this paragraph (e), MACRS property changes to tax-exempt bond financed property when a tax-exempt bond is first issued after the MACRS property is placed in service. MACRS property continues to be tax-exempt bond financed property in the hands of the taxpayer even if the tax-exempt bond (including any refunding issue) is not outstanding at, or is redeemed by, the end of the placed-in-service year.

(iii) *Other mandatory alternative depreciation system property.* The depreciation allowance for the placed-in-service year for MACRS property that changes to, or changes from, property described in section 168(g)(1)(B) (tax-exempt use property) or (D) (imported property covered by an Executive Order) during that taxable year is determined under—

(A) The alternative depreciation system if the MACRS property is described in section 168(g)(1)(B) or (D) at the end of the placed-in-service year; or

(B) The general depreciation system if the MACRS property is not described in section 168(g)(1)(B) or (D) at the end of the placed-in-service year.

(3) *Examples.* The application of this paragraph (e) is illustrated by the following examples:

Example 1. (i) *Z,* a utility and calendar-year corporation, places in service on January 1, 2003, equipment at a cost of $100,000. *Z* uses this equipment in its combustion turbine production plant for 4 months and then uses the equipment in its steam production plant for the remainder of 2003. *Z*'s combustion turbine production plant assets are classified as 15-year property and are depreciated by *Z* under the general depreciation system using a 15-year recovery period and the 150-percent declining balance method of depreciation. *Z*'s steam production plant assets are classified as 20-year property and are depreciated by *Z* under the general depreciation system using a 20-year recovery period and the 150-percent declining balance method of depreciation. *Z* uses the optional depreciation tables. The equipment is qualified property for purposes of section 168(k)(1).

(ii) Pursuant to this paragraph (e), *Z* must determine depreciation based on the primary use of the equipment during the placed-in-service year. *Z* has consistently determined the primary use of all of its MACRS property by comparing the number of full months in the taxable year during which a MACRS property is used in one manner with the number of full months in that taxable year during which that MACRS property is used in another manner. Applying this approach, *Z* determines the depreciation allowance for the equipment for 2003 is based on the equipment being classified as 20-year property because the equipment was used by *Z* in its steam production plant for 8 months in 2003. If the half-year convention applies in 2003, the appropriate optional depreciation table is table 1 in Rev. Proc. 87–57, which is the table for MACRS property subject to the general depreciation system, the 150-percent declining balance method, a 20-year recovery period, and the half-year convention. Thus, the depreciation allowance for the equipment for 2003 is $32,625, which is the total of $30,000 for the additional 30-percent first-year depreciation deduction allowable (the unadjusted depreciable basis of $100,000 multiplied by .30), plus $2,625 for the 2003 depreciation allowance on the remaining basis of $70,000 [(the unadjusted depreciable basis of $100,000 less the additional first-year depreciation deduction of $30,000) multiplied by the annual depreciation rate of .0375 in table 1 for recovery year 1 for a 20-year recovery period].

Example 2. T, a calendar year corporation, places in service on January 1, 2003, several computers at a total cost of $100,000. *T* uses these computers within the United States for 3 months in 2003 and then moves and uses the computers outside the United States for the remainder of 2003. Pursuant to § 1.48–1(g)(1)(i), the computers are considered as used predominantly outside the United States in 2003. As a result, for 2003, the computers are required to be depreciated under the alternative depreciation system of section 168(g) with a recovery period of 5 years pursuant to section 168(g)(3)(C). *T* uses the optional depreciation tables. If the half-year convention applies in 2003, the appropriate optional depreciation table is table 8 in Rev. Proc. 87–57, which is the table for MACRS property subject to the alternative depreciation system, the straight-line method, a 5-year recovery period, and the half-year convention. Thus, the depreciation allowance for the computers for 2003 is $10,000, which is equal to the unadjusted depreciable basis of $100,000 multiplied by the annual depreciation rate of .10 in table 8 for recovery year 1 for a 5-year recovery period. Because the computers are required to be depreciated under the alternative depreciation system in their placed-in-service year, the computers are not eligible for the additional first year depreciation deduction provided by section 168(k).

(f) *No change in accounting method.* A change in computing the depreciation allowance in the year of change for property subject to this section results from a change in underlying facts and, thus, is not a change in method of accounting under section 446(e).

(g) *Effective date*—(1) *In general.* This section applies to changes in the use of MACRS property in taxable years ending on or after the date of publication of the final regulations in the **Federal Register**. For changes in the use of MACRS property after December 31, 1986, in taxable years ending before the date of publication of the final regulations in the **Federal Register**, the Internal Revenue Service will allow any reasonable method of depreciating the property under section 168 in the year of change and the subsequent taxable years that is consistently applied to any property that changed use in the hands of the taxpayer.

(2) *Change in method of accounting*—(i) *In general.* If a taxpayer adopted a method of accounting for depreciation due to a change in the use of MACRS property and the method is not in accordance with the method of accounting for depreciation provided in this section, a change to the method of accounting for depreciation provided in this section is a change in method of accounting to which the provisions of sections 446(e) and 481 and the regulations thereunder apply. Also, a revocation of the election provided in paragraph (d)(3)(ii) of this section to disregard a change in the use is a change in method of accounting to which the provisions of sections 446(e) and 481 and the regulations thereunder apply.

(ii) *Automatic consent to change method of accounting.* For any taxable year ending on or after the date of publication of the final regulations in the **Federal Register**, a taxpayer changing its method of accounting in accordance with this paragraph (g)(2) must follow the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, for example, *see* Rev. Proc. 2002–9 (2002–1 C.B. 327) and § 601.601(d)(2)(ii)(*b*) of this chapter). Any change in method of accounting made under this paragraph (g)(2) must be made using an adjustment under section 481(a).

Robert E. Wenzel,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 03–18325 Filed 7–18–03; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–162625–02]

RIN 1545–BB73

Real Estate Mortgage Investment Conduits; Application of Section 446 With Respect To Inducement Fees

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the

proper timing and source of income from fees received to induce the acquisition of noneconomic residual interests in Real Estate Mortgage Investment Conduits (REMICs). The proposed regulations would apply to taxpayers who receive inducement fees in connection with becoming the holder of a noneconomic REMIC residual interest. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by October 20, 2003. Outlines of topics to be discussed at the public hearing scheduled for November 18, 2003, at 10 a.m. must be received by October 28, 2003.

ADDRESSES: Send submissions to CC:PA:RU (REG–162625–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG–162625–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit electronic comments via the IRS Internet site at: *http://www.irs.gov/regs.* The public hearing will be held in the IRS Auditorium, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John W. Rogers III at (202) 622–3950; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 446(b) (relating to general rules for methods of accounting), 860C (relating to other definitions and special rules applicable to REMICs), and 863(a) (relating to special rules for determining source) of the Internal Revenue Code of 1986 (Code). The proposed regulations prescribe certain accounting rules for taking an inducement fee into income over a period that is related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest. The proposed regulations set forth two safe harbor methods of accounting for inducement fees. The proposed regulations also contain a rule clarifying that an inducement fee is income from sources within the United States.

Explanation of Provisions

Final regulations governing REMICs, issued in 1992, contain rules governing the transfer of noneconomic residual interests. Those regulations do not, however, contain rules that address the transferee's treatment of the fee received to induce the acquisition of a REMIC noneconomic residual interest.

An inducement fee is paid to a transferee of a noneconomic residual interest because, under sections 860C(a)(1) and 860E(a)(1) of the Code, the holder of a REMIC residual interest must take into account the REMIC's taxable income or net loss. The holder of a noneconomic residual interest will receive insufficient distributions to cover the resulting tax liabilities, and a transferee will, therefore, require an inducement fee to become the holder of the noneconomic residual interest.

In its earlier years, a REMIC typically accrues more taxable interest income than deductible interest expense. As a result, in its earliest years, the REMIC will have net income (generally referred to as phantom income) taxable to the residual holder. This phenomenon generally will reverse, resulting in REMIC net loss (phantom loss) in later years.

Following release of the final REMIC regulations, the IRS and the Treasury Department received requests for guidance on the proper method of accounting to be used by taxpayers for inducement fee income. The proposed regulations provide rules relating to the proper timing and source of income from an inducement fee received in connection with becoming the holder of a noneconomic residual interest in a REMIC.

The proposed regulations provide that, to clearly reflect income, an inducement fee must be included in income over a period that is reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest. The proposed regulations provide that an inducement fee generally may not be taken into account in a single tax year.

The proposed regulations set forth two safe harbor methods of accounting for inducement fees. These safe harbor methods are:

(1) A book method, under which an inducement fee is recognized for federal income tax purposes in the same amounts and over the same period in which that inducement fee is included in income by the taxpayer for financial reporting purposes, provided that the period is not shorter than the period over which the applicable REMIC is expected to generate taxable income; and

(2) A method under which the inducement fee is recognized for federal income tax purposes ratably over the remaining anticipated weighted average life of the REMIC determined as of the time the noneconomic residual interest is transferred to the taxpayer. This method is based on rules in the final REMIC regulations for taking into account a REMIC sponsor's unrecognized gain or loss on a REMIC residual interest upon the formation of a REMIC.

Additionally, the proposed regulations contain a rule that applies if a holder of a residual interest sells or otherwise disposes of the residual interest. Under this rule, the holder must take into account, at the time of the sale or other disposition, any unrecognized portion of the inducement fee for that residual interest. Transactions to which section 381(c)(4) applies are excluded from this rule because section 381 and the regulations thereunder provide for the carryover of tax attributes, including methods of accounting. The IRS and the Treasury Department considered excluding other non-recognition transactions, such as contributions under sections 351 or 721. These other transactions, however, do not provide for the carryover of tax attributes. The proposed regulations, therefore, do not permit continued deferral of the unrecognized portion of an inducement fee following these other transactions.

The proposed regulations also contain a rule clarifying that an inducement fee is income from sources within the United States.

The IRS and the Treasury Department request comments on other possible safe harbor methods of accounting for these inducement fees. In particular, comments are requested on whether a safe harbor method that recognizes inducement fees proportionally to the anticipated future financing costs for funding the net tax liabilities of the noneconomic residual interest would be of general use to taxpayers and, if so, what factors should be used under that safe harbor method for determining a taxpayer's anticipated future financing costs.

The proposed regulations state that the treatment of inducement fees is a method of accounting that must be applied consistently to all inducement fees received in connection with noneconomic REMIC residual interests. Thus, if a taxpayer uses a safe harbor

method, the taxpayer must use that same safe harbor method for all inducement fees received in connection with any noneconomic REMIC residual interests held by the taxpayer.

The proposed regulations regarding the timing for inclusion of inducement fees in income, if finalized as proposed, would apply for taxable years ending on or after publication of the final regulations in the **Federal Register**. The IRS and the Treasury Department request comments with respect to whether the applicability of the regulations should be limited to transactions arising on or after the effective date of these regulations and whether some delay in the effective date of these regulations is warranted.

The proposed regulations clarifying the source of inducement fees, if finalized as proposed, would apply for taxable years ending on or after publication of the final regulations in the **Federal Register**.

A taxpayer may not change its method of accounting for inducement fees without securing the prior consent of the Commissioner. The Commissioner may prescribe terms and conditions necessary to obtain the Commissioner's consent to effect a change in method of accounting and to prevent amounts from being duplicated or omitted. *See* sections 446 and 481; § 1.446–1(e)(3). The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or with an adjustment under section 481(a). The IRS and the Treasury Department request comments on how best to effect any change in method of accounting necessitated by these regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. The IRS and the Treasury Department also specifically request comments on the safe harbor methods provided in the regulations and suggestions for other possible safe harbor methods of accounting for these inducement fees. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 18, 2003, beginning at 10 a.m. in the IRS Auditorium, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by October 28, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are John W. Rogers III, Office of Associate Chief Counsel (Financial Institutions & Products), and Courtney L. Shepardson, Office of Division Counsel (Large and Midsize Business). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.446–6 also issued under 26 U.S.C 446 and 26 U.S.C. 860G * * *

Par. 2. Section 1.446–6 is added to read as follows:

§ 1.446–6 REMIC inducement fees.

(a) *Purpose.* This section provides specific timing rules for the clear reflection of income from an inducement fee received in connection with becoming the holder of a noneconomic REMIC residual interest. An inducement fee must be included in income over a period reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest.

(b) *Definitions.* For purposes of this section—(1) *Applicable REMIC.* The applicable REMIC is the REMIC that issued the noneconomic residual interest with respect to which the inducement fee is paid.

(2) *Inducement fee.* An inducement fee is the amount paid to induce a person to become the holder of a noneconomic residual interest in an applicable REMIC.

(3) *Noneconomic residual interest.* A REMIC residual interest is a noneconomic residual interest if it is a noneconomic residual interest within the meaning of § 1.860E–1(c)(2).

(4) *Remaining anticipated weighted average life.* The remaining anticipated weighted average life is the anticipated weighted average life determined using the methodology set forth in § 1.860E–1(a)(3)(iv) applied as of the date of acquisition of the noneconomic residual interest.

(5) *REMIC.* The term REMIC has the same meaning in this section as given in § 1.860D–1.

(c) *General rule.* All taxpayers, regardless of their overall method of accounting, must recognize an inducement fee over the remaining expected life of the applicable REMIC in a manner that reasonably reflects, without regard to this paragraph, the after-tax costs and benefits of holding that noneconomic residual interest.

(d) *Special rule on disposition of a residual interest.* If any portion of an

inducement fee received with respect to the acquisition of a noneconomic residual interest in an applicable REMIC has not been recognized in full by the holder as of the time the holder sells, or otherwise disposes of, that residual interest in the applicable REMIC (in a transaction other than a transaction to which section 381(c)(4) applies), then the holder must include the unrecognized portion of the inducement fee in income at that time.

(e) *Safe harbors.* If inducement fees are recognized in accordance with a method described in this paragraph (e), that method complies with the requirements of paragraph (c) of this section.

(1) *The book method.* Under the book method, an inducement fee is recognized in accordance with the method of accounting, and over the same period, that is used by the taxpayer for financial reporting purposes (including consolidated financial statements to shareholders, partners, beneficiaries, other proprietors and for credit purposes), provided that the inducement fee is included in income for financial reporting purposes over a period that is not shorter than the period during which the applicable REMIC is expected to generate taxable income.

(2) *The modified REMIC regulatory method.* Under the modified REMIC regulatory method, the inducement fee is recognized ratably over the remaining anticipated weighted average life of the applicable REMIC as if the inducement fee were unrecognized gain being included in gross income under § 1.860F–2(b)(4)(iii).

(3) *Additional safe harbor methods.* The Commissioner, by revenue ruling or revenue procedure published in the Internal Revenue Bulletin, may provide additional safe harbor methods for recognizing inducement fees on noneconomic REMIC residual interests.

(f) *Method of accounting.* The treatment of inducement fees is a method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. A taxpayer is generally permitted to adopt a method of accounting for inducement fees that satisfies the requirements of paragraph (c) of this section. Once a taxpayer adopts a method of accounting for inducement fees, that method must be applied consistently to all inducement fees received in connection with noneconomic REMIC residual interests and may be changed only with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(g) *Effective date.* This section is applicable for taxable years ending on or after the date this document is published as a final regulation in the **Federal Register**.

Par. 3. Section 1.860A–0 is amended by adding an entry in the outline for § 1.860C–1(d) to read as follows:

§ 1.860A–0 Outline of REMIC provisions.

* * * * *

§ 1.860C–1 Taxation of holders of residual interests.

* * * * *

(d) Treatment of REMIC inducement fees.

* * * * *

Par. 4. Section 1.860C–1 is amended by adding paragraph (d) to read as follows:

§ 1.860C–1 Taxation of holders of residual interests.

* * * * *

(d) For rules on the proper accounting for income from inducement fees, *see* § 1.446–6.

Par. 5. Section 1.863–0 is amended by:

1. Adding an entry for § 1.863–1(d).
2. Redesignating the entry for § 1.863–1(e) as § 1.863–1(f).
3. Adding a new entry for § 1.863–1(e).

The additions read as follows:

§ 1.863–0 Table of contents.

* * * * *

§ 1.863–1 Allocation of gross income.

* * * * *

(d) Scholarships, fellowship grants, grants, prizes and awards.

(e) REMIC inducement fees.

* * * * *

Par. 6. Section 1.863–1 is amended as follows:

1. Paragraph (e) is revised.
2. Paragraph (f) is added.

The revision and addition reads as follows:

§ 1.863–1 Allocation of gross income under section 863(a).

* * * * *

(e) *REMIC inducement fees.* An inducement fee (as defined in § 1.446–6(b)(2)) shall be treated as income from sources within the United States.

(f) *Effective dates.* The rules of paragraphs (a), (b) and (c) of this section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of paragraphs (a), (b) and (c) of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, *see* § 1.863–1 (as contained in 26 CFR part 1 revised as of April 1, 1996). *See* paragraph (d)(4) of this section for rules regarding the applicability date of paragraph (d) of this section. Paragraph (e) of this section is applicable for taxable years ending on or after the date this document is published as a final regulation in the **Federal Register**.

Robert E. Wenzel,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 03–18212 Filed 7–18–03; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–129709–03]

RIN 1545–BC34

Prohibited Allocations of Securities in an S Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In the Rules and Regulations section of this issue of the **Federal Register,** the IRS is issuing temporary regulations that provide guidance on identifying disqualified persons and determining whether a plan year is a nonallocation year under section 409(p) and on the definition of synthetic equity under section 409(p)(5). These proposed regulations would generally affect plan sponsors of, and participants in, ESOPs holding stock of Subchapter S corporations. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by October 20, 2003.

Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for November 20, 2003, at 10 a.m. must be received by October 30, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–129709–03), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG–129709–03), Courier's Desk, Internal Revenue