U.S.-dollar liabilities shown on the books of the offices or branches of the foreign corporation outside the United States by the average U.S.-dollar denominated liabilities (whether interest-bearing or not) shown on the books of the offices or branches of the foreign corporation outside the United States for the taxable year.

(6) *Examples.* The following examples illustrate the rules of this section:

Example 1. Computation of interest expense; actual ratio—(i) *Facts.* (A) *FC* is a foreign corporation that is not a bank and that actively conducts a real estate business through a branch, *B*, in the United States. For the taxable year, *FC*'s balance sheet and income statement is as follows (assume amounts are in U.S. dollars and computed in accordance with paragraphs (b)(2) and (b)(3) of this section):

| | Value | |
|-------------|---------|------------------|
| Asset 1 | \$2,000 | |
| Asset 2 | \$2,500 | |
| Asset 3 | \$5,500 | |
| | Amount | Interest Expense |
| Liability 1 | \$ 800 | 56 |
| Liability 2 | \$3,200 | 256 |
| Capital | \$6,000 | 0 |

(B) Asset 1 is the stock of *FC*'s wholly-owned domestic subsidiary that is also actively engaged in the real estate business. Asset 2 is a building in the United States producing rental income that is entirely ECI to *FC*. Asset 3 is a building in the home country of *FC* that produces rental income. Liabilities 1 and 2 are loans that bear interest at the rates of 7% and 8%, respectively. Liability 1 is a booked liability of *B*, and Liability 2 is booked in *FC*'s home country. Assume that *FC* has not elected to use the fixed ratio in Step 2.

(ii) *Step 1.* Under paragraph (b)(1) of this section, Assets 1 and 3 are not U.S. assets, while Asset 2 qualifies as a U.S. asset. Thus, under paragraph (b)(3) of this section, the total value of

U.S. assets for the taxable year is \$2,500, the value of Asset 2.

(iii) *Step 2.* Under paragraph (c)(1) of this section, the amount of *FC*'s U.S.-connected liabilities for the taxable year is determined by multiplying \$2,500 (the value of U.S. assets determined under Step 1) by the actual ratio for the taxable year. The actual ratio is the average amount of *FC*'s worldwide liabilities divided by the average value of *FC*'s worldwide assets. The amount of Liability 1 is \$800, and the amount of Liability 2 is \$3,200. Thus, the numerator of the actual ratio is \$4,000. The average value of worldwide assets is \$10,000 (Asset 1 + Asset 2 + Asset 3). The actual ratio, therefore, is 40% (\$4,000/\$10,000), and the amount of U.S.-connected liabilities for the taxable year is \$1,000 (\$2,500 U.S. assets × 40%).

(iv) *Step 3.* Because the amount of *FC*'s U.S.-connected liabilities (\$1,000) exceeds the average total amount of U.S. booked liabilities of *B* (\$800), *FC* determines its interest expense in accordance with paragraph (d)(5) of this section by adding the interest paid or accrued on U.S. booked liabilities, and the interest expense associated with the excess of its U.S.-connected liabilities over its average total amount of U.S. booked liabilities. Under paragraph (d)(5)(ii) of this section, *FC* determines the interest rate attributable to its excess U.S.-connected liabilities by dividing the interest expense paid or accrued by the average amount of U.S.-dollar denominated liabilities, which produces an interest rate of 8% (\$256/\$3200). Therefore, *FC*'s allocable interest expense is \$72 (\$56 of interest expense from U.S. booked liabilities plus \$16 (\$200 × 8%) of interest expense attributable to its excess U.S.-connected liabilities).

Example 2. Computation of interest expense; fixed ratio—(i) The facts are the same as in Example 1, except that *FC* makes a fixed ratio election under paragraph (c)(4) of this section. The conclusions under Step 1 are the same as in Example 1.

(ii) *Step 2.* Under paragraph (c)(1) of this section, the amount of U.S.-connected liabilities for the taxable year is determined by multiplying \$2,500 (the value of U.S. assets determined under Step 1) by the fixed ratio for the taxable year, which, under paragraph (c)(4) of this section is 50 percent. Thus, the amount of U.S.-connected liabilities for the taxable year is \$1,250 (\$2,500 U.S. assets × 50%).

(iii) *Step 3.* As in Example 1, the amount of *FC*'s U.S.-connected liabilities exceed the average total amount of U.S. booked liabilities of *B*, requiring *FC* to determine its interest expense under paragraph (d)(5) of this section. In this case, however, *FC* has excess U.S.-connected liabilities of \$450 (\$1,250 of U.S.-connected liabilities — \$800 U.S. booked liabilities). *FC* therefore has allocable interest expense of \$92 (\$56 of interest expense from U.S. booked liabilities plus \$36 (\$450 × 8%) of interest expense attributable to its excess U.S.-connected liabilities).

Example 3. Scaling ratio.—(i) *Facts.* Bank *Z*, a resident of country *X*, has a branch in the United States through which it conducts its banking business. For the taxable year, *Z* has U.S.-connected liabilities, determined under paragraph (c) of this section, equal to \$300. *Z*, however, has U.S. booked liabilities of \$300 and *U500*. Therefore, assuming an exchange rate of the *U* to the U.S. dollar of 5:1, *Z* has U.S. booked liabilities of \$400 (\$300 + (*U500* ÷ 5)).

(ii) *U.S.-connected liabilities.* Because *Z*'s U.S. booked liabilities of \$400 exceed its U.S.-

connected liabilities by \$100, all of Z's interest expense allocable to its U.S. trade or business must be scaled back pro-rata. To determine the scaling ratio, Z divides its U.S.-connected liabilities by its U.S. booked liabilities, as required by paragraph (d)(4) of this section. Z's interest expense is scaled back pro rata by the resulting ratio of $\frac{3}{4}$ ($\$300 \div \400). Z's income, expense, gain or loss from hedging transactions described in paragraph (d)(2)(vi) of this section must be similarly reduced.

Example 4. [Reserved]

(e) *Separate currency pools method*—(1) *General rule.* If a foreign corporation elects to use the method in this paragraph, its total interest expense allocable to ECI is the sum of the separate interest deductions for each of the currencies in which the foreign corporation has U.S. assets. The separate interest deductions are determined under the following three-step process.

(i) *Determine the value of U.S. assets in each currency pool.* First, the foreign corporation must determine the amount of its U.S. assets, using the methodology in paragraph (b) of this section, in each currency pool. The foreign corporation may convert into U.S. dollars any currency pool in which the foreign corporation holds less than 3% of its U.S. assets. A transaction (or transactions) that hedges a U.S. asset shall be taken into account for purposes of determining the currency denomination and the value of the U.S. asset.

(ii) *Determine the U.S.-connected liabilities in each currency pool.* Second, the foreign corporation must determine the amount of its U.S.-connected liabilities in each currency pool by multiplying the amount of U.S. assets (as determined under paragraph (b)(3) of this section) in the currency pool by the foreign corporation's actual ratio (as determined under paragraph (c)(2) of this section) for the taxable year or, if the taxpayer has made an election in accordance with paragraph (c)(4) of this section, by the fixed ratio.

(iii) *Determine the interest expense attributable to each currency pool.* Third, the foreign corporation must determine the interest expense attributable to each currency pool by multiplying the U.S.-connected liabilities in each currency pool by the prescribed interest rate as defined in paragraph (e)(2) of this section.

(2) *Prescribed interest rate.* For each currency pool, the prescribed interest rate is determined by dividing the total interest expense that is paid or accrued for the taxable year with respect to the

foreign corporation's worldwide liabilities denominated in that currency, by the foreign corporation's average worldwide liabilities (whether interest bearing or not) denominated in that currency. The interest expense and liabilities are to be stated in that currency.

(3) *Hedging transactions.* [Reserved]

(4) *Election not available if excessive hyperinflationary assets.* The election to use the separate currency pools method of this paragraph (e) is not available if the value of the foreign corporation's U.S. assets denominated in a hyperinflationary currency, as defined in § 1.985-1, exceeds ten percent of the value of the foreign corporation's total U.S. assets. If a foreign corporation made a valid election to use the separate currency pools method in a prior year but no longer qualifies to use such method pursuant to this paragraph (e)(4), the taxpayer must use the method provided by paragraphs (b) through (d) of this section.

(5) *Examples.* The separate currency pools method of this paragraph (e) is illustrated by the following examples:

Example 1. Separate currency pools method—

(i) *Facts.* (A) Bank Z, a resident of country X, has a branch in the United States through which it conducts its banking business. For its 1997 taxable year, Z has U.S. assets, as defined in paragraph (b) of this section, that are denominated in U.S. dollars and in U, the country X currency. Accordingly, Z's U.S. assets are as follows:

| | Average Value |
|--------------------|---------------|
| U.S. Dollar Assets | \$20,000 |
| U Assets | U 5,000 |

(B) Z's worldwide liabilities are also denominated in U.S. dollars and in U. The average interest rates on Z's worldwide liabilities, including those in the United States, are 6% on its U.S. dollar liabilities, and 12% on its liabilities denominated in U. Assume that Z has properly elected to use its actual ratio of 95% to determine its U.S.-connected liabilities in Step 2, and has also properly elected to use the separate currency pools method provided in paragraph (e) of this section.

(ii) *Determination of interest expense.* Z determines the interest expense attributable to its U.S.-connected liabilities according to the steps described below.

(A) First, Z separates its U.S. assets into two currency pools, one denominated in U.S. dollars (\$20,000) and the other denominated in U (U5,000).

(B) Second, Z multiplies each pool of assets by the applicable ratio of worldwide liabilities to assets, which in this case is 95%. Thus, Z has U.S.-connected liabilities of \$19,000 ($\$20,000 \times 95\%$), and U4750 ($U5000 \times 95\%$).

(C) Third, Z calculates its interest expense by multiplying each pool of its U.S.-connected

liabilities by the relevant interest rates. Accordingly, Z's allocable interest expense for the year is \$1140 ($\$19,000 \times 6\%$), the sum of the expense associated with its U.S. dollar liabilities, plus U570 ($U4750 \times 12\%$), the interest expense associated with its liabilities denominated in U. Z must translate its interest expense denominated in U in accordance with the rules provided in section 988, and then must determine whether it is subject to any other provision of the Code that would disallow or defer any portion of its interest expense so determined.

Example 2. [Reserved]

(f) *Effective date*—(1) *General rule.* This section is effective for taxable years beginning on or after June 6, 1996.

(2) *Special rules for financial products.* [Reserved]

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved February 28, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 5, 1996, 8:45 a.m., and published in the issue of the Federal Register for March 8, 1996, 61 F.R. 9326)

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

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 807, 846, 1288, 7520, 7872.)

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

Rev. Rul. 96-19

This revenue ruling provides various prescribed rates for federal income tax purposes for April 1996 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b).

Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-

income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an

annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

| REV. RUL. 96-19 TABLE 1 | | | | |
|---|-------------------------------|-------------------|------------------|----------------|
| Applicable Federal Rates (AFR) for April 1996 | | | | |
| | <i>Period for Compounding</i> | | | |
| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
| <i>Short-Term</i> | | | | |
| AFR | 5.33% | 5.26% | 5.23% | 5.20% |
| 110% AFR | 5.87% | 5.79% | 5.75% | 5.72% |
| 120% AFR | 6.41% | 6.31% | 6.26% | 6.23% |
| 130% AFR | 6.96% | 6.84% | 6.78% | 6.74% |
| <i>Mid-Term</i> | | | | |
| AFR | 5.88% | 5.80% | 5.76% | 5.73% |
| 110% AFR | 6.48% | 6.38% | 6.33% | 6.30% |
| 120% AFR | 7.08% | 6.96% | 6.90% | 6.86% |
| 130% AFR | 7.68% | 7.54% | 7.47% | 7.42% |
| 150% AFR | 8.89% | 8.70% | 8.61% | 8.55% |
| 175% AFR | 10.41% | 10.15% | 10.02% | 9.94% |
| <i>Long-Term</i> | | | | |
| AFR | 6.51% | 6.41% | 6.36% | 6.33% |
| 110% AFR | 7.17% | 7.05% | 6.99% | 6.95% |
| 120% AFR | 7.84% | 7.69% | 7.62% | 7.57% |
| 130% AFR | 8.50% | 8.33% | 8.25% | 8.19% |

| REV. RUL. 96-19 TABLE 2 | | | | |
|-----------------------------|-------------------------------|-------------------|------------------|----------------|
| Adjusted AFR for April 1996 | | | | |
| | <i>Period for Compounding</i> | | | |
| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
| Short-Term adjusted AFR | 3.40% | 3.37% | 3.36% | 3.35% |
| Mid-term adjusted AFR | 4.37% | 4.32% | 4.30% | 4.28% |
| Long-term adjusted AFR | 5.31% | 5.24% | 5.21% | 5.18% |

| REV. RUL. 96-19 TABLE 3 | |
|--|-------|
| Rates Under Section 382 for April 1996 | |
| Adjusted federal long-term rate for the current month | 5.31% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.) | 5.31% |

REV. RUL. 96-19 TABLE 4

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

| | |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.45% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.62% |

REV. RUL. 96-19 TABLE 5

Rate Under Section 7520 for April 1996

| | |
|---|------|
| Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest | 7.0% |
|---|------|

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1996. See Rev. Rul. 96-19, page 24.

Part III. Administrative, Procedural, and Miscellaneous

Interest Netting Study

Notice 96-18

This Notice invites public comment in connection with the Internal Revenue Service's and Treasury's study of "interest netting." This study was initially described in Announcement 96-5, "Administrative Initiatives to Enhance Taxpayer Rights," 1996-4 I.R.B. 99 at 101 (January 22, 1996).

BACKGROUND

The Internal Revenue Code provides that taxpayers who underpay their taxes generally must pay interest to the government for the period of the underpayment. Section 6601. The IRS has limited authority to abate the interest that is required by statute. Section 6404.

The Code likewise generally requires the government to pay interest to taxpayers with respect to any overpayment of taxes. Section 6611. There are, however, a number of limitations on the government's liability for interest, including the rule that no interest is payable with respect to a tax refund claimed for a current year if the refund is issued within 45 days of the last day prescribed for filing a return claiming the refund. Section 6611(e).

Prior to enactment of the Tax Reform Act of 1986, the same interest rate applied to underpayments and overpayments. The Tax Reform Act of 1986, however, provided for the interest rate charged on underpayments to be one percentage point higher than the interest rate paid on overpayments. See §§ 6621(a)(1) and (2). The Omnibus Budget Reconciliation Act of 1990 added that, under certain conditions, the interest rate on large corporate underpayments would be 3 percentage points higher than the interest rate on overpayments. The Uruguay Round Agreements Act, enacted in 1994, increased the differential between large corporate underpayments and certain corporate overpayments to 4.5 percentage points. See §§ 6621(a)(1) and (c).

If an overpayment is credited against an underpayment, the effect of these interest rate differences is reduced. Section 6601(f) provides:

If any portion of a tax is satisfied by credit of an overpayment, then no

interest shall be imposed ... on the portion of the tax so satisfied for any period during which, if the credit had not been made, interest would have been allowable with respect to such overpayment.

Section 6402(a) provides general authority for the IRS to credit an overpayment against an underpayment. This section states:

In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall ... refund any balance to such person.

Section 301.6402-1 of the Regulations on Procedure and Administration provides that the Commissioner may credit any overpayment of tax against any "outstanding liability" for any tax.

Congress has recognized the potential burden that the interest rate differential places on taxpayers who have both overpayments and underpayments. Thus, each time Congress has increased the interest rate differential, Congress has stated in legislative history that the Service should implement the most comprehensive procedures "consistent with sound administrative practice" to allow overpayments to be credited against underpayments. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., 1986-3 C.B. (Vol. 4) 785 (accompanying the Tax Reform Act of 1986); H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess., 1991-2 C.B. 591 (accompanying the Omnibus Budget Reconciliation Act of 1990); H.R. Rep. No. 826, 103d Cong., 2d Sess., 1995-1 C.B. 254 (accompanying the Uruguay Round Agreements Act).

The Service has developed substantial crediting procedures to implement interest netting. For example:

(a) The Service will consider all increases and decreases in a taxpayer's liabilities within a single tax year before applying the statutory interest rules to that year. Rev. Proc. 94-60, 1994-2 C.B. 774, provides that a taxpayer will not be charged the differential interest rate under § 6621(a) on an underpayment that is satisfied by credit of an overpayment arising in the same taxable year. This interest netting procedure is referred to as "annual interest netting."

(b) The Service permits crediting of overpayments against underpayments for the period of time when the underpayments and overpayments are both unpaid and outstanding, even if they are from different tax years or for different types of tax. This procedure for interest netting is referred to as "offsetting."

The Service, however, generally does not net interest where a taxpayer realizes an overpayment in one tax year that overlaps with a deficiency that a taxpayer has already paid for a different tax year. Likewise, the Service generally does not net interest where an unpaid deficiency in one tax year overlaps with an overpayment that the Service has already paid for a different tax year. This kind of interest netting is referred to as "global interest netting."

The Eighth Circuit recently addressed whether the Service is required to perform global interest netting calculations. *Northern States Power Co. v. United States*, 73 F.3d 764 (8th Cir. 1996). Interpreting §§ 6402(a) and 301.6402-1, the Eighth Circuit held that where the taxpayer's liability was fully paid, there was no "outstanding liability" against which to net the taxpayer's subsequent overpayment. The court further held that the Service, in any event, has the discretion whether to credit overpayments against underpayments.

REQUEST FOR PUBLIC COMMENT

Many taxpayers and practitioners have suggested that the Service adopt global interest netting procedures. Global interest netting, however, raises a number of legal, policy and administrative issues. Thus, Announcement 96-5 states that the Service will conduct a study of these issues and solicit public comments for the study.

Legal and Policy Issues of Global Interest Netting

As described above, global interest netting would allow the taxpayer or the Service to recalculate interest for a certain period of time whenever a taxpayer has either a new overpayment that overlaps with an underpayment that the taxpayer has already paid to the Service, or a new underpayment that overlaps with an overpayment that

the Service has already paid to the taxpayer. The Service requests comments on the following issues:

1. In view of the policy generally favoring the finality of tax determinations, should a rule concerning the finality of global interest netting computations be adopted, and, if so, what should that rule be? What effect, if any, should the statute of limitations have on global interest netting, particularly considering the language in § 6402(a) regarding the applicable period of limitations? Should the statute of limitations be kept open longer in light of global interest netting?

2. When would it be appropriate for the Service to net interest globally for a particular tax year or period? For example, would it be appropriate to net interest globally before the final decision of an appeal or court decision for a tax period overlapping with the period at issue that might affect the interest calculation for such period? Would it be appropriate to net interest globally before the final decision of an appeal or court decision for a tax period that does not overlap with the period at issue, if such decision could produce an adjustment, such as a net operating loss or credit, that might affect the interest calculation for such period?

3. What would be the effect of carrybacks and carryforwards (e.g., net operating losses, various credits, etc.) on the global interest netting calculation for a certain period? Would carrybacks and carryforwards always require a recalculation of interest for such period? Or should global interest netting calculations only be made after carryforwards and carrybacks that might affect the period at issue are finally determined? How would the analysis be affected by the restricted interest provisions of §§ 6601(d) and 6611(f)?

4. Does global interest netting present any unique implications for taxpayers filing consolidated returns?

5. How would global interest netting affect § 861 allocations or interact with other U.S. international tax provisions?

Administrative Issues

The Service's computer system does not have the data storage capacity to keep information concerning paid deficiencies and paid refunds on line. The Service thus cannot make global interest netting calculations on its computer

system but must instead retrieve the data on paid deficiencies and paid refunds from its computer storage files and then manually make the interest calculations. This procedure could entail a significant additional commitment of IRS resources, primarily because of the need to verify the accuracy and completeness of the data necessary to make a global interest netting calculation and ensure an accurate calculation. Accordingly, the Service requests the following comments:

1. To the extent that taxpayers or practitioners currently make global interest netting calculations for themselves or their clients, the Service would like to receive a detailed description of how those calculations are performed, the cost of performing those calculations, and the reasons why the method used by particular taxpayers or practitioners would be appropriate for the Service to apply to large numbers of taxpayers without requiring significant additional Service resources.

2. How should the Service fulfill its obligation to verify the accuracy and completeness of all taxpayer data relevant to make a global interest netting calculation for a particular period, given the Service's computer data storage limitations?

Time and Address for Comments

The Service and Treasury would appreciate written comments on the above issues. Comments should be submitted by June 30, 1996, to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:DOM:CORP:T:R:IT&A
(Branch 1) Room 5228
Washington, DC 20044

The comments you submit will be available for public inspection and copying.

DRAFTING INFORMATION

For further information regarding this notice, contact Joel Rutstein on (202) 622-4530 (not a toll-free call).

Study of Certain Joint Return and Community Property Issues For Divorced and Separated Taxpayers

Notice 96-19

This Notice invites public comments

for a study being conducted by the Service and Treasury on certain joint return and community property issues, particularly as they affect divorced and separated taxpayers. This study was initially described in Announcement 96-5, "Administrative Initiatives to Enhance Taxpayer Rights," 1996-4 I.R.B. 99 at 101 (Jan. 22, 1996).

BACKGROUND

Section 6013(a) of the Internal Revenue Code generally provides that spouses may file a joint return even though one of the spouses has neither gross income nor deductions. Section 6013(d)(3) states that spouses are jointly and severally liable for the taxes on a joint return.

For married taxpayers who filed jointly but then divorce or separate, joint and several liability means that a former spouse remains liable for all taxes, additions to tax, penalties and interest due with respect to the joint return even if all the income was earned by the other spouse. This liability remains regardless of the terms of any divorce decree or separation agreement.

Congress was concerned that the joint and several liability standard could unfairly attribute tax liability on a joint return to a spouse who should not be held liable for such taxes under certain circumstances. Congress thus enacted the innocent spouse provisions of § 6013(e). Section 6013(e), however, establishes a detailed set of requirements that must be met to obtain innocent spouse relief. As a result, the innocent spouse provisions do not apply in many situations.

"Community property" laws also present unique issues for divorced or separated taxpayers. Community property laws generally consider each spouse to own one-half of the community income of the spouses. Consistent with these general principles of community property laws, the Supreme Court in 1930 held that spouses who live in community property jurisdictions but file separate returns must each include half of the community income in his or her return, even if all the income was earned by one spouse. *Poe v. Seaborn*, 282 U.S. 101 (1930). Under this rule, each spouse would be liable for taxes, additions to tax, penalties and interest due with respect

to the amount required to be reported on his or her return.

Congress recognized that the rule of *Poe v. Seaborn* could cause hardship for taxpayers in community property states. Congress thus amended the Internal Revenue Code to provide that under certain conditions, the community property laws would be disregarded in determining certain types of income for federal income tax purposes. In particular, §§ 66 and 879(a) overrule *Poe v. Seaborn*, in part, generally by taxing income to the spouse who earned, managed or controlled such income. The requirements of these sections, however, can be difficult to meet and they do not apply in many situations.

The community property laws also present unique issues regarding which assets and income may be collected to satisfy federal tax liabilities. For example, all or a portion of the community property of the spouses may be used to satisfy a separate tax obligation of one spouse, even if the tax arose before the marriage or even during a previous marriage.

REQUEST FOR PUBLIC COMMENT

The Service and Treasury are studying the effects of certain proposals to change current law regarding the tax treatment of divorced and separated taxpayers. The Service and Treasury request comments on the following proposals:

A. *Replace the Joint and Several Liability Standard with a Proportionate Liability Standard*

A proportionate liability standard would hold each spouse liable for only that portion of the tax attributable to a joint return that relates to that spouse's contribution to the aggregate joint return tax liability of both spouses. Please comment on the effects of changing the current joint and several liability standard to a proportionate liability standard, particularly as it would affect divorced and separated taxpayers. Comments on the following issues would be particularly helpful:

1. How would such a system work if the former spouses are not cooperating with one another, or with the Service, regarding their respective shares of the tax liability?

2. Would a proportionate liability standard allow taxpayers to take undue

advantage of the tax system by inter-spousal property transfers, particularly in view of the nonrecognition of gain on such transfers under § 1041?

3. Under a proportionate liability standard, how would the Service trace assets and allocate deductions and credits between the spouses to determine each spouse's correct tax liability and to collect amounts due in the most efficient manner possible?

4. Would a proportionate liability standard create burdensome filing requirements by requiring additional schedules or columns for reporting the items attributable to each spouse, such as those on some state income tax returns?

5. If a proportionate liability standard is adopted, what changes would be necessary to the current rules concerning communications with taxpayers, examinations, assessments, collections, payments and refunds of tax, penalties and interest?

6. How would adoption of a proportionate liability standard affect state, local, and other tax systems?

B. *Base the Respective Spouses' Tax Obligations and Liabilities on the Terms of a Divorce Decree, Separation Agreement or Other Property Settlement*

Please comment on the effects of basing the respective spouses' tax obligations and liabilities on the terms of a divorce decree, separation agreement or other property settlement. In particular, please comment on the following:

1. Would the Service be required to be a party to divorce or separation proceedings? If not, how could the interests of the government be represented in such cases?

2. What rule would apply if the divorce decree or separation agreement did not provide for allocation of tax liability?

3. How would this proposal affect those spouses less able to influence the terms of a divorce decree or separation agreement (e.g., because of limited financial or legal resources)?

C. *Reform the Innocent Spouse Provisions*

Under the current joint and several liability standard, please comment on

the specific requirements of §§ 66 and 6013(e), particularly with respect to divorced and separated taxpayers.

1. Are there situations in which the innocent spouse provisions do not function in an appropriate manner? Describe these situations.

2. Are there situations in which expanded innocent spouse relief could be abused by taxpayers seeking inappropriate relief? If so, what limitations would prevent such abuses?

3. Are there changes to the Service's administrative practices that should be made with respect to the innocent spouse provisions?

D. *Further Limit the Income-Splitting Effect of Poe v. Seaborn in Community Property Jurisdictions*

Please comment on the effects of further limiting the income splitting rule of *Poe v. Seaborn* in favor of some form of income tracing, such as in § 879, particularly as it would affect divorced and separated taxpayers.

1. Would this proposal present the same issues as those raised above with respect to proportionate liability? Why or why not?

2. How would this proposal work if the divorced or separated taxpayers live in different jurisdictions with different property laws?

3. Would further limiting *Poe v. Seaborn* affect the assets or income of a divorced or separated spouse that could be collected to satisfy the federal income tax liability of each spouse?

E. *Limit the Amount of Community Property Subject to Collection Actions*

Please comment on the effects of limiting the amount of community property that is subject to collection actions to satisfy the separate tax liabilities of one of the spouses that arose before the couple's marriage.

1. Would this proposal require changes to state or federal law?

2. What specific changes, if any, would be required?

Time and Address for Comments

The Service and Treasury would appreciate written comments on the

above issues. Comments should be submitted by June 30, 1996, to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:CORP:T:R:ITA (Branch 4), Room 5228
Washington, D.C. 20044

The comments you submit will be available for public inspection and copying.

DRAFTING INFORMATION

For further information regarding this notice, contact Joel Rutstein on (202) 622-4530 (not a toll-free call).

Specifications for filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Magnetically or Electronically

Notice 96-20

The format for the country and

postal codes (positions 324-332 of the "Q" record) was listed incorrectly in Internal Revenue Bulletin 1996-2, Revenue Procedure 96-11, January 8, 1996, reprinted as Publication 1187 (Rev. 1-96), Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Magnetically and Electronically. Listed below is the correct format to be used in the "Q" record when submitting the Form 1042-S magnetically or electronically:

RECORD NAME: RECIPIENT "Q" RECORD-CONTINUED

| Positions | Field Title | Length | Description and Remarks |
|-----------|------------------------------------|--------|---|
| 324-332 | Postal Code | 9 | Enter a Foreign or U.S. Postal Code (ZIP Code). A Postal Code is REQUIRED for United States and U.S. Territories, Canadian, and Australian addresses. Withholding Agents should make an effort to obtain postal codes for all other countries. Only alphabetic, numeric, and blank characters are valid. Do not omit any blanks that may appear in the ZIP code. Use the following table to format Postal Codes for the three required countries ("a" denotes alpha characters, "n" denotes numerics, "b" denotes a blank). All postal codes should be left-justified and blank filled. |
| | <i>Country</i> | | <i>Postal Code Format</i> |
| | United States and U.S. Territories | | nnnnnbbbb or nnnnnnnnn |
| | Canadian | | anabnanbb |
| | Australian | | nnnnbbbbbb |

Time for Furnishing Wage Statements on Termination of Employer's Operations; Correction

Notice 96-21

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains a correction to final regulations [TD 8636 (1996-4 I.R.B. 64)] which were published in the Federal Register for Thursday, December 21, 1995 (60 FR 66139). The final regulations relate to the time for furnishing wage statements to employees and for filing wage statements with the Social Security Administration upon the termination of an employer's operations.

EFFECTIVE DATE: January 1, 1997.

FOR FURTHER INFORMATION CONTACT: Jean M. Casey, (202) 622-6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of this correction are under section 6051, 6071, and 6081 of the Internal Revenue Code.

Need for Correction

As published, TD 8636 contains a typographical error that is in need of clarification.

Correction of Publication

Accordingly, the publication of the

final regulations which is the subject of FR Doc. 95-30685, is corrected as follows:

On page 66140, column 2, in the preamble under the paragraph heading "Additional month to provide Forms W-2 and W-3 to SSA", last line, the language "the final Form 941 is due." is corrected to read "the end of the quarter."

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on February 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for February 27, 1996, 61 F.R. 7214)

Actuarial Tables Exceptions; Correction

Notice 96-22

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains a correction to final regulations [TD 8630 (1996-3 I.R.B. 19)] which were published in the Federal Register for Wednesday, December 13, 1995 (60 FR 63913). The final regulations relate to income, estate, and gift tax regulations regarding exceptions to the use of valuation tables.

EFFECTIVE DATE: December 13, 1995.

FOR FURTHER INFORMATION CONTACT: William L. Blodgett, (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of this correction are under sections 170, 642, 664, 2031, 2512 and 7520 of the Internal Revenue Code.

Need for Correction

As published, TD 8630 contains a typographical error that is in need of clarification.

Correction of Publication

Accordingly, the publication of the final regulations which is the subject of FR Doc. 95-30272, is corrected as follows:

On page 63913, column 1, in the preamble in the caption "EFFECTIVE DATE," line 2, the language "effective December 13, 1995." is corrected to read "effective December 13, 1995, and applicable for transfers after December 13, 1995."

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on February 29, 1996, 8:45 a.m., and published in the issue of the Federal Register for March 1, 1996, 61 F.R. 7991)

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, Sections 62, 162, 267, 274; 1.62-2, 1.162-17, 1.267(a)-1, 1.274-5T, 1.274(d)-1(a).)

Rev. Proc. 96-28

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 94-77, 1994-2 C.B. 825, by providing rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and/or incidental expenses incurred while traveling away from home will be deemed substantiated under § 1.274-5T of the temporary Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. This revenue procedure also provides an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. Use of a method described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation.

SECTION 2. BACKGROUND

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct expenses paid or incurred while traveling away from home in pursuit of a trade or business. However, under § 262, no portion of such travel expenses that is attributable to personal, living, or family expenses is deductible.

.02 Section 274(d) provides, in part, that no deduction shall be allowed under § 162 for any traveling expense (including meals and lodging while away from home) unless the taxpayer complies with certain substantiation requirements. The section further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by such regulations.

.03 Section 1.274(d)-1(a) of the regulations, in part, grants the Commissioner the authority to prescribe rules

relating to reimbursement arrangements or per diem allowances for ordinary and necessary expenses paid or incurred while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which such arrangements or allowances, if in accordance with reasonable business practice, will be regarded (1) as equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of such travel expenses for purposes of § 1.274-5T(c), and (2) as satisfying the requirements of an adequate accounting to the employer of the amount of such travel expenses for purposes of § 1.274-5T(f).

.04 Section 1.274-5T(j) grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for meals paid or incurred while traveling away from home in lieu of substantiating the actual cost of meals.

.05 For purposes of determining adjusted gross income, § 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein shall not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for such expense.

.07 Under § 1.62-2(c)(1) a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regula-

tions. Section 1.62-2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274(d)-1(a) or 1.274-5T(j) will be treated as substantiation of the amount of such expenses for purposes of § 1.62-2. Under § 1.62-2(f)(2), the Commissioner may prescribe rules under which an arrangement providing per diem allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of such an allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of such an allowance that relates to days of travel not substantiated.

.08 Section 1.62-2(h)(2)(i)(B) provides that if a payor pays a per diem allowance that meets the requirements of § 1.62-2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62-2(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under § 274(d) and § 1.274(d)-1(a) or § 1.274-5T(j), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)-3, 31.3231(e)-3, 31.3306(b)-2, and 31.3401(a)-4. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62-2(g) (relating to the return of excess amounts) do not apply to this portion.

.09 Under § 1.62-2(h)(2)(i)(B)(4), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on per diem allowances.

SECTION 3. DEFINITIONS

.01 *Per diem allowance.* The term "per diem allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62-2(c)(1) and that is:

(1) paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and/or incidental expenses for travel away from home in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at the applicable Federal per diem rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.02 *Federal per diem rate.*

(1) *General rule.* The Federal per diem rate is equal to the sum of the Federal lodging expense rate and the Federal meal and incidental expense (M&IE) rate for the locality of travel. Each of these rates for a particular locality in the continental United States ("CONUS") is set forth in Appendix A of 41 C.F.R., Chapter 301, as amended. See 41 C.F.R. Part 301-7 (1995), as amended, for specific rules regarding these Federal rates. Each of these rates is established by the Secretary of Defense for a particular non-foreign locality outside the continental United States ("OCONUS") (including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States), and by the Secretary of State for a particular foreign OCONUS locality. Each of these OCONUS rates is published in the Per Diem Supplement to the Standardized Regulations (Government Civilians, Foreign Areas). See, e.g., Maximum Travel Per Diem Allowances for Foreign Areas, PD Supplement 382, issued March 1, 1996.

(2) *Locality of travel.* The term "locality of travel" means the locality where an employee traveling away from home in connection with the performance of services as an employee of the employer stops for sleep or rest.

(3) *Incidental expenses.* The term "incidental expenses" includes, but is not limited to, expenses for laundry, cleaning and pressing of clothing, and fees and tips for services, such as for porters and baggage carriers. The term "incidental expenses" does not include taxicab fares or the costs of telegrams or telephone calls.

.03 *Flat rate or stated schedule.*

(1) *In general.* Except as provided in section 3.03(2), an allowance is paid

at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 3.01. Such allowance may be paid with respect to the number of days away from home in connection with the performance of services as an employee or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, an hourly payment to cover meal and incidental expenses paid to a pilot or flight attendant who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule. Likewise, a payment based on the number of miles traveled (e.g., cents per mile) to cover meal and incidental expenses paid to an over-the-road truck driver who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

(2) *Limitation.* For purposes of this revenue procedure, an allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced) does not meet the business connection requirement of § 1.62-2(d), is not a per diem allowance, and is not paid at a flat rate or stated schedule, unless, as of December 12, 1989, (a) the allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the allowance, or (b) an allowance computed on that basis was commonly used in the industry in which the employee is employed. See § 1.62-2(d)(3)(ii).

SECTION 4. PER DIEM SUBSTANTIATION METHOD

.01 *Per diem allowance.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day (or part of the calendar day, see section 6.04) is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal per diem rate for the locality of travel for such day (or part of such day, see section 6.04).

.02 *Meals only per diem allowance.* If a payor pays a per diem allowance only for meal and incidental expenses in lieu of reimbursing actual expenses for meal and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day (or part of the calendar day, see section 6.04) is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal M&IE rate for the locality of travel for such day (or part of such day, see section 6.04). A per diem allowance is treated as paid only for meal and incidental expenses if (1) the payor pays the employee for actual expenses for lodging, (2) the payor provides the lodging in kind, (3) the payor pays the actual expenses for lodging directly to the provider of the lodging, (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee, or (5) the allowance is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced).

.03 *Optional method for meals only deduction.* In lieu of using actual expenses, employees and self-employed individuals, in computing the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred for travel away from home, may use an amount computed at the Federal M&IE rate for the locality of travel for each calendar day (or part thereof, see section 6.04) the employee or self-employed individual is away from home. Such amount will be deemed substantiated for purposes of paragraphs (b)(2) (travel away from home) and (c) of § 1.274-5T, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel expenses in accordance with those regulations.

.04 *Special rules for transportation industry.*

(1) *In general.* This section 4.04 applies to (a) a payor that pays a per diem allowance only for meal and incidental expenses for travel away from home as described in section 4.02 to an employee in the transportation industry, or (b) an employee or self-

employed individual in the transportation industry who computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03.

(2) *Rates.* A taxpayer described in section 4.04(1) may treat \$32 as the Federal M&IE rate for any locality of travel in CONUS, and/or \$36 as the Federal M&IE rate for any locality of travel OCONUS. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts subject to section 4.02 paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. Similarly, an employee or self-employed individual that uses either (or both) of these special rates must use the special rate(s) for all amounts computed pursuant to section 4.03 for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year.

(3) *Periodic rule.* A payor described in section 4.04(1) may compute the amount of the employee's expenses that is deemed substantiated under section 4.02 periodically (not less frequently than monthly), rather than daily, by comparing the total per diem allowance paid for the period to the sum of the amounts computed at the Federal M&IE rate(s) for the localities of travel for the days (or partial days, see section 6.04) the employee is away from home during the period. For example, assume an employee in the transportation industry travels away from home within CONUS on 17 days (including partial days under section 6.04) during a calendar month and receives a per diem allowance only for meal and incidental expenses from a payor that uses the special rule under section 4.04(2). The amount deemed substantiated under section 4.02 is equal to the lesser of the total per diem allowance paid for the month or \$544 (17 days at \$32 per day).

(4) *Transportation industry defined.* For purposes of this section 4.04, an employee or self-employed individual is "in the transportation industry" only if the employee's or individual's work (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b)

regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing Federal M&IE rates. For purposes of the preceding sentence, a payor must determine that an employee or a group of employees is "in the transportation industry" by using a method that is consistently applied and in accordance with reasonable business practice.

SECTION 5. HIGH-LOW SUBSTANTIATION METHOD

.01 *General rule.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home and the payor uses the high-low substantiation method described in this section 5 for travel within CONUS, the amount of the expenses that is deemed substantiated for each calendar day (or part of the calendar day, see section 6.04) is equal to the lesser of the per diem allowance for such day or the amount computed at the rate set forth in section 5.02 for the locality of travel for such day (or part of such day, see section 6.04). This high-low substantiation method may be used in lieu of the per diem substantiation method provided in section 4.01, but may not be used in lieu of the meals only substantiation method provided in section 4.02 or 4.03.

.02 *Specific high-low rates.* The per diem rate set forth in this section 5.02 is \$152 for travel to any "high-cost locality" specified in section 5.03, or \$95 for travel to any other locality within CONUS. Whichever per diem rate applies, it is applied as if it were the Federal per diem rate for the locality of travel. For purposes of applying the high-low substantiation method, the Federal M&IE rate shall be treated as \$36 for a high-cost locality and \$28 for any other locality within CONUS.

.03 *High-cost localities.* The following localities have a Federal per diem rate of \$123 or more for all or part of the calendar year, and are high-cost localities for all of the calendar year or the portion of the calendar year specified in parenthesis under the key city name:

| <i>Key city</i> | <i>County and other defined location</i> |
|---|---|
| Alabama | |
| Gulf Shores (May 1–September 30) | Baldwin |
| Arizona | |
| Grand Canyon | All points in the Grand Canyon National Park and Kaibab National Forest within Coconino County |
| Phoenix/Scottsdale (October 1–May 14) | Maricopa |
| California | |
| Gualala/Point Arena | Mendocino |
| Los Angeles | Los Angeles, Kern, Orange, and Ventura Counties; Edwards Air Force Base; Naval Weapons Center and Ordnance Test Station, China Lake |
| Palo Alto/San Jose | Santa Clara |
| San Francisco | San Francisco |
| Santa Barbara (June 1–September 30) | Santa Barbara |
| South Lake Tahoe | El Dorado |
| Yosemite Nat'l Park | Mariposa |
| Colorado | |
| Aspen (January 15–March 31) | Pitkin |
| Boulder (May 1–October 31) | Boulder |
| Denver | Denver, Adams, Arapahoe and Jefferson |
| Keystone/Silverthorne | Summit |
| Steamboat Springs (December 15–March 31) | Routt |
| Telluride (November 1–March 31) | San Miquel |
| Vail | Eagle |
| Connecticut | |
| Bridgeport/Danbury | Fairfield |
| District of Columbia | |
| Washington, D.C. | Washington, D.C.; the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington, Loudoun, and Fairfax in Virginia; and the counties of Montgomery and Prince Georges in Maryland |
| Florida | |
| Key West | Monroe |
| Naples (December 15–April 30) | Collier |
| Illinois | |
| Chicago | Du Page, Cook, and Lake |
| Indiana | |
| Nashville (June 1–October 31) | Brown |
| Maine | |
| Bar Harbor (July 1–September 14) | Hancock |
| Rockport (June 15–October 31) | Knox |
| Maryland | |
| Annapolis | Anne Arundel |
| Baltimore | Baltimore and Harford |
| Ocean City (May 1–September 30) | Worcester |
| Massachusetts | |
| Boston | Suffolk |

| <i>Key city</i> | <i>County and other defined location</i> |
|--|---|
| Cambridge/Lowell | Middlesex |
| Hyannis (July 1–September 30) | Barnstable |
| Martha’s Vineyard/ Nantucket | Dukes and Nantucket |
| Michigan | |
| Detroit | Wayne |
| Leland (May 1–September 30) | Leelanau |
| Mackinac Island (June 1–September 30) | Mackinac |
| Traverse City (May 1–September 30) | Grand Traverse |
| Nevada | |
| Incline Village | Incline Village |
| Stateline | Douglas |
| New Jersey | |
| Atlantic City (April 1–November 30) | Atlantic |
| Newark | Bergen, Essex, Hudson, Passaic and Union |
| Ocean City/Cape May | Cape May |
| Parsippany/Dover | Morris County; Picatinny Arsenal |
| Princeton/Trenton | Mercer |
| New Mexico | |
| Santa Fe | Santa Fe |
| New York | |
| Lake Placid (June 1–November 14) | Essex |
| New York City | The boroughs of Bronx, Brooklyn, Manhattan, Queens, and Staten Island; Nassau and Suffolk Counties |
| White Plains | Westchester |
| North Carolina | |
| Duck/Outer Banks (May 1–September 30) | Dare |
| Ohio | |
| Sandusky (May 1–September 30) | Erie |
| Oregon | |
| Crater Lake/Klamath Falls | Klamath |
| Pennsylvania | |
| Philadelphia | Philadelphia; city of Bala Cynwyd in Montgomery County |
| Valley Forge/Malvern | Chester |
| Rhode Island | |
| Newport (May 1–October 14) | Newport |
| Providence | Providence |
| South Carolina | |
| Myrtle Beach (May 1–September 30) | Horry County; Myrtle Beach Air Force Base |
| Utah | |
| Bullfrog (April 1–October 31) | Garfield |
| Park City (December 1–March 31) | Summit |

Key city

Virginia

Virginia Beach

(May 1–September 30)

Wintergreen

Wisconsin

Wisconsin Dells

(June 1–September 14)

Wyoming

Jackson

(June 1–October 14)

County and other defined location

Virginia Beach, Norfolk, Portsmouth
and Chesapeake

Nelson

Columbia

Teton

.04 *Changes in high-cost localities.*

The list of high-cost localities in section 5.03 of this Revenue Procedure differs from the list of high-cost localities in section 5.03 of Rev. Proc. 94-77. The following localities have been added to the list of high-cost localities: Phoenix/Scottsdale, Arizona (October 1–May 14); Palo Alto/San Jose, California, and Santa Barbara, California (June 1–September 30); Boulder, Colorado, Denver, Colorado, and Telluride, Colorado (November 1–March 31); Bridgeport/Danbury, Connecticut; Nashville, Indiana (June 1–October 31); Annapolis, Maryland, and Baltimore, Maryland; Detroit, Michigan, Leland, Michigan (May 1–September 30), and Traverse City, Michigan (May 1–September 30); Incline Village, Nevada; Parsippany/Dover, New Jersey, and Princeton/Trenton, New Jersey; Outer Banks, North Carolina (May 1–September 30); Sandusky, Ohio (May 1–September 30); Crater Lake/Klamath, Oregon; Valley Forge/Malvern, Pennsylvania; Providence, Rhode Island; and Park City, Utah (December 1–March 31). The portion of the year for which the following are high-cost localities has been changed: Gulf Shores, Alabama (May 1–September 30); South Lake Tahoe, California (all year); Steamboat Springs, Colorado (December 15–March 31), and Vail, Colorado (all year); Naples, Florida (December 15–April 30); Bar Harbor, Maine (July 1–September 14), and Rockport, Maine (June 15–October 31); Hyannis, Massachusetts (July 1–September 30); State-line, Nevada (all year); Ocean City/Cape May, New Jersey (all year); Santa Fe, New Mexico (all year); and Bullfrog, Utah (April 1–October 31). The following localities have been removed from the list of high-cost localities: Chinle, Arizona; Death Valley, California, and Santa Cruz, California; Durango, Colorado; Fort Myers, Florida;

Columbia, Maryland; and Chestor/Radnor, Pennsylvania.

.05 *Specific limitation.* A payor that uses the high-low substantiation method with respect to an employee must use that method for all amounts paid to that employee for travel away from home within CONUS during the calendar year. However, with respect to that employee, the payor may still reimburse actual expenses or use the meals only per diem method described in section 4.02 for any travel away from home, and may use the per diem substantiation method described in section 4.01 for any OCONUS travel away from home.

SECTION 6. LIMITATIONS AND SPECIAL RULES

.01 *In general.* The Federal per diem rate, the Federal lodging expense rate, and the Federal M&IE rate described in section 3.02 for the locality of travel will be applied in the same manner as applied under the Federal Travel Regulations, 41 C.F.R. Part 301-7 (1995), except as provided in sections 6.02 through 6.04.

.02 *Federal per diem rate.* A receipt for lodging expenses is not required in order to apply the Federal per diem rate for the locality of travel.

.03 *Federal per diem or M&IE rate.* A payor is not required to reduce the Federal per diem rate or the Federal M&IE rate for the locality of travel for meals provided in kind, provided the payor has a reasonable belief that meal and incidental expenses were or will be incurred by the employee.

.04 *Proration of the Federal per diem or M&IE rate.* Pursuant to the Federal Travel Regulations, in determining the Federal per diem rate or the Federal M&IE rate for the locality of travel, the full applicable Federal M&IE rate is available for a full day of

travel from 12:01 a.m. to 12:00 midnight. For purposes of determining the amount deemed substantiated under section 4 or 5 with respect to partial days of travel away from home, either of the following methods may be used to prorate the Federal M&IE rate to determine the Federal per diem rate or the Federal M&IE rate for the partial days of travel:

(1) Such rate may be prorated using the method prescribed by the Federal Travel Regulations under which one-fourth of the applicable Federal M&IE rate is allowed for each 6-hour quarter of the day (*i.e.*, midnight to 6 a.m., 6 a.m. to noon, noon to 6 p.m., and 6 p.m. to midnight) during any portion of which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual; or

(2) Such rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to 2 times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1 1/2 times the Federal M&IE rate would be allowed under the Federal Travel Regulations). Similarly, if a self-employed individual travels away from home from 7 p.m. one day to 9 p.m. the next day, a method of proration that results in an amount equal to 1 1/2 times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1 1/4 times the Federal M&IE rate would be allowed under the Federal Travel Regulations).

.05 *Application of the 50-percent limitation on meal expenses.* When a per diem allowance is paid only for

meal and incidental expenses or when an amount for meal and incidental expenses is computed pursuant to section 4.03, an amount equal to the lesser of the per diem allowance for each calendar day (or part of the calendar day, see section 6.04) or the Federal M&IE rate for the locality of travel for such day (or part of such day, see section 6.04) is treated as an expense for food and beverages. When a per diem allowance is paid for lodging, meal, and incidental expenses, the payor must treat an amount equal to the Federal M&IE rate for the locality of travel for each calendar day (or part of the calendar day, see section 6.04) the employee is away from home as an expense for food and beverages. For purposes of the preceding sentence, when a per diem allowance for lodging, meal, and incidental expenses for a full day of travel is paid at a rate that is less than the Federal per diem rate for the locality of travel, the payor may treat an amount equal to 40 percent of such per diem allowance for a full day of travel as the Federal M&IE rate for the locality of travel.

.06 *No double reimbursement or deduction.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and/or incidental expenses in accordance with section 4 or 5, any additional payment with respect to such expenses is treated as paid under a nonaccountable plan, is included in the employee's gross income, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. Similarly, if an employee or self-employed individual computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 or 4.04, no other deduction is allowed to the employee or self-employed individual with respect to such expenses. For example, assume an employee receives a per diem allowance from a payor for lodging, meal, and/or incidental expenses incurred while traveling away from home. During that trip, the employee pays for dinner for the employee and two business associates. The payor reimburses as a business entertainment meal expense the meal expense for the employee and the two business associates. Because the payor also pays a per diem allowance to cover the cost of the employee's meals, the amount paid by

the payor for the employee's portion of the business entertainment meal expense is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes.

.07 *Related parties.* Sections 4.01, 4.02, 4.04 (to the extent it relates to section 4.02), and 5 of this revenue procedure will not apply in any case in which a payor and an employee are related within the meaning of § 267(b), but for this purpose the percentage of ownership interest referred to in § 267(b)(2) shall be 10 percent.

SECTION 7. APPLICATION

.01 If the amount of travel expenses is deemed substantiated under the rules provided in section 4 or 5, and the employee actually substantiates to the payor the elements of time, place, and business purpose of the travel expenses in accordance with paragraphs (b)(2) (travel away from home) and (c) (other than subparagraph (2)(iii)(A) thereof) of § 1.274-5T, the employee is deemed to satisfy the adequate accounting requirements of § 1.274-5T(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274-5T(c). See § 1.62-2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.02 An arrangement providing per diem allowances will be treated as satisfying the requirement of § 1.62-2(f)(2) with respect to returning amounts in excess of expenses if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) any portion of such an allowance that relates to days of travel not substantiated, even though the arrangement does not require the employee to return the portion of such an allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance per diem allowance for meal and incidental expenses of \$200, based on an anticipated 5 days of business travel at \$40 per day to a locality for which the Federal M&IE rate is \$34, and the employee substanti-

ates 3 full days of business travel. The requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) the portion of the allowance that is attributable to the 2 unsubstantiated days of travel (\$80), even though the employee is not required to return the portion of the allowance (\$18) that exceeds the amount of the employee's expenses deemed substantiated under section 4.02 (\$102) for the 3 substantiated days of travel. However, the \$18 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 7.04.

.03 An employee is not required to include in gross income the portion of a per diem allowance received from a payor that is less than or equal to the amount deemed substantiated under the rules provided in section 4 or 5 if the employee substantiates the business travel expenses covered by the per diem allowance in accordance with section 7.01. See § 1.274-5T(f)(2)(i). In addition, such portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W-2, and is exempt from the withholding and payment of employment taxes. See § 1.62-2(c)(2) and (c)(4).

.04 An employee is required to include in gross income only the portion of the per diem allowance received from a payor that exceeds the amount deemed substantiated under the rules provided in section 4 or 5 if the employee substantiates the business travel expenses covered by the per diem allowance in accordance with section 7.01. See § 1.274-5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. See § 1.62-2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.05 If the amount of the expenses that is deemed substantiated under the rules provided in section 4.01, 4.02, or 5 is less than the amount of the employee's business expenses for travel away from home, the employee may claim an itemized deduction for the amount by which the business travel expenses exceed the amount that is deemed substantiated, provided the

employee substantiates all the business travel expenses, includes on Form 2106, Employee Business Expenses, the deemed substantiated portion of the per diem allowance received from the payor, and includes in gross income the portion (if any) of the per diem allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274-5T(f)(2)(iii). However, for purposes of claiming this itemized deduction with respect to meal and incidental expenses, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the amount computed under section 4.03 minus the amount deemed substantiated under section 4.02 and section 7.01. The itemized deduction is subject to the 50-percent limitation on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.06 An employee who does not receive a per diem allowance for meal and incidental expenses may deduct an amount computed pursuant to section 4.03 only as an itemized deduction. This itemized deduction is subject to the 50-percent limitation on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.07 A self-employed individual may deduct an amount computed pursuant to section 4.03 in determining adjusted gross income under § 62(a)(1). This deduction is subject to the 50-percent limitation on meal and entertainment expenses provided in § 274(n).

.08 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, such payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62-2(c)(3), (c)(5), and (h)(2).

SECTION 8. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES.

.01 The portion of a per diem allowance, if any, that relates to the days of business travel substantiated and that exceeds the amount deemed substantiated for those days under section 4.01, 4.02, or 5 is subject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

(1) In the case of a per diem allowance paid as a reimbursement, the excess described in this section 8.01 is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days of travel substantiated. See § 1.62-2(h)(2)(i)(B)(2).

(2) In the case of a per diem allowance paid as an advance, the excess described in this section 8.01 is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the days of travel with respect to which the advance was paid are substantiated. See § 1.62-2(h)(2)(i)(B)(3). If some or all of the days of travel with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those days within a reasonable period of time, the portion of the allowance that relates to those days is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

(3) In the case of a per diem allowance only for meal and incidental expenses for travel away from home paid to an employee in the transportation industry by a payor that uses the rule in section 4.04(3), the excess of the per diem allowance paid for the period over the amount deemed substantiated for the period under section 4.02 (after applying section 4.04(3)), is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62-2(h)(2)(i)(B)(4).

(4) For example, assume that a payor pays an employee a per diem allowance to cover business expenses for meals and lodging for travel away from home at a rate of 120 percent of the Federal per diem rate for the localities to which the employee travels. The employer does not require the employee to return the 20 percent by which the reimbursement for those expenses exceeds the Federal per diem rate. The employee substantiates 6 days of travel away from home: 2 days in a locality in which the Federal per diem rate is \$100 and 4 days in a locality in which the Federal per diem rate is \$125. The employer reimburses the employee \$840 for the 6 days of travel away from home ($2 \times (120\% \times \$100) + 4 \times (120\% \times \$125)$), and does not require the employee to return the excess payment of \$140 ($(2 \text{ days} \times \$20 (\$120 - \$100) + 4 \text{ days} \times \$25 (\$150 - \$125))$). For the payroll period in which the employer reimburses the expenses, the employer must withhold and pay employment taxes on \$140.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 94-77 is hereby superseded for per diem allowances paid to an employee on or after April 1, 1996, with respect to lodging, meal, and/or incidental expenses paid or incurred for travel while away from home on or after April 1, 1996, and, for purposes of computing the amount allowable as a deduction, for meal and incidental expenses paid or incurred by an employee or self-employed individual for travel while away from home on or after April 1, 1996.

DRAFTING INFORMATION

The principal author of this revenue procedure is G. Channing Horton of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Horton on (202) 622-1585 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Proposed Amendments to the Regulations on the Determination of Interest Expense Deduction of Foreign Corporations and Branch Profits Tax

INTL-0054-95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed Income Tax Regulations relating to the determination of the interest expense deduction of foreign corporations under section 882 and the branch profits tax under section 884 of the Internal Revenue Code of 1986. These proposed regulations are necessary to provide guidance that coordinates with guidance provided in final regulations under sections 882 and 884 published in * * * [T.D. 8657, page 4, and T.D. 8658, page 13, this Bulletin]. These regulations will affect foreign corporations engaged in a U.S. trade or business. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by June 6, 1996. Outlines of topics to be discussed at the public hearing scheduled for Thursday, June 6, 1996, at 10:00 a.m. must be received by May 23, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL-0054-95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (INTL-0054-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington DC. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regula-

tions, Ahmad Pirasteh or Richard Hoge, (202) 622-3870; and the hearing, Michael Slaughter (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations amending the Income Tax Regulations (26 CFR Part 1) under sections 882 and 884 of the Internal Revenue Code. In final regulations under sections 882 and 884, published elsewhere in this issue of the Federal Register, various sections were reserved. These proposed regulations would provide guidance under those reserved sections, as well as amend other sections, to coordinate with the final regulations.

Explanation of the Provisions

I. Financial products.

The proposed regulations include several provisions that take into account recent developments in the tax treatment of financial instruments, such as the enactment of section 475, the development of hedging rules and the introduction of profit split methodologies in global trading Advance Pricing Agreements. The IRS and Treasury intend to issue regulations under section 864 that will address these recent developments as they affect the determination of a foreign corporation's effectively connected income. Comments are solicited on these proposed regulations as they relate to financial products and on their interaction with the determination of effectively connected income.

A. "Split asset" rule for section 475 securities and section 1256 contracts. Currently § 1.884-1(d)(2)(vii) provides a "split asset" rule for certain securities described in § 1.864-4(c)(5)(ii)(b)(3) that produce income only a portion of which is treated as effectively connected with the conduct of a U.S. trade or business. Since other securities may also produce income split between effectively connected and non-effectively connected income, the rule has been broadened to cover all financial instruments that meet the

definition of a security under section 475(c)(2), as well as section 1256 contracts, that may produce such split income. Accordingly, a foreign corporation that, under an Advance Pricing Agreement, is permitted to apply a "profit split" methodology to determine the portion of its income from a portfolio of securities that is effectively connected with the conduct of a U.S. trade or business would apply this rule. This rule will also apply to determine the portion of a foreign corporation's portfolio of securities that is a U.S. asset for purposes of § 1.882-5.

B. *Hedging transactions.* Proposed § 1.884-1(c)(2)(ii) introduces a new rule for hedging transactions for purposes of section 884. The new rule requires that a taxpayer increase or decrease, as the case may be, the amount of their U.S. assets by the amount of any gain or loss on any transaction that hedges the U.S. assets. If the hedging transaction is undertaken outside the United States, perhaps as part of a global hedging strategy of the foreign corporation, then the hedging transaction is only taken into account to the extent that income from the transaction would be treated as income effectively connected with the U.S. trade or business of the taxpayer. If, however, the hedging transaction is entered into by the U.S. branch, it will only affect the amount of U.S. assets if it is contemporaneously identified as a hedging transaction in accordance with the provisions of § 1.1221-2.

In response to comments, hedging rules also have been added to the interest allocation rules of § 1.882-5. These rules provide that a transaction that hedges a U.S. booked liability will be taken into account in determining the amount, currency denomination, and interest rate associated with that liability for purposes of performing the second and third steps of the interest expense calculation.

C. *Securities marked-to-market.* Section 1.884-1(d)(6), which provides "E&P basis" rules for specific types of U.S. assets, has been clarified to provide rules for securities subject to mark-to-market accounting. The new provision in § 1.884-1(d)(6)(v) specifies that securities subject to section 475, as well as section 1256 contracts, have an E&P basis equal to their mark-to-market value as of the determination

date. Proposed § 1.882-5(b)(2)(iv) provides a basis adjustment rule under which such assets are treated as having been marked-to-market on each determination date. Examples are contained in the proposed regulations that illustrate the effect of these rules on the calculation of worldwide assets and liabilities.

II. *Transactions between partners and partnerships.*

Example 4 in proposed § 1.882-5(c)(5) would clarify that an obligation of a partnership to make payments to its partner for the use of capital, which gives rise to guaranteed payments under section 707(c), is not a liability for purposes of § 1.882-5. The Service and Treasury solicit comments on the treatment of loans between partners and partnerships as part of Treasury's review of the international tax aspects of pass-through entities.

Special Analyses

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

Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, June 6, 1996, at 10:00 a.m. in the Auditorium, 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 written comments by June 6, 1996, and submit an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by May 23, 1996.

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

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury Department participated in drafting these regulations.

* * * * *

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 1.882-5 is amended as follows:

1. The text of paragraph (b)(2)(iv) is added.
2. The text of paragraph (c)(2)(v) is added.
3. In paragraph (c)(5), *Example 4*, *Example 6*, and *Example 7* are added.
4. The text of paragraph (d)(2)(vi) is added.
5. In paragraph (d)(6), *Example 4* is added.
6. The text of paragraph (e)(3) is added.
7. In paragraph (e)(5), *Example 2* is added.
8. The text of paragraph (f)(2) is added.

The added provisions read as follows:

§ 1.882-5 *Determination of interest deduction.*

* * * * *

(b) * * *

(2) * * *

(iv) *Adjustment to basis of financial instruments.* The basis of a security or contract that is marked to market pursuant to section 475 or section 1256 will be determined as if each determination date were the last business day of the taxpayer's taxable year. A financial instrument with a fair market value of less than zero is a liability, not an asset, for purposes of this section.

* * * * *

(c) * * *

(2) * * *

(v) *Hedging transactions.* A transaction (or transactions) that hedges an asset or liability, or a pool of assets or a pool of liabilities, will be taken into account in determining the value, amount and currency denomination of the asset or liability that it hedges. A transaction will be considered to hedge an asset or liability only if the transaction meets the requirements of § 1.1221-2.

* * * * *

(5) * * *

Example 4. Partnership liabilities. X and Y are each foreign corporations engaged in the active conduct of a trade or business within the United States through a partnership, P. Under the partnership agreement, X and Y each have a 50% interest in the capital and profits of P, and X is also entitled to a return of 6% per annum on its capital account that is a guaranteed payment under section 707(c). In addition, P has incurred a liability of \$100x to an unrelated bank, B. Under paragraph (c)(2)(vi) of this section, X and Y each share equally in P's liability to B. In accordance with U.S. tax principles, P's obligation to make guaranteed payments to X does not constitute a liability of P, and therefore neither X nor Y take into account that obligation of the partnership in computing their actual ratio.

* * * * *

Example 6. Securities in ratio as assets. FC is a foreign corporation engaged in a trade or business in the United States through a U.S. branch. FC is a dealer in securities within the meaning of section 475(c)(1)(B) because it regularly offers to enter into positions in currency spot and forward contracts with customers in the ordinary course of its trade or business. FC has not elected to use the fixed ratio. On December 31, 1996, the end of FC's taxable year, the mark-to-market value of the spot and forward contracts entered into by FC worldwide is 1000x, which includes a mark-to-

market gain of 500x with respect to the spot and forward contracts that are shown on the books of its U.S. branch and that produce effectively connected income. On its December 31, 1996, determination date, FC includes 500x in its U.S. assets, and 1000x in its worldwide assets.

Example 7. Securities in ratio as assets and liabilities. The facts are the same as in *Example 4*, except that on December 31, 1996, the mark-to-market value of the spot and forward contracts entered into by FC worldwide is 1000x, and FC has a mark-to-market loss of 500x with respect to the spot and forward contracts that are shown on the books of its U.S. branch and that would produce effectively connected income. On its December 31, 1996, determination date, FC includes the 1000x in its worldwide assets for purposes of determining its ratio of worldwide liabilities to worldwide assets. For purposes of Step 3, however, FC has U.S.-booked liabilities in the United States equal to the 500x U.S. loss position.

(d) * * *

(2) * * *

(vi) *Hedging transactions.* A transaction (or transactions) that hedges a U.S. booked liability, or a pool of U.S. booked liabilities, will be taken into account in determining the currency denomination, amount of, and interest rate associated with, that liability. A transaction will be considered to hedge a U.S. booked liability only if the transaction meets the requirements of § 1.1221-2(a), (b), and (c), and is identified in accordance with the requirements of § 1.1221-2(e).

* * * * *

(6) * * *

Example 4. Liability hedge—(i) Facts. FC is a foreign corporation that meets the definition of a bank, as defined in section 585(a)(2)(B) (without regard to the second sentence thereof), and that is engaged in a banking business in the United States through its branch, B. FC's corporate policy is to match the currency denomination of its assets and liabilities, thereby minimizing potential gains and losses from currency fluctuations. Thus, at the close of each business day, FC enters into one or more hedging transactions as needed to maintain a balanced currency position, and instructs each branch to do the same. At the close of business on December 31, 1998, B has 100x of U.S. dollar assets, and U.S. booked liabilities of 90x U.S. dollars and 1000x Japanese yen (exchange rate: \$1 = ¥100). To eliminate the currency mismatch in this situation, B enters into a forward contract with an unrelated third party that requires FC to pay 10x dollars in return for 1000x yen. Through this hedging transaction, FC has effectively converted its 1000x Japanese yen liability into a U.S. dollar liability. FC uses its actual ratio of 90% in 1998 for Step 2, the adjusted U.S. booked liabilities method for purposes of Step 3, and is a calendar year taxpayer.

(ii) *Analysis.* Under paragraph 1.882-5(d)(2)(vi), FC is required to take into account hedges of U.S. booked liabilities in determining

the currency denomination, amount, and interest rate associated with those liabilities. Accordingly, FC must treat the Japanese yen liabilities booked in the United States on December 31, 1998, as U.S. dollar liabilities to determine both the amount of the liabilities and the interest paid or accrued on U.S. booked liabilities for purposes of this section. Moreover, in applying the scaling ratio prescribed in paragraph (d)(4)(i) of this section, FC must scale back both the U.S. booked liabilities and the hedge(s) of those liabilities. Assuming that FC's average U.S. booked liabilities for the year ending December 31, 1998, exceed its U.S.-connected liabilities determined under paragraphs (a)(1) through (c)(5) of this section by 10%, FC must scale back by 10% both its interest expense associated with U.S. booked liabilities, and any income or loss from the forward contract to purchase Japanese yen that hedges its U.S. booked liabilities.

(e) * * *

(3) *Hedging transactions.* A transaction (or transactions) that hedges a liability, or a pool of liabilities, will be taken into account in determining the amount of, or interest rate associated with, that liability. A transaction will be considered to hedge a liability only if the transaction meets the requirements of § 1.1221-2(a), (b), and (c).

* * * * *

(5) * * *

Example 2. Asset hedge—(i) Facts. FC is a foreign corporation that meets the definition of a bank, as defined in section 585(a)(2)(B) (without regard to the second sentence thereof), and that is engaged in the banking business in the United States through its branch, B. FC's corporate policy is to match the currency denomination of its assets and liabilities, thereby minimizing potential gains and losses from currency fluctuations. Thus, at the close of each business day, FC enters into one or more hedging transactions as needed to maintain a balanced currency position, and instructs each branch to do the same. At the close of business on December 31, 1998, B has two U.S. assets, a loan of 90x U.S. dollars and a loan of 1000x Japanese yen (exchange rate: \$1 = ¥100). B has U.S. booked liabilities, however, of 100x U.S. dollars. To eliminate the currency mismatch, B enters into a forward contract with an unrelated third party that requires FC to pay 1000x yen in return for 10x dollars. Through this hedging transaction, FC has effectively converted its 1000x Japanese yen asset into a U.S. dollar asset. FC uses its actual ratio of 90% in 1998 for Step 2, has elected the separate currency pools method in paragraph (e) of this section, and is a calendar year taxpayer.

(ii) *Analysis.* Under paragraph (e)(1)(i) of this section, FC must take into account any transaction that hedges a U.S. asset in determining the currency denomination and value of that asset. FC's Japanese yen asset will therefore be treated as a U.S. dollar asset in determining its U.S. assets in each currency. Accordingly, FC will be treated as having only U.S. dollar assets in making its separate currency pools computation.

(f) * * *

(2) *Special rules for financial products.* Paragraphs (b)(2)(iv), (c)(2)(v), (d)(2)(vi), and (e)(3) of this section will be effective for taxable years beginning on or after the date these regulations are published as final regulations in the Federal Register.

Par. 3. Section 1.884-1 is amended as follows:

1. Paragraph (c)(2)(iii) is added.

2. Paragraph (d)(2) is amended as follows:

a. Paragraph (d)(2)(vii) is revised.

b. In paragraph (d)(2)(xi), *Example 6* through *Example 8* are added.

3. The text of paragraph (d)(6)(v) is added.

4. In paragraph (i)(4), a sentence is added at the end of the existing text.

The revised and added provisions read as follows:

§ 1.884-1 *Branch profits tax.*

* * * * *

(c) * * *

(2) * * *

(iii) *Hedging transactions.* A transaction that hedges a U.S. asset, or a pool of U.S. assets, will be taken into account in determining the amount of that asset (or pool of assets) to the extent that income or loss from the hedging transaction produces ECI or reduces ECI. A transaction that hedges a U.S. asset, or pool of U.S. assets, is also taken into account in determining the currency denomination of the U.S. asset (or pool of U.S. assets). A transaction will be considered to hedge a U.S. asset only if the transaction meets the requirements of § 1.1221-2(a), (b), and (c), and is identified in accordance with the requirements of § 1.1221-2(e).

(d) * * *

(2) * * *

(vii) *Financial instruments.* A financial instrument, including a security as defined in section 475 and a section 1256 contract, shall be treated as a U.S. asset of a foreign corporation in the same proportion that the income, gain, or loss from such security is ECI for the taxable year.

* * * * *

(xi) * * *

Example 6. Hedging transactions—(i) Facts. FC is a foreign corporation engaged in a trade or

business in the United States through a U.S. branch. The functional currency of FC's U.S. branch is the U.S. dollar. On January 1, 1997, in the ordinary course of its business, the U.S. branch of FC enters into a forward contract with an unrelated party to purchase 100 German marks (DM) on March 31, 1997, for \$50. To hedge the risk of currency fluctuation on this transaction, the U.S. branch also enters into a forward contract with another unrelated party to sell 100 DM on March 31, 1997, for \$52, identifying this contract as a hedging transaction in accordance with the requirements of § 1.1221-2(e). FC marks its foreign currency transactions to market for U.S. tax purposes.

(ii) *Net assets.* At the end of FC's taxable year, the value of the forward contract to purchase 100 DM is marked to market, resulting in gain of \$10 being realized and recognized as U.S. source effectively connected income by FC. Similarly, FC marks to market the contract to sell 100 DM, resulting in \$8 of realized and recognized loss by FC. Pursuant to paragraph (c)(2)(iii) of this section, FC must increase or decrease the amount of its U.S. assets to take into account any transaction that hedges the contract to purchase 100 DM. Consequently, FC has a U.S. asset of \$2 (\$10 (the adjusted basis of the contract to purchase 100 DM) - \$8 (the loss on the contract to sell 100 DM)).

Example 7. Split hedge. The facts are the same as in *Example 5*, except that the contract to sell

100 DM is entered into with an unrelated third party by the home office of FC. FC includes the contract to sell 100 DM in a pool of assets treated as producing income effectively connected with the U.S. trade or business of FC. Therefore, under paragraph (c)(2)(iii) of this section, at its next determination date FC will report a U.S. asset of \$2, computed as in *Example 5*.

Example 8. Securities. FC is a foreign corporation engaged in a U.S. trade or business through a branch in the United States. During the taxable year 1997, FC derives \$100 of income from securities, of which \$60 is treated as U.S. source effectively connected income under the terms of an Advance Pricing Agreement that uses a profit split methodology. Accordingly, pursuant to paragraph (d)(2)(vii) of this section, FC has a U.S. asset equal to 60% (\$60 of ECI divided by \$100 of gross income from securities) of the value of the securities.

* * * * *

(6) * * *

(v) *Computation of E&P basis of financial instruments.* For purposes of this section, the E&P basis of a security that is marked to market under section 475 and a section 1256 contract shall be adjusted to take into

account gains and losses recognized by reason of section 475 or section 1256. The E&P basis must be further adjusted to take into account a transaction that hedges a U.S. asset, as provided in paragraph (c)(2)(ii) of this section.

* * * * *

(i) * * *

(4) * * * Paragraphs (c)(2)(iii), (d)(2)(vii), and (d)(6)(v) of this section will be effective for taxable years beginning on or after the date these regulations are published as final regulations in the Federal Register.

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

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

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

Attorneys, certified public accountants, enrolled agents and enrolled actuaries are prohibited in any Internal

Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attor-

ney, certified public accountant, enrolled agent or enrolled actuary and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

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

| Name | Address | Designation | Date of Suspension |
|-----------------------|-------------------|----------------|--------------------------------------|
| Miller, Gorden A. | Mineral Wells, WV | CPA | February 1, 1996 to April 30, 1996 |
| Barnes, Charles E. | Louisville, KY | Enrolled Agent | Indefinite from February 1, 1996 |
| Polizzi, Angelo J. | Grosse Point, MI | Attorney | Indefinite from February 6, 1996 |
| Pegler, Charles R. | Islandia, NY | CPA | Indefinite from February 7, 1996 |
| Foster, David M. | Birmingham, MI | Attorney | Indefinite from February 9, 1996 |
| Smith, Jerry A. | Evansville, IN | CPA | February 9, 1996 to November 8, 1996 |
| Penn, Michael J. | Dearborn, MI | CPA | February 9, 1996 to February 8, 1997 |
| Mueller, E. Laird | Seal Beach, CA | CPA | February 12, 1996 to June 11, 1996 |
| Zeizima, Paul P. | Norwalk, CT | CPA | April 1, 1996 to May 31, 1996 |
| Van Houten, Robert R. | Danbury, CT | CPA | May 1, 1996 to April 30, 1997 |

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

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly

or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled

agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

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

| Name | Address | Designation | Effective Date |
|-------------------|----------------|-------------|------------------|
| Gimbel, Stephen | Columbia, SC | CPA | January 20, 1996 |
| Tropsa, Donna C. | Stamford, CT | Attorney | January 20, 1996 |
| Seifert, Frank J. | Birmingham, AL | CPA | January 20, 1996 |
| Hansen, Joe B. | Lubbock, TX | CPA | March 2, 1996 |

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

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

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal

Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled

agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

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

| Name | Address | Designation | Date of Suspension |
|----------------------|-------------------|-------------|-----------------------------------|
| Ginsberg, Melvin R. | Univ. Heights, OH | Attorney | Indefinite from January 24, 1996 |
| Lahey, Charles W. | South Bend, IN | Attorney | Indefinite from January 24, 1996 |
| DePiano, Robert | Venice, CA | Attorney | Indefinite from January 24, 1996 |
| Kraig, Jerry B. | Shaker Hgts, OH | Attorney | Indefinite from January 29, 1996 |
| Brown, David M. | Los Angeles, CA | Attorney | Indefinite from January 29, 1996 |
| Hanke Jr., Dale L. | Duluth, MN | Attorney | Indefinite from February 1, 1996 |
| Guillory, Patrick R. | San Francisco, CA | Attorney | Indefinite from February 1, 1996 |
| Miller, Brian R. | Grove, OK | CPA | Indefinite from February 23, 1996 |
| McLeod, Timothy R. | Saginaw, MI | Attorney | Indefinite from February 26, 1996 |
| Simone, Robert F. | Philadelphia, PA | Attorney | Indefinite from February 26, 1996 |
| Bowen, David Lee | Frisco City, AL | CPA | Indefinite from February 27, 1996 |
| Lindley, Clarkson | Wayzata, MN | Attorney | Indefinite from February 27, 1996 |

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior

ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings.

If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.

E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.

PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
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Key to Abbreviations:

| | |
|-----|----------------------------------|
| RR | Revenue Ruling |
| RP | Revenue Procedure |
| TD | Treasury Decision |
| CD | Court Decision |
| PL | Public Law |
| EO | Executive Order |
| DO | Delegation Order |
| TDO | Treasury Department Order |
| TC | Tax Convention |
| SPR | Statement of Procedural Rules |
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