Internal Revenue
bulletin

Bulletin No. 2003-41
October 14, 2003

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. 2003–107, page 815.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for October 2003.

T.D. 9082, page 807.

Final and temporary regulations require the use of taxpayer identifying numbers to properly identify foreign taxpayers for which submissions are made for the reduction or elimination of tax under sections 897 and 1445 of the Code. The regulations also address other miscellaneous items under section 1445.

T.D. 9085, page 775.

Final regulations under sections 148 and 141 of the Code relate to the definition of investment-type property and private loan for the arbitrage and private activity restrictions, respectively, applicable to tax-exempt bonds issued by state and local governments. Final regulations relate to certain natural gas and electricity prepayment transactions.

T.D. 9087, page 781.

Final regulations under section 883 of the Code concern when a foreign corporation engaged in the international operation of ships or aircraft may exempt its U.S source income from federal income tax. The rules apply to a corporation organized in a foreign country that grants a reciprocal exemption to U.S. corporations, if the foreign corporation satisfies certain ownership requirements.

REG–140378–01, page 825.

Proposed regulations under section 6334 of the Code relate to property exempt from levy. The regulations have been revised to provide guidance with respect to the procedures for obtaining prior judicial approval of certain principal residence levies and for exemption from levy for certain residences and business assets. The regulations have also been revised to reflect recent legislative changes.

REG–128203–02, page 828.

Proposed regulations under section 460 of the Code provide guidance regarding the income tax consequences of certain partnership transactions involving contracts accounted for under a long-term contract method of accounting.

Notice 2003–68, page 824.

Qualified community development entity (CDE) loan purchases. The Treasury Department and the Service announce that they will clarify and amend the definition of a qualified low-income community investment under section 1.45D–1T(d)(1)(ii) of the regulations.

TAX CONVENTIONS

Announcement 2003–62, page 821.

This announcement provides the rates for various types of income under new tax conventions. The United States recently exchanged instruments of ratification for a new income tax treaty with the United Kingdom and new protocols for the income tax treaties with Australia and Mexico.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

T.D. 9086, page 817.
Final regulations under section 7122 of the Code impose a $150.00 user fee for the processing of offers to compromise effective November 1, 2003. The user fee does not apply to offers based on doubt as to liability or offers made by low income taxpayers. The fee will be applied against the amount of the offer or refunded to the taxpayer if the offer is accepted to promote effective tax administration or accepted based on doubt as to collectibility where there has been a determination that, although an amount greater than the amount offered could be collected, collection of more than the amount offered would create economic hardship within the meaning of regulations section 301.6343–1.

REG–140378–01, page 825.
Proposed regulations under section 6334 of the Code relate to property exempt from levy. The regulations have been revised to provide guidance with respect to the procedures for obtaining prior judicial approval of certain principal residence levies and for exemption from levy for certain residences and business assets. The regulations have also been revised to reflect recent legislative changes.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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

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 October 2003. See Rev. Rul. 2003-107, page 815.

Section 141.—Private Activity Bond; Qualified Bond

26 CFR 1.141-5: Private loan financing test.

Which prepayments for property or services made with the proceeds of tax-exempt bonds give rise to a private loan under section 141(c)? See T.D. 9085, page 775.

Section 148.—Arbitrage

26 CFR 1.141–5: Private loan financing test.
26 CFR 1.148–1: Definitions and elections.

T.D. 9085

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR part 1

Arbitrage and Private Activity Restrictions Applicable to Tax-Exempt Bonds Issued by State and Local Governments; Investment-Type Property (prepayment); Private Loan (prepayment)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the arbitrage and private activity restrictions applicable to tax-exempt bonds issued by State and local governments. These regulations affect issuers of tax-exempt bonds and provide guidance on the definitions of investment-type property and private loan to help issuers comply with the arbitrage and private activity restrictions.

DATES: *Effective Date:* These regulations are effective October 3, 2003.

Applicability Date: For dates of applicability, see §§1.141–15(b)(3) and 1.148–11(j) of these regulations.

FOR FURTHER INFORMATION CONTACT: Johanna Som de Cerff (202) 622–3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR part 1) under sections 141 and 148 of the Internal Revenue Code by providing rules for determining whether a prepayment for property or services results in a private loan or investment-type property (the final regulations). On April 17, 2002, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–113526–98; REG–105369–00, 2002–1 C.B. 828 [67 FR 18835]) (the proposed regulations). The proposed regulations modify §§1.141–5(c)(2) and 1.148–1(e) of the Income Tax Regulations to establish which prepayments for property or services give rise to a private loan under section 141(c) or investment-type property under section 148(b)(2)(D). On September 25, 2002, the IRS held a public hearing on the proposed regulations. Written comments responding to the proposed regulations were also received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

I. *Investment-type Property*

A. *Existing regulations*

The existing regulations, at §1.148–1(e)(2), contain rules for determining when a prepayment for property or services results in investment-type property. Under that provision, a prepayment generally gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. However, a prepayment does not give rise to investment-type property under the existing regulations if (1) it is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment (the *business purpose exception*); or (2) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (the *customary exception*).

B. *Business purpose exception*

The proposed regulations narrow the scope of the business purpose exception. Under the proposed regulations, a prepayment meets the business purpose exception only if the primary purpose for the prepayment is to accomplish one or more substantial business purposes that (1) are unrelated to any investment return based on the time value of money and (2) cannot be accomplished without the prepayment.

Commentators suggested that the business purpose exception in the proposed regulations would have limited usefulness and that the language in the existing regulations is superior. However, as discussed in the preamble to the proposed regulations, the business purpose exception in the existing regulations was intended to be a narrow exception and has raised difficult interpretive questions. For example, in many instances it may be unclear whether the alternatives available to the issuer are "commercially reasonable." The IRS and Treasury Department have considered all of the comments relating to the business purpose exception and have concluded that a standard that considers whether one or more business purposes and/or commercially reasonable alternatives exist is not an administrable test for determining whether prepayments give rise to investment-type property. Therefore, based on tax administration considerations and the broad scope of the investment-type property concept, the final regulations delete the business purpose exception. However, the final regulations provide that the Commissioner may, by published guidance, set forth additional circumstances in which a

prepayment does not give rise to investment-type property.

C. *Customary exception*

The proposed regulations retain the customary exception in its present form. Commentators expressed concern that the customary exception may be difficult to apply in some cases. They suggested that the regulations identify examples of prepayments that satisfy the exception. The final regulations retain the customary exception and indicate that it generally applies based on all the facts and circumstances. In addition, the final regulations contain a safe harbor under which a prepayment is deemed to satisfy the customary exception if: (1) the prepayment is made for maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment), or updates or maintenance or support services with respect to computer software; and (2) the same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

D. *Certain prepayments to acquire a supply of natural gas or electricity*

1. Prepayments for Natural Gas

The proposed regulations add an exception to the definition of investment-type property for certain natural gas prepayments that are made by or for one or more utilities that are owned by a governmental person, as defined in §1.141–1(b) (for example, if a joint action agency acquires a natural gas supply for one or more municipal gas or electric utilities). The exception applies only if at least 95 percent of the natural gas purchased with the prepayment is to be consumed by retail customers in the service area of a municipal gas utility, or used to produce electricity that will be furnished to retail customers that a municipal electric utility is obligated to serve under state or Federal law (the *use requirement*). For this purpose, the service area of a municipal gas utility is defined as (1) any area throughout which the municipal utility provided (at all times during the five-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area, or (2) any area where the municipal utility is obligated under state or Federal law to provide gas distribution services as provided in such law.

Some commentators recommended that the 95 percent threshold be reduced to 85 percent. These commentators stated that various factors make it difficult for municipal gas utilities to determine in advance the precise quantity of gas supplies they will need to serve their customers during a given period. These factors include a limited capability to store gas and variations in demand due to circumstances beyond the utilities' control, such as economic conditions and the weather. In recognition of these unique factors, the final regulations reduce the 95 percent threshold to 90 percent.

Some commentators recommended that the use requirement apply based on the issuer's reasonable expectations as of the issue date. To ensure that the prepaid gas is consumed by retail customers in the service area of the municipal utility, the final regulations retain the requirement that the prepaid gas supply actually be used for a qualifying purpose.

Some commentators suggested that the use of natural gas to fuel the transportation of the prepaid gas supply on a pipeline should be a qualifying use under the natural gas exception. The final regulations adopt this comment. Under the final regulations, the use of gas to fuel the pipeline transportation of the prepaid gas supply is a qualifying use and is not pro-rated based on the amount of qualified and nonqualified use of the remaining prepaid gas.

Commentators indicated that most municipal gas and electric utilities do not have an obligation to serve that arises under state or Federal law. These commentators suggested replacing the "obligation to serve" requirement for municipal electric utilities with a service area rule that is similar to the rule for municipal gas utilities. The final regulations adopt this comment. Commentators also recommended that the definition of *service area* be expanded to include any area recognized as the service area of the municipal utility under state or federal law. The final regulations adopt this comment.

Commentators requested clarification that sales to governmental persons are qualifying sales under the use test. Commentators also requested clarification that a retail customer of a municipal utility is a qualifying end-user even if the prepayment was made by or for another municipal utility. The final regulations do not provide that all sales to governmental persons, or to retail customers of a municipal utility, are qualifying sales. Rather, the final regulations clarify that, in the case of a natural gas prepayment by or for one or more municipal utilities (each, the issuing municipal utility), the use of prepaid gas is a qualifying use if the gas is: (1) furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility (other than sales of gas to produce electricity for sale); (2) used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; (3) used by the issuing municipal utility to produce electricity that will be sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser; (4) sold to a municipal utility if the requirements of (1), (2) or (3) of this paragraph are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or (5) used to fuel the transportation of the prepaid gas supply on a pipeline. Thus, for example, the sale of gas or electricity by the issuing municipal utility directly to customers of another municipal utility is not a qualifying use.

Some commentators recommended that the final regulations define "retail customer" as a customer that is not purchasing for resale. The final regulations provide that a retail customer is a customer that purchases natural gas or electricity, as applicable, other than for resale. The final regulations also clarify that the consumption of natural gas by a nongovernmental person to produce electricity for sale is not a qualifying use of natural gas under the 90 percent use test.

Some commentators requested clarification of which "contiguous" areas may be treated as part of a municipal utility's service area. One commentator suggested that contiguous areas should not be considered part of the service area. To provide

clarity, and in light of the expansion of the service area definition to include any area recognized as the service area under state or Federal law, the final regulations eliminate contiguous areas from the definition of service area.

Some commentators suggested that the definition of service area should be expanded to include any area "in which" (rather than "throughout which") the municipal utility provided service during the five-year period. To ensure that the gas or electricity is consumed by customers in an area recognized as the service area of a municipal utility under state or Federal law, or throughout which the municipal utility provided service during the five-year period, the final regulations do not adopt this comment.

2. Prepayments for Electricity

Some commentators suggested that the natural gas exception should be expanded to include prepayments for electricity. These commentators stated that the restructuring of the electric power industry has affected municipal electric utilities in a manner that is similar to the effect that deregulation of the natural gas industry had on municipal gas utilities. These commentators stated that restructuring has threatened the ability of municipal electric utilities to obtain a secure supply of electric power on commercially reasonable terms, and that electric power prepayment transactions are necessary to obtain a guaranteed supply of electric power on favorable terms in light of restructuring.

The final regulations add an exception to the definition of investment-type property for certain electricity prepayments that are made by or for one or more municipal utilities (for example, if a joint action agency acquires electricity for one or more municipal electric utilities). The exception applies only if at least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. For this purpose, electricity is used for a qualifying use if it is to be: (1) furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or (2) sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

3. Remedial Actions

The preamble to the proposed regulations states that issuers may apply principles similar to the rules of §1.141–12 to cure a violation of the use requirement. Commentators requested clarification regarding which remedies under §1.141–12 are available for this purpose. The final regulations provide that issuers may apply principles similar to the rules of §1.141–12 to cure a violation of the 90 percent use requirement, and that the "redemption or defeasance" remedy in §1.141–12(d) and the "alternative use of disposition proceeds" remedy in §1.141–12(e) are available for this purpose.

Some commentators requested clarification of the amount of nonqualified bonds that must be redeemed or defeased under the "redemption or defeasance" remedy. Under the final regulations, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of §1.141–7(d), treating nonqualified sales of gas or electricity as satisfying the benefits and burdens test under §1.141–7(c)(1). Commentators also suggested that the definition of "nonqualified bonds" under §1.141–12 may require excessive amounts of bonds to be retired. The IRS and Treasury Department are considering this comment in connection with possible amendments to §1.141–12.

4. Commodity Swap Contracts

The proposed regulations provide that a transaction will not fail to qualify for the natural gas exception by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. For this purpose, the proposed regulations provide that a swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas supply contract or another swap contract). Notice 2002–52, 2002–2 C.B. 187, provides that a natural gas commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas supplier to deliver gas for which the swap contract is a hedge.

Commentators generally agreed with the provision on swap contracts in the proposed regulations, as modified by Notice 2002–52. The final regulations retain the provision on commodity swap contracts for natural gas prepayments, as modified by Notice 2002–52, and expand it to apply to electricity prepayments.

E. *De minimis prepayments*

The proposed regulations add an exception for prepayments made within 90 days of the date of delivery of all the property or services to which the prepayment relates. Commentators recommended that the exception apply based on reasonable expectations. The final regulations adopt this comment. This change to a reasonable expectations standard is intended to permit a prepayment to qualify for the *de minimis* exception even if an unexpected event beyond the control of the issuer causes delivery of the property or services to be delayed beyond the 90-day period. The reasonable expectations standard does not, however, apply to any change to the terms of the prepayment other than an unexpected delay in delivery.

II. *Private Loans*

The existing regulations, at §1.141–5(c)(2)(ii), provide rules for determining whether a prepayment for property or services is treated as a loan for purposes of the private loan financing test. The existing regulations for private loans are similar to the existing regulations in §1.148–1(e)(2) for determining whether a prepayment gives rise to investment-type property, except that the private loan regulations focus on whether the prepayment provides a benefit of tax-exempt financing to the seller. The final regulations amend the private loan provisions of §1.141–5(c)(2) to conform to the amendments to the definition of investment-type property in the final regulations.

III. *Tables of Contents*

The final regulations amend the tables of contents in §§1.141–0 and 1.148–0 to reflect the final regulations and certain previously issued regulations under sections 141 and 148.

Effective Dates

The final regulations apply to bonds sold on or after October 3, 2003. In addition, issuers may apply the final regulations to bonds sold before October 3, 2003, that are subject to §§1.141–5 and 1.148–1.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It 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 rule does not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) do not apply.

Drafting Information

The principal authors of these regulations are Rebecca L. Harrigal and Johanna Som de Cerff, Office of Chief Counsel (TE/GE), IRS, and Stephen J. Watson, Office of Tax Policy, Treasury Department. However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.141–0 is amended by revising the entry for §1.141–15(b) to read as follows:

§1.141–0 Table of contents.

* * * * *

§1.141–15 Effective dates.

* * * * *

(b) Effective dates.

(1) In general.

(2) Certain short-term arrangements.

(3) Certain prepayments.

* * * * *

Par. 3. In §1.141–5, paragraph (c)(2)(ii) is revised and paragraphs (c)(2)(iii) and (c)(2)(iv) are added to read as follows:

§1.141–5 Private loan financing test.

* * * * *

(c) * * *

(2) * * *

(ii) *Certain prepayments treated as loans*. Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if—

(A) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(B) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(C) The prepayment meets the requirements of §1.148–1(e)(2)(iii)(A) or (B) (relating to certain prepayments to acquire a supply of natural gas or electricity).

(iii) *Customary prepayments*. The determination of whether a prepayment satisfies paragraph (c)(2)(ii)(A) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (c)(2)(ii)(A) of this section if—

(A) The prepayment is made for—

(*1*) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(*2*) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iv) *Additional prepayments as permitted by the Commissioner*. The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment is not treated as a loan for purposes of the private loan financing test.

* * * * *

Par. 4. Section 1.141–15 is amended by adding paragraph (b)(3) to read as follows:

§1.141–15 Effective dates.

* * * * *

(b) * * *

(3) *Certain prepayments*. Except as provided in paragraph (c) of this section, paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of §1.141–5 apply to bonds sold on or after October 3, 2003. Issuers may apply paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of §1.141–5, in whole but not in part, to bonds sold before October 3, 2003, that are subject to §1.141–5.

Par. 5. Section 1.148–0 is amended by:

1. Adding entries in paragraph (c) for §1.148–1, paragraphs (e)(1) through (e)(3).

2. Adding entries in paragraph (c) for §1.148–11, paragraphs (b)(4), (h), (i) and (j).

The additions read as follows:

§1.148–0 Scope and table of contents.

* * * * *

(c) *Table of contents*.

* * * * *

§1.148–1 Definitions and elections.

* * * * *

(e) * * *

(1) In general.

(2) Prepayments.

(3) Certain hedges.

* * * * *

§1.148–11 Effective dates.

(b) * * *

(4) No elective retroactive application for safe harbor for establishing fair market

value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.

* * * * *

(h) Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.

(i) Special rule for investments purchased for a yield restricted defeasance escrow.

(j) Certain prepayments.

Par. 6. In §1.148–1, paragraphs (e)(1) and (2) are revised to read as follows:

§1.148–1 Definitions and elections.

* * * * *

(e) *Investment-type property*—(1) *In general*. Investment-type property includes any property, other than property described in section 148(b)(2)(A), (B), (C) or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money.

(2) *Prepayments*—(i) *In general*—(A) *Generally*. Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if—

(*1*) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(*2*) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(*3*) The prepayment meets the requirements of paragraph (e)(2)(iii)(A) or (B) of this section.

(B) *Example*. The following example illustrates an application of this paragraph (e)(2)(i):

Example. Prepayment after contract is executed. In 1998, City A enters into a ten-year contract with Company Y. Under the contract, Company Y is to provide services to City A over the term of the contract and in return City A will pay Company Y for its services as they are provided. In 2004, City A issues bonds to finance a lump sum payment to Company Y in satisfaction of City A's obligation to pay for Company Y's services to be provided over the remaining term of the contract. The use of bond proceeds to make the lump sum payment constitutes a prepayment for services under paragraph (e)(2)(i) of this section, even though the payment is made after the date that the contract is executed.

(ii) *Customary prepayments*. The determination of whether a prepayment satisfies paragraph (e)(2)(i)(A)(*1*) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (e)(2)(i)(A)(*1*) of this section if—

(A) The prepayment is made for—

(*1*) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(*2*) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iii) *Certain prepayments to acquire a supply of natural gas or electricity*—(A) *Natural gas prepayments*. A prepayment meets the requirements of this paragraph (e)(2)(iii)(A) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person, as defined in §1.141–1(b) (each of which is referred to in this paragraph (e)(2)(iii)(A) as the issuing municipal utility), to purchase a supply of natural gas; and

(*2*) At least 90 percent of the prepaid natural gas financed by the issue is used for a qualifying use. Natural gas is used for a qualifying use if it is to be—

(*i*) Furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, provided, however, that gas used to produce electricity for sale shall not be included under this paragraph (e)(2)(iii)(A)(*2*)(*i*);

(*ii*) Used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility;

(*iii*) Used by the issuing municipal utility to produce electricity that will be sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser;

(*iv*) Sold to a utility that is owned by a governmental person if the requirements of paragraph (e)(2)(iii)(A)(*2*)(*i*), (*ii*) or (*iii*) of this section are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or

(*v*) Used to fuel the pipeline transportation of the prepaid gas supply acquired in accordance with this paragraph (e)(2)(iii)(A).

(B) *Electricity prepayments*. A prepayment meets the requirements of this paragraph (e)(2)(iii)(B) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person (each of which is referred to in this paragraph (e)(2)(iii)(B) as the issuing municipal utility) to purchase a supply of electricity; and

(*2*) At least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. Electricity is used for a qualifying use if it is to be—

(*i*) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or

(*ii*) Sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

(C) *Service area*. For purposes of this paragraph (e)(2)(iii), the service area of a utility owned by a governmental person consists of—

(*1*) Any area throughout which the utility provided, at all times during the 5-year period ending on the issue date—

(*i*) In the case of a natural gas utility, natural gas transmission or distribution service; and

(*ii*) In the case of an electric utility, electricity distribution service; and

(*2*) Any area recognized as the service area of the utility under state or Federal law.

(D) *Retail customer*. For purposes of this paragraph (e)(2)(iii), a retail customer

is a customer that purchases natural gas or electricity, as applicable, other than for resale.

(E) *Commodity swaps*. A prepayment does not fail to meet the requirements of this paragraph (e)(2)(iii) by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas or electricity supplier), or between the gas or electricity supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas or electricity supply contract or another swap contract); provided, however, that a commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas or electricity supplier to deliver gas or electricity for which the swap contract is a hedge.

(F) *Remedial action*. Issuers may apply principles similar to the rules of §1.141–12, including §1.141–12(d) (relating to redemption or defeasance of nonqualified bonds) and §1.141–12(e) (relating to alternative use of disposition proceeds), to cure a violation of paragraph (e)(2)(iii)(A)(*2*) or (e)(2)(iii)(B)(*2*) of this section. For this purpose, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of §1.141–7(d), treating nonqualified sales of gas or electricity under this paragraph (e)(2)(iii) as satisfying the benefits and burdens test under §1.141–7(c)(1).

(iv) *Additional prepayments as permitted by the Commissioner*. The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

* * * * *

Par. 7. Section 1.148–11 is amended by adding paragraph (j) to read as follows:

§1.148–11 Effective dates.

* * * * *

(j) *Certain prepayments*. Section 1.148–1(e)(1) and (2) apply to bonds sold on or after October 3, 2003. Issuers may apply §1.148–1(e)(1) and (2), in whole but not in part, to bonds sold before October 3, 2003, that are subject to §1.148–1.

Dale F. Hart,
Acting Deputy Commissioner for Services and Enforcement.

Approved July 25, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 1, 2003, 8:45 a.m., and published in the issue of the Federal Register for August 4, 2003, 68 F.R. 45772)

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2003. See Rev. Rul. 2003-107, page 815.

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

The adjusted applicable federal long-term rate is set forth for the month of October 2003. See Rev. Rul. 2003-107, page 815.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2003. See Rev. Rul. 2003-107, page 815.

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 October 2003. See Rev. Rul. 2003-107, page 815.

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 October 2003. See Rev. Rul. 2003-107, page 815.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2003. See Rev. Rul. 2003-107, page 815.

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 October 2003. See Rev. Rul. 2003-107, page 815.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2003. See Rev. Rul. 2003-107, page 815.

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 October 2003. See Rev. Rul. 2003-107, page 815.

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 October 2003. See Rev. Rul. 2003-107, page 815.

Section 883.—Exclusions From Gross Income

26 CFR 1.883–1: Exclusion of income from the international operation of ships or aircraft.

T.D. 9087

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

Exclusions From Gross Income of Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations implementing sections 883(a) and (c) that relate to income derived by foreign corporations from the international operation of ships or aircraft. The final regulations reflect changes made by the Tax Reform Act of 1986 and subsequent legislative amendments. The final regulations provide, in general, that a foreign corporation organized in a qualified foreign country and engaged in the international operation of ships or aircraft shall exclude qualified income from gross income for purposes of U.S. federal income taxation, provided that the corporation can satisfy certain ownership and related documentation requirements. The final regulations explain when a foreign country is a qualified foreign country and what income is considered to be qualified income. The final regulations specify how a foreign corporation may satisfy the ownership and related documentation requirements. In addition, the final regulations describe the information that the foreign corporation must include on its U.S. income tax return in order to claim an exemption. All foreign corporations engaged in the international operation of ships or aircraft that claim an exemption from U.S. federal income tax based on section 883 are affected by these regulations.

DATES: *Effective Date*: These regulations are effective August 26, 2003.

Applicability Date: These regulations are applicable to taxable years of the foreign corporation beginning 30 days or more after August 26, 2003.

FOR FURTHER INFORMATION CONTACT: Patricia A. Bray or David L. Lundy at (202) 622–3880 (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 1545–1677. Responses to these collections of information are mandatory.

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

For corporations, the estimated annual burden per respondent varies from 30 minutes to eight hours, depending on the individual circumstances of the foreign corporation, with an estimated average of one hour. For shareholders, the estimated annual burden per respondent varies from zero minutes to eight hours, depending on the individual circumstances of the shareholder or intermediary, with an estimated average of 90 minutes.

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, W:CAR:MP:T:T:SP, 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 become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

A notice of proposed rulemaking (REG–208280–86, 2000–1 C.B. 654 [65 FR 6065]) under sections 883(a) and (c) was published in the **Federal Register** on February 8, 2000 (the 2000 proposed regulations). Due to the substantial number of comments that were received on the 2000 proposed regulations, and the significant impact the regulations have on large segments of the shipping and air transport industries, the 2000 proposed regulations were withdrawn on August 2, 2002. A revised notice of proposed rulemaking (REG–136311–01, 2002–2 C.B. 485 [67 FR 50510]) was published in the **Federal Register** on August 2, 2002 (the proposed regulations), and provided an opportunity for additional comments. A public hearing on the proposed regulations was held on November 25, 2002. Numerous comments have been received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision.

The preamble to the 2000 proposed regulations contains a detailed explanation of the provisions in the 2000 proposed regulations, and the preamble to the proposed regulations describes the comments received on the 2000 proposed regulations and the consequent changes reflected in the proposed regulations. The explanations contained in those preambles are not repeated herein. The comments submitted to the IRS on the proposed regulations and the consequent changes reflected in the final regulations are described herein.

Public Comments

Comments Relating to §1.883–1: Exclusion of Income From The International Operation of Ships or Aircraft

A. *Substantiation and reporting requirements*

For a foreign corporation to be considered a qualified foreign corporation under §1.883–1(c)(3), the proposed regulations require that the corporation provide on its return a reasonable estimate of the amount of income in each category of qualified income for which an exemption is

claimed to the extent such amounts are readily determinable. Commentators criticized this requirement on the ground that it could require the creation of a separate accounting system, and would necessitate the allocation of expenses to each of the specific categories of income. Commentators suggested that whether amounts are *readily determinable* should depend on whether records to ascertain such amounts are available in the ordinary course of business.

The IRS and Treasury believe that the suggested definition of *readily determinable* does not ensure that adequate records will be maintained. That term should be interpreted in accordance with §1.6012–2(g)(1)(i). However, the final regulations have been revised to clarify that a reasonable estimate of the *gross* amount of income in each category is required. Accordingly, there is no requirement that expenses be allocated to each category of income.

B. *Operation of ships or aircraft*

Section 1.883–1(e) of the proposed regulations provides generally that a corporation is considered engaged in the operation of ships or aircraft only when it is an owner or lessee of an entire ship or aircraft used in the carriage of passengers or cargo for hire. Commentators said that a shipping company utilizing less than the entire space on several vessels also should be considered engaged in the operation of ships or aircraft. The final regulations do not adopt this suggestion. The IRS and Treasury believe that it is appropriate to consider a foreign corporation to be engaged in the operation of ships or aircraft for purposes of section 883 only when it is an owner or lessee of an entire ship or aircraft.

C. *Pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture*

Section 1.883–1(e)(2) generally treats a foreign corporation as engaged in the operation of ships or aircraft with respect to its participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture. Commentators asked that these rules be made applicable to single-member disregarded entities in addition to arrangements with multiple owners. Commentators also asked for clarification concerning whether these rules apply to tiered partnerships, such as in the case of a foreign corporation that is a partner in a partnership, whose sole activity is to be a partner in another partnership that is engaged in international shipping.

The rules have been revised to cover single-member disregarded entities, and to clarify that they apply to tiered entities in the case of both joint venture entities and joint ventures that are not entities. An example was added to illustrate these revisions.

D. *Cruises to nowhere*

Section 1.883–1(f)(1) excludes from the international operation of ships or aircraft the carriage of passengers or cargo on a voyage or flight that begins and ends in the United States, even if the voyage or flight contains a segment extending beyond the territorial limits of the United States, unless the passenger disembarks or the cargo is unloaded outside the United States. Commentators renewed their objection to this exclusion of such "cruises to nowhere." The final regulations continue to exclude cruises to nowhere because such travel has beginning and ending points within the United States within the meaning of section 863(c)(1).

E. *Determining whether income is derived from international operation of ships or aircraft*

Section 1.883–1(f)(2) of the proposed regulations provides that whether income is derived from international operation of ships or aircraft is determined on a passenger by passenger basis and on an item-of-cargo by item-of-cargo basis. Commentators suggested that with respect to the carriage of passengers by ship, the determination should be made on a voyage by voyage basis. Commentators said the voyage should be treated as international if it cannot be completed because of weather or similar factors.

The final regulations do not adopt the suggestion that income be determined on a voyage by voyage basis. The regulations have been revised, however, to exempt income from the sale of a ticket for international carriage of a passenger when the passenger does not begin or complete an international journey because of unanticipated circumstances. For example, if a passenger does not leave on an international flight because of a change in plans, or is unable to complete an international voyage because of illness, any income derived from the sale of the ticket nonetheless will qualify for exemption.

F. *International carriage of cargo*

Under §1.883–1(e)(1), a foreign corporation is considered engaged in the operation of ships or aircraft only if the ship or aircraft is used in the carriage of passengers or cargo for hire. Commentators pointed out that the regulations do not define the term *for hire*. They expressed concern that requiring the carriage of cargo for hire might be interpreted to exclude income derived by a vessel owner or operator who charters a vessel to a lessee, if the lessee uses it to transport the lessee's own cargo or repositions the vessel without cargo on board for its next voyage. Commentators suggested that the term *for hire* be defined to include carriage of proprietary goods and an empty backhaul voyage, or that it be deleted from the regulations.

Section 1.883–1(f)(2)(iv) of the final regulations provides that if a foreign corporation time, voyage, or bareboat charters out a ship or aircraft, and the lowest-tier lessee uses the ship or aircraft to carry passengers or cargo on a fee basis, the ship or aircraft is considered used to carry passengers or cargo for hire, regardless of whether the ship or aircraft may be empty during a portion of the charter period due to a backhaul voyage or flight or for purposes of repositioning. If a foreign corporation time, voyage, or bareboat charters out a ship or aircraft, and the lowest-tier lessee uses the ship or aircraft for the carriage of proprietary goods, including an empty backhaul voyage or flight or repositioning related to such carriage of proprietary goods, the ship or aircraft similarly will be treated as used to carry cargo for hire.

G. *Bareboat charter of ships or dry lease of aircraft used in international operation of ships or aircraft*

When a foreign corporation bareboat charters a ship or dry leases an aircraft

to a lessee, §1.883–1(f)(2)(iii) of the proposed regulations requires the corporation to adopt a reasonable method for determining the amount of charter income attributable to the international operation of ships or aircraft by the lowest tier lessee. The regulations contain two ratios that may provide a reasonable method for determining the amount of qualifying charter income.

Commentators asked for clarification that business records or log books are a reasonable method for determining the amount of charter income when those records show that the vessel has been used exclusively in international transportation. Commentators also asserted that the ratios are unnecessary and suggested that they be deleted.

The IRS and Treasury believe that business records or log books showing that a ship or aircraft has been used exclusively on voyages or flights that begin or end in the United States (but not both) may be sufficient to establish that the foreign corporation's entire gross income is income from the international operation of ships or aircraft. However, if the ship or aircraft also has been used on voyages or flights that begin and end outside the United States, the foreign corporation must determine the amount of the charter income that is attributable to voyages or flights that begin or end in the United States (but not both) to determine the amount of income potentially within the scope of section 883. The final regulations have been revised generally to require such a foreign corporation to determine the amount of such income based on the total number of days of uninterrupted travel on voyages or flights between the United States and the farthest point or points where cargo or passengers are loaded en route to, or discharged en route from, the United States. However, the final regulations permit the foreign corporation to adopt an alternative method for determining the amount of the charter income that is attributable to the international operation of ships or aircraft if it can establish that the alternative method more accurately reflects the amount of such income.

H. *Activities incidental to the international operation of ships or aircraft*

Section 1.883–1(g) of the proposed regulations provides that certain activities of an operator of a ship or aircraft are so closely related to the primary activity of the international operation of ships or aircraft that income from those incidental activities shall be considered income from the international operation of ships or aircraft, and thus eligible for exemption.

Intermodal Containers.

Section 1.883–1(g)(1)(x) of the proposed regulations treats certain container rental activities in the United States as incidental to the international operation of ships or aircraft. The regulations limit incidental treatment to the rental of containers for use in the United States for a period not exceeding five days beyond the original delivery date to the consignee as stated on the bill of lading, and also impose other limitations on incidental treatment.

Commentators stated that ocean carriers provide containers to their customers as an integral part of international shipping, but do not "rent" containers or provide them for "temporary warehousing" of cargo. Commentators also noted that deliveries can be delayed beyond five days for many reasons that clearly do not involve warehousing, such as congestion at port facilities. Commentators said it would be difficult and unrealistic to allocate a portion of the shipping charges to the use of containers.

For these reasons, the reference to container rental as an incidental activity has been modified. The "five day" rule has been eliminated and replaced with a more flexible rule under which the provision of containers or other related equipment by the foreign corporation in connection with the international carriage of cargo for use by its customers, including short-term use within the United States immediately preceding or following the international carriage of cargo, is considered an incidental activity. The regulations presume that a container is used in connection with the international carriage of cargo if it is used for a period of five days or less immediately preceding or following the international carriage of cargo. Beyond this five-day period, whether a container is being used in connection with the international carriage of cargo, or for some other purpose such as warehousing of cargo, will depend on the facts and circumstances. The regulations make clear that the use of containers for any such other purpose will be considered to give rise to income that is not incidental to the international operation of ships or aircraft.

Hotel Accommodations.

Arranging for one night in a hotel within the United States before or after a cruise is considered incidental to the international operation of ships under §1.883–1(g)(1)(vii) of the proposed regulations. Commentators suggested that the exception also should apply to one-night hotel accommodations arranged by airlines. Commentators said that airlines occasionally provide such accommodations to passengers on tour packages for the same reasons that cruise companies provide accommodations. The final regulations do not adopt this suggestion. The IRS and Treasury believe that different rules are appropriate in light of operational differences between the airline and cruise industries.

Inland Transportation of Cargo.

Section 1.883–1(g)(1)(v) treats the inland transportation of cargo by a related or unrelated corporation as incidental. Commentators suggested that inland transportation of cargo by the foreign corporation itself (after the cargo has passed through Customs) also should be treated as incidental. The final regulations do not adopt this suggestion. The IRS and Treasury are concerned that an exemption would permit foreign corporations engaged in international transportation to compete unfairly with other corporations engaged in the inland transportation of cargo.

Under the proposed regulations, inland transportation by another corporation must be documented by a through bill of lading, airway bill, or similar document. Commentators asked whether the term *similar document* can include any document showing an inland leg to international transportation, such as a seaway bill or cargo receipt. The IRS and Treasury believe

that *similar document* may be construed broadly to include any appropriate document.

Commentators stated that some unincorporated entities provide inland transportation, and asked that such entities be included in the regulations. Accordingly, the final regulations have been revised to permit any unrelated person (whether incorporated or not) to provide inland transportation of cargo. The final regulations also provide that the rules of section 267(b) shall apply for purposes of determining whether persons are related.

Inland Transportation of Passengers.

Section 1.883–1(g)(1)(vi) treats the sale or issuance by a foreign corporation of interline or code-sharing tickets for the inland transportation of passengers by air as an incidental activity. Commentators suggested that the inland segment of an international journey also should be treated as incidental when provided by the foreign airline itself through the sale or issuance of an intraline ticket. The final regulations extend incidental treatment to the sale or issuance of intraline tickets. The final regulations also impose a maximum 12-hour scheduled interval between the international and inland segments of any flight involving intraline tickets.

Shore Excursions.

Land tour packages are excluded from incidental activities under §1.883–1(g)(2)(i). Commentators contend that single-day shore excursions are not the same as land tour packages and should qualify as an incidental activity. The final regulations do not adopt this suggestion because the two activities are similar in nature.

Short-term Use.

Ships normally engaged in international cruises may occasionally be used for other purposes, such as cruises to nowhere. Commentators asked that such short-term use be treated as an incidental activity. The final regulations do not adopt this suggestion because domestic use of a vessel does not qualify as the international operation of ships or aircraft.

Airline Tickets.

Section 1.883–1(g)(1) treats as incidental the sale of tickets by an airline for international transportation on another airline, and the sale of tickets by a ship operator on behalf of another ship operator. Section 1.883–1(g)(2)(iii), however, excludes from incidental income the sale of airline tickets by a cruise company. Commentators objected to this exclusion. This exclusion is retained in the final regulations. Cruise companies that sell airline tickets are acting in a capacity comparable to travel agents, and would have an unfair competitive advantage if their income from this activity were exempt.

Ground Services and Other Services.

The proposed regulations, in §1.883–1(g)(3), reserve on the treatment of ground services, maintenance and catering, as well as other services not mentioned as included among incidental activities. In the absence of a clear international norm or standard regarding the appropriate treatment of such services, the IRS and Treasury solicited comments on an appropriate rule. Commentators generally suggested that activities be treated as incidental unless they rise to the level of a separate, nonshipping business. The final regulations continue to reserve on this issue, pending further consideration by the IRS and Treasury.

I. *Determining equivalent exemptions for each category of income*

Section 1.883–1(h)(2) of the proposed regulations provides that if an exemption is unavailable in a foreign country for one of the eight enumerated categories of income, the foreign country is not considered to grant an equivalent exemption with respect to that category of income. Paragraph (h)(2)(vi) of this section treats incidental income, other than incidental bareboat charter or dry lease income and incidental container-related income, as one category of income.

Commentators suggested that an equivalent exemption be determined on an item-of-income basis rather than by category of income. Commentators objected to the requirement that a foreign country exempt all items of income within a category of income to be treated as granting an equivalent exemption. The examples provided by commentators indicated that this concern arose primarily in the context of the residual category of incidental income described in paragraph (h)(2)(vi).

The final regulations retain the requirement that a foreign country exempt all items of income within a category of income, but provide an exception for incidental income described in paragraph (h)(2)(vi). The final regulations permit an exemption of any type of incidental income that qualifies under paragraph (g)(1) if a foreign country grants an equivalent exemption with respect to that type of income. For example, if a foreign country grants an equivalent exemption for the sale of airline tickets on behalf of another corporation engaged in international operation of aircraft, as provided in paragraph (g)(1)(iii), but does not provide an equivalent exemption for the inland transportation of cargo, as provided in paragraph (g)(1)(v), the foreign country is nonetheless considered to grant an equivalent exemption for the sale of airline tickets.

Commentators also pointed out that some income items may be described in more than one category of income, and asked which category would apply for purposes of determining whether the foreign country provides an equivalent exemption. The IRS and Treasury believe that the taxpayer can select any applicable category of income that provides an exemption.

J. *Special rules with respect to income tax conventions*

Section 1.883–1(h)(3)(i) of the proposed regulations provides that if a taxpayer is eligible to exempt income under both an applicable income tax convention and section 883, the taxpayer may claim an exemption under both the applicable income tax convention and section 883 with respect to such category of income. Such an election must be made with respect to all income of the foreign corporation from the international operation of ships or aircraft, and cannot be made separately with respect to different categories of income.

Commentators requested clarification concerning the election to claim an exemption under both the applicable income tax convention and section 883 when the benefits under the two exemptions are not

co-extensive with respect to any category of income.

The final regulations have been clarified to provide that if a corporation chooses to claim an exemption under an income tax convention, it may simultaneously claim an exemption under section 883 with respect to any category of income listed in paragraphs (h)(2)(i) through (v), (vii), and (viii) of §1.883–1 and to any type of income described in paragraph (h)(2)(vi) of §1.883–1, but only to the extent that such income also is exempt under the income tax convention.

K. *Participation in certain joint ventures*

Under §1.883–1(h)(3)(i), a corporation organized in a foreign country that provides an exemption only through an income tax convention is not permitted to claim an exemption under section 883, with one exception. Paragraph (h)(3)(ii) permits such corporation to claim an exemption under section 883 if the foreign corporation participates in a joint venture described in paragraph (e)(2) that is not treated as fiscally transparent with respect to the category of income derived from the joint venture under the income tax laws of the jurisdiction where the foreign corporation is organized, and treaty benefits would be available but for this reason.

Commentators suggested that the exception in §1.883–1(h)(3)(ii) should apply to single-owner disregarded entities in addition to transparent joint ventures. This suggestion was not adopted. The IRS and Treasury believe that the policy justification for relief in the joint venture context is not present in the context of a wholly owned entity.

L. *Independent interpretation of income tax conventions*

Section 1.883–1(h)(3)(iii) of the proposed regulations clarifies that definitions provided in these regulations do not give meaning or provide guidance regarding similar terms in U.S. income tax conventions or the scope of any treaty exemption. Commentators stated that definitions in the regulations and income tax conventions should have the same scope and be interpreted in the same way. The IRS and Treasury continue to believe that terms used in the proposed regulations should not be used to interpret terms and concepts in U.S. income tax conventions except to the extent that a treaty that entered into force after August 26, 2003, or its legislative history explicitly refers to section 883 and guidance thereunder for its meaning.

Comments Relating to §1.883–2: Treatment of Publicly-traded Corporations

A. *Closely-held classes of stock not treated as meeting trading requirements*

Section 1.883–2(d)(3)(i) of the proposed regulations disqualifies a class of stock from being relied on to satisfy the publicly traded test if, at any time during the taxable year, one or more 5-percent shareholders of that class of stock (determined without regard to the attribution rules in §1.883–4) owns, in the aggregate, 50 percent or more of the total vote and value of that class of stock (closely-held rule).

Commentators pointed out that a company could lose its exemption if a nonqualified shareholder held a sufficiently large block of stock for one day. Commentators suggested requiring a longer period of ownership by nonqualified shareholders before disqualifying a class of stock from being relied on to satisfy the publicly traded test.

This suggestion has been adopted. The final regulations provide that a class of stock will be disqualified if one or more 5-percent shareholders of that class of stock owns, in the aggregate, 50 percent or more of the total vote and value of that class of stock for more than half the number of days during the corporation's taxable year. In this way, the closely-held rule matches the exception provided in §1.883–2(d)(3)(ii) which permits a foreign corporation to establish that qualified shareholders own sufficient shares in the closely-held block of stock to preclude nonqualified shareholders from owning 50 percent or more of the total value of the class of stock for more than half the number of days during the taxable year.

To demonstrate that a class of stock is not closely-held for purposes of §1.883–2(d)(3)(i), a foreign corporation whose stock is traded on an established securities market in the United States may rely on current Schedule 13G filings with the Securities and Exchange Commission to identify its 5-percent shareholders in each class of stock relied upon to meet the regularly traded test, without having to make any independent investigation to determine the identity of the 5-percent shareholders. §1.883–4(d)(3)(viii). Commentators suggested that a foreign corporation also be permitted to rely on current Schedule 13D filings with the Securities and Exchange Commission to identify 5-percent shareholders for purposes of meeting the exception contained in §1.883–2(d)(3)(ii). The final regulations adopt this suggestion.

Under §1.883–2(d)(3)(iii)(B) of the proposed regulations, an investment company registered under the Investment Company Act of 1940 will not be treated as a 5-percent shareholder if no person owns both 5 percent or more of the value of the outstanding interests in the investment company and 5 percent or more of the value of the shares of the class of stock of the foreign corporation. Commentators suggested that this exception be extended to foreign mutual funds, other investment companies not registered under the Investment Company Act of 1940, and financial institutions with customer or nominee accounts. Commentators also pointed out that it would be difficult for a shipping company to determine the identity of 5-percent owners of a mutual fund because most mutual fund shares are held in street name.

The final regulations eliminate the provision that treats an investment company registered under the Investment Company Act of 1940 as a 5-percent shareholder if a person owns both 5 percent or more of the value of the outstanding interests in the investment company and 5 percent or more of the value of the shares of the class of stock of the foreign corporation. Instead, the final regulations provide that such an investment company shall not be treated as a 5-percent shareholder for purposes of these regulations. The final regulations do not expand the mutual fund exception to include other types of investment vehicles or financial institutions.

Comments relating to §1.883–3: Treatment of Controlled Foreign Corporations

Income inclusion test

Section 883(c)(2) provides that the stock ownership test of section 883(c)(1) shall not apply to controlled foreign corporations (CFCs). Under the proposed regulations, a CFC is considered to satisfy the CFC exception of section 883(c)(1) if it meets the requirements of §1.883–3. One such requirement is the income inclusion test of §1.883–3(b). This test requires that more than 50 percent of the subpart F income derived by the CFC from the international operation of ships or aircraft be includible in the gross income of one or more U.S. citizens, individual residents of the United States, or domestic corporations.

Commentators restated their objection to the income inclusion test. They argued that the test is too restrictive because it could deny qualified foreign corporation status to CFCs legitimately owned and controlled by U.S. shareholders.

The IRS and Treasury continue to believe that the income inclusion rule contained in the proposed regulations is supported by the legislative history to section 883(c). The Conference report accompanying the legislation that added the CFC exception provides with respect to the exception that "corporations are not considered residents of countries that exempt U.S. persons unless 50 percent or more of the ultimate individual owners are U.S. shareholders of controlled foreign corporations". H.R. Conf. Rep. No. 99–841, 99th Cong., 2d Sess. 598 (1986), reprinted in 1986–3 C.B. vol. 4, at 598 (1986). The intent of the CFC exception, therefore, is for the general ownership requirement of section 883(c)(1) to apply unless the foreign corporation is a CFC and 50 percent or more of the subpart F income of that corporation derived from the international operation of ships or aircraft is includible by U.S. citizens, individual residents, or domestic corporations.

Commentators stated that if the income inclusion test is retained, the regulations should provide that income derived by U.S. tax-exempt organizations holding shares in CFCs should be counted toward satisfying the income inclusion test even though the income is not taxed.

The final regulations do not adopt this suggestion. A U.S. tax-exempt organization is not in substance different from a U.S. person that is not required to include in its gross income the subpart F income of a CFC.

Comments Relating to §1.883–4: Qualified Shareholder Stock Ownership Test

A. *Qualified shareholders*

A foreign corporation satisfies the stock ownership test of §1.883–1(c)(2) if more than 50 percent of the value of its outstanding shares is owned, or treated as owned through attribution, for at least half of the number of days in the foreign corporation's taxable year by one or more qualified shareholders. Section 1.883–4(b)(1)(i)(A) of the proposed regulations treats an individual resident in a qualified foreign country as a qualified shareholder, but excludes individuals described in §1.883–4(b)(1)(i)(E) and (F). Commentators stated that the exclusion of pension fund beneficiaries described in paragraph (b)(1)(i)(E) could be interpreted to prevent the qualification of an individual under paragraph (b)(1)(i)(A). For example, if an individual held stock directly in a shipping company and also was the beneficiary of a pension fund holding stock in the same company, commentators believe that the individual might not qualify under paragraph (b)(1)(i)(A) with respect to the individual's direct ownership. The final regulations clarify that an individual can be a qualified shareholder under paragraph (b)(1)(i)(A) and also be a qualified shareholder under paragraph (b)(1)(i)(E) with respect to a category of income for which a foreign corporation is seeking an exemption.

Under §1.883–4(b)(1)(i)(D) of the proposed regulations, a not-for-profit organization described in §1.883–4(b)(4) is treated as a qualified shareholder. Section 1.883–4(b)(4)(iii)(A) requires a not-for-profit organization to expend more than 50 percent of its annual support on behalf of individuals described in §1.883–4(b)(1)(i)(A).

Commentators suggested that the category of recipients eligible for support be expanded to include other not-for-profit organizations. This suggestion has been adopted in part. The final regulations provide that a not-for-profit organization may be a qualified shareholder if it expends more than 50 percent of its annual support on behalf of U.S. organizations that have received determination letters under section 501(c)(3) and on behalf of individuals described in §1.883–4(b)(1)(i)(A).

Commentators asked that the list of qualified shareholders in §1.883–4(b)(1)(i) be expanded to include international organizations as defined in section 7701(a)(18), and pension funds established for employees of such organizations. The final regulations do not adopt this suggestion. Under section 883(c)(1) and §1.883–4(a), a foreign corporation satisfies the stock ownership test if more than 50 percent of the value of its outstanding shares is owned by qualified shareholders who are residents of qualified foreign countries. The remaining shares of the foreign corporation can be owned by nonqualified shareholders, including international organizations.

Section 1.883–4(b)(1)(ii) of the proposed regulations provides that a shareholder is a qualified shareholder only if the shareholder does not own its interest in the foreign corporation through bearer shares, either directly or by applying the attribution rules of §1.883–4(c). Commentators renewed their objection to this rule. The final regulations retain this provision due to the difficulty of reliably demonstrating the true ownership of bearer shares.

B. *Substantiation of stock ownership*

Section 1.883–4(b)(1)(iii) of the proposed regulations provides that a shareholder is a qualified shareholder only if the shareholder provides to the foreign corporation the documentation required in §1.883–4(d), and the foreign corporation meets the reporting requirements of §1.883–4(e) with respect to such shareholder. Commentators argued that the required reporting requirements are burdensome, and suggested that taxpayers have the option of submitting a sworn statement with their return stating that qualified individuals own the corporation and that supporting documentation has been deposited with a qualified tax practitioner in the United States. The final

regulations do not adopt this suggestion. The IRS and Treasury continue to believe that this information is necessary for proper administration of section 883 and that the provision of this information with the foreign corporation's tax return is not unduly burdensome.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of U.S. small entities. This certification is based upon the fact that these regulations apply to foreign corporations and impose only a limited collection of information burden on shareholders of such corporations, which in some cases may include U.S. small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the 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 final regulations is David L. Lundy of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.883–1 is also issued under 26 U.S.C. 883.

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

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

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

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

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

§1.883–0 Outline of major topics.

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

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

(a) General rule.
(b) Qualified income.
(c) Qualified foreign corporation.
(1) General rule.
(2) Stock ownership test.
(3) Substantiation and reporting requirements.
(i) General rule.
(ii) Further documentation.
(4) Commissioner's discretion to cure defects in documentation.
(d) Qualified foreign country.
(e) Operation of ships or aircraft.
(1) General rule.
(2) Pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture.
(3) Activities not considered operation of ships or aircraft.
(4) Examples.
(5) Definitions.
(i) Bareboat charter.
(ii) Code-sharing arrangement.
(iii) Dry lease.
(iv) Entity.
(v) Fiscally transparent entity under the income tax laws of the United States.
(vi) Full charter.
(vii) Nonvessel operating common carrier.
(viii) Space or slot charter.
(ix) Time charter.
(x) Voyage charter.
(xi) Wet lease.
(f) International operation of ships or aircraft.
(1) General rule.
(2) Determining whether income is derived from international operation of ships or aircraft.
(i) International carriage of passengers.
(A) General rule.
(B) Round trip travel on ships.
(ii) International carriage of cargo.
(iii) Bareboat charter of ships or dry lease of aircraft used in international operation of ships or aircraft.
(iv) Charter of ships or aircraft for hire.
(g) Activities incidental to the international operation of ships or aircraft.
(1) General rule.
(2) Activities not considered incidental to the international operation of ships or aircraft.
(3) Services.
(i) Ground services, maintenance, and catering.
(ii) Other services.
(4) Activities involved in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture.
(h) Equivalent exemption.
(1) General rule.
(2) Determining equivalent exemptions for each category of income.
(3) Special rules with respect to income tax conventions.
(i) General rule.
(ii) Participation in certain joint ventures.
(iii) Independent interpretation of income tax conventions.
(4) Exemptions not qualifying as equivalent exemptions.
(i) General rule.
(ii) Reduced tax rate or time limited exemption.
(iii) Inbound or outbound freight tax.
(iv) Exemptions for limited types of cargo.
(v) Territorial tax systems.
(vi) Countries that tax on a residence basis.
(vii) Exemptions within categories of income.
(i) Treatment of possessions.
(j) Expenses related to qualified income.

§1.883–2 Treatment of publicly-traded corporations.

(a) General rule.
(b) Established securities market.
(1) General rule.
(2) Exchanges with multiple tiers.
(3) Computation of dollar value of stock traded.
(4) Over-the-counter market.

(5) Discretion to determine that an exchange does not qualify as an established securities market.
(c) Primarily traded.
(d) Regularly traded.
(1) General rule.
(2) Classes of stock traded on a domestic established securities market treated as meeting trading requirements.
(3) Closely-held classes of stock not treated as meeting trading requirements.
(i) General rule.
(ii) Exception.
(iii) Five-percent shareholders.
(A) Related persons.
(B) Investment companies.
(4) Anti-abuse rule.
(5) Example.
(e) Substantiation that a foreign corporation is publicly traded.
(1) General rule.
(2) Availability and retention of documents for inspection.
(f) Reporting requirements.

§1.883–3 Treatment of controlled foreign corporations.

(a) General rule.
(b) Income inclusion test.
(1) General rule.
(2) Examples.
(c) Substantiation of CFC stock ownership.
(1) General rule.
(2) Documentation from certain United States shareholders.
(i) General rule.
(ii) Availability and retention of documents for inspection.
(d) Reporting requirements.

§1.883–4 Qualified shareholder stock ownership test.

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

§1.883–5 Effective dates.

(a) General rule.
(b) Election for retroactive application.
(c) Transitional information reporting rule.

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

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

(a) *General rule*. Qualified income derived by a qualified foreign corporation from its international operation of ships or aircraft is excluded from gross income and exempt from United States federal income tax. Paragraph (b) of this section defines the term *qualified income*. Paragraph (c) of this section defines the term *qualified foreign corporation*. Paragraph (f) of this section defines the term *international operation of ships or aircraft*.

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

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

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

(c) *Qualified foreign corporation*—(1) *General rule*. A qualified foreign corporation is a corporation that is organized in a qualified foreign country and considered engaged in the international operation of ships or aircraft. The term *corporation* is defined in section 7701(a)(3) and the regulations thereunder. Paragraph (d) of this section defines the term *qualified foreign*

country. Paragraph (e) of this section defines the term *operation of ships or aircraft*, and paragraph (f) of this section defines the term *international operation of ships or aircraft*. To be a qualified foreign corporation, the corporation must satisfy the stock ownership test of paragraph (c)(2) of this section and satisfy the substantiation and reporting requirements described in paragraph (c)(3) of this section. A corporation may be a qualified foreign corporation with respect to one category of qualified income but not with respect to another such category. See paragraph (h)(2) of this section for a discussion of the categories of qualified income.

(2) *Stock ownership test*. To be a qualified foreign corporation, a foreign corporation must satisfy the publicly-traded test of §1.883–2(a), the CFC stock ownership test of §1.883–3(a), or the qualified shareholder stock ownership test of §1.883–4(a).

(3) *Substantiation and reporting requirements*—(i) *General rule*. To be a qualified foreign corporation, a foreign corporation must include the following information in its Form 1120–F, "*U.S. Income Tax Return of a Foreign Corporation,*" in the manner prescribed by such form and its accompanying instructions—

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

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

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

(D) The applicable authority for an equivalent exemption, for example, citation of a statute in the country where the corporation is organized, a diplomatic note between the United States and such country, (for further guidance, see Rev. Rul. 2001–48, 2001–2 C.B. 324 (see §601.601(d)(2) of this chapter)), or, in the case of a corporation described in paragraph (h)(3)(ii) of this section, an income tax convention between the United States and such country;

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

(F) A reasonable estimate of the gross amount of income in each category of qualified income for which the exemption is claimed, to the extent such amounts are readily determinable;

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

(H) Any other relevant information specified by the Form 1120–F and its accompanying instructions.

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

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

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

(e) *Operation of ships or aircraft*—(1) *General rule*. Except as provided in paragraph (e)(2) of this section, a foreign corporation is considered engaged in the operation of ships or aircraft only during the time it is an owner or lessee of one or more entire ships or aircraft and uses such ships or aircraft in one or more of the following activities—

(i) Carriage of passengers or cargo for hire;

(ii) In the case of a ship, the leasing out of the ship under a time or voyage charter (full charter), space or slot charter, or bareboat charter, as those terms are defined in paragraph (e)(5) of this section, provided the ship is used to carry passengers or cargo for hire; and

(iii) In the case of aircraft, the leasing out of the aircraft under a wet lease (full charter), space, slot, or block-seat charter, or dry lease, as those terms are defined in paragraph (e)(5) of this section, provided the aircraft is used to carry passengers or cargo for hire.

(2) *Pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture*. A foreign corporation is considered engaged in the operation of ships or aircraft within the meaning of paragraph (e)(1) of this section with respect to its participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture if it directly, or indirectly through one or more fiscally transparent entities under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section—

(i) Owns an interest in a partnership, disregarded entity, or other fiscally transparent entity under the income tax laws of the United States that itself would be considered engaged in the operation of ships or aircraft under paragraph (e)(1) of this section if it were a foreign corporation; or

(ii) Participates in a pool, strategic alliance, joint operating agreement, code-sharing arrangement, or other joint venture that is not an entity, as defined in paragraph (e)(5)(iv) of this section, involving one or more activities described in paragraphs (e)(1)(i) through (iii) of this section, but only if—

(A) In the case of a direct interest, the foreign corporation is otherwise engaged in the operation of ships or aircraft under paragraph (e)(1) of this section; or

(B) In the case of an indirect interest, either the foreign corporation is otherwise engaged, or one of the fiscally transparent entities would be considered engaged if it were a foreign corporation, in the operation of ships or aircraft under paragraph (e)(1) of this section.

(3) *Activities not considered operation of ships or aircraft.* Activities that do not constitute operation of ships or aircraft include, but are not limited to—

(i) The activities of a nonvessel operating common carrier, as defined in paragraph (e)(5)(vii) of this section;

(ii) Ship or aircraft management;

(iii) Obtaining crews for ships or aircraft operated by another party;

(iv) Acting as a ship's agent;

(v) Ship or aircraft brokering;

(vi) Freight forwarding;

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

(viii) Rental by a container leasing company of containers and related equipment; and

(ix) The activities of a concessionaire.

(4) *Examples.* The rules of paragraphs (e)(1) through (3) of this section are illustrated by the following examples:

Example 1. Three tiers of charters—(i) *Facts.* A, B, and C are foreign corporations. A purchases a ship. A and B enter into a bareboat charter of the ship for a term of 20 years, and B, in turn, enters into a time charter of the ship with C for a term of 5 years. Under the time charter, B is responsible for the complete operation of the ship, including providing the crew and maintenance. C uses the ship during the term of the time charter to carry its customers' freight between U.S. and foreign ports. C owns no ships.

(ii) *Analysis.* Because A is the owner of the entire ship and leases out the ship under a bareboat charter to B, and because the sublessor, C, uses the ship to carry cargo for hire, A is considered engaged in the operation of a ship under paragraph (e)(1) of this section during the term of the time charter. B leases in the entire ship from A and leases out the ship under a time charter to C, who uses the ship to carry cargo for hire. Therefore, B is considered engaged in the operation of a ship under paragraph (e)(1) of this section during the term of the time charter. C time charters the entire ship from B and uses the ship to carry its customers' freight during the term of the charter. Therefore, C is also engaged in the operation of a ship under paragraph (e)(1) of this section during the term of the time charter.

Example 2. Partnership with contributed shipping assets—(i) *Facts.* X, Y, and Z, each a foreign corporation, enter into a partnership, P. P is a fiscally transparent entity under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section. Under the terms of the partnership agreement, each partner contributes all of the ships in its fleet to P in exchange for interests in the partnership and shares in the P profits from the international carriage of cargo. The partners share in the overall management of P, but each partner, acting in its capacity as partner, continues to crew and manage all ships previously in its fleet.

(ii) *Analysis.* P owns the ships contributed by the partners and uses these ships to carry cargo for hire. Therefore, if P were a foreign corporation, it would be considered engaged in the operation of ships within the meaning of paragraph (e)(1) of this section. Accordingly, because P is a fiscally transparent entity under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section, X, Y, and Z are each considered engaged in the operation of ships through P, within the meaning of paragraph (e)(2)(i) of this section, with respect to their distributive share of income from P's international carriage of cargo.

Example 3. Joint venture with chartered in ships—(i) *Facts.* Foreign corporation A owns a number of foreign subsidiaries involved in various aspects of the shipping business, including S1, S2, S3, and S4. S4 is a foreign corporation that provides cruises but does not own any ships. S1, S2, and S3 are foreign corporations that own cruise ships. S1, S2, S3, and S4 form joint venture JV, in which they are all interest holders, to conduct cruises. JV is a fiscally transparent entity under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section. Under the terms of the joint venture, S1, S2, and S3 each enter into time charter agreements with JV, pursuant to which S1, S2, and S3 retain control of the navigation and management of the individual ships, and JV will use the ships to carry passengers for hire. The overall management of the cruise line will be provided by S4.

(ii) *Analysis.* S1, S2, and S3 each owns ships and time charters those ships to JV, which uses the ships to carry passengers for hire. Accordingly, S1, S2, and S3 are each considered engaged in the operation of ships under paragraph (e)(1) of this section. JV leases in entire ships by means of the time charters, and JV uses those ships to carry passengers on cruises. Thus, JV would be engaged in the operation of ships within the meaning of paragraph (e)(1) of this section if it were a foreign corporation. Therefore, although S4 does not directly own or lease in a ship, S4 also is engaged in the operation of ships, within the meaning of paragraph (e)(2)(i) of this section, with respect to its participation in JV.

Example 4. Tiered partnerships—(i) *Facts.* Foreign corporations A, B, and C enter into a partnership, P1. P1 is one of several shareholders of Poolco, a foreign limited liability company that makes an election pursuant to §301.7701–3 of this chapter to be treated as a partnership for U.S. tax purposes. P1 acquires several ships and time charters them out to Poolco. Poolco slot or voyage charters such ships out to third parties for use in the carriage of cargo for hire. P1 and Poolco are fiscally transparent entities under the income tax laws of the United States, as defined in paragraph (e)(5)(v) of this section.

(ii) *Analysis.* A, B, and C are considered engaged in the operation of ships under paragraph (e)(2)(i) of this section with respect to their direct interest in P1 and with respect to their indirect interest in Poolco because both P1 and Poolco are fiscally transparent entities under the income tax laws of the United States and would be considered engaged in the operation of ships under paragraph (e)(1) of this section if they were foreign corporations. The result would be the same if Poolco were a single-member disregarded entity owned solely by P1.

(5) *Definitions*—(i) *Bareboat charter.* A bareboat charter is a contract for the use of a ship or aircraft whereby the lessee is in complete possession, control, and command of the ship or aircraft. For example, in a bareboat charter, the lessee is responsible for the navigation and management of the ship or aircraft, the crew, supplies, repairs and maintenance, fees, insurance, charges, commissions and other expenses connected with the use of the ship or aircraft. The lessor of the ship bears none of the expense or responsibility of operation of the ship or aircraft.

(ii) *Code-sharing arrangement.* A code-sharing arrangement is an arrangement in which one air carrier puts its identification code on the flight of another carrier. This arrangement allows the first carrier to hold itself out as providing service in markets where it does not otherwise operate or where it operates infrequently. Code-sharing arrangements can range from a very limited agreement between two carriers involving only one market to agreements involving multiple markets and alliances between or among international carriers which also include joint marketing, baggage handling, one-stop check-in service, sharing of frequent flyer awards, and other services. For rules involving the sale of code-sharing tickets, see paragraph (g)(1)(vi) of this section.

(iii) *Dry lease.* A dry lease is the bareboat charter of an aircraft.

(iv) *Entity.* For purposes of this paragraph (e), an entity is any person that is treated by the United States as other than an individual for U.S. federal income tax purposes. The term includes disregarded entities.

(v) *Fiscally transparent entity under the income tax laws of the United States.* For purposes of this paragraph (e), an entity is fiscally transparent under the income tax laws of the United States if the entity would be considered fiscally transparent under the income tax laws of the United States under the principles of §1.894–1(d)(3).

(vi) *Full charter.* Full charter (or full rental) means a time charter or a voyage charter of a ship or a wet lease of an aircraft but during which the full crew and management are provided by the lessor.

(vii) *Nonvessel operating common carrier.* A nonvessel operating common carrier is an entity that does not exercise control over any part of a vessel, but holds itself out to the public as providing transportation for hire, issues bills of lading,

assumes responsibility or is liable by law as a common carrier for safe transportation of shipments, and arranges in its own name with other common carriers, including those engaged in the operation of ships, for the performance of such transportation.

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

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

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

(xi) *Wet lease*. A wet lease is the time or voyage charter of an aircraft.

(f) *International operation of ships or aircraft*—(1) *General rule*. The term *international operation of ships or aircraft* means the operation of ships or aircraft, as defined in paragraph (e) of this section, with respect to the carriage of passengers or cargo on voyages or flights that begin or end in the United States, as determined under paragraph (f)(2) of this section. The term does not include the carriage of passengers or cargo on a voyage or flight that begins and ends in the United States, even if the voyage or flight contains a segment extending beyond the territorial limits of the United States, unless the passenger disembarks or the cargo is unloaded outside the United States. Operation of ships or aircraft beyond the territorial limits of the United States does not constitute in itself international operation of ships or aircraft.

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

(i) *International carriage of passengers*—(A) *General rule*. Except in the case of a round trip described in paragraph (f)(2)(i)(B) of this section, income derived from the carriage of a passenger will be income from international operation of ships or aircraft if the passenger is carried between a beginning point in the United States and an ending point outside the United States, or vice versa. Carriage of a passenger will be treated as ending at the passenger's final destination even if, en route to the passenger's final destination, a stop is made at an intermediate point for refueling, maintenance, or other business reasons, provided the passenger does not change ships or aircraft at the intermediate point. Similarly, carriage of a passenger will be treated as beginning at the passenger's point of origin even if, en route to the passenger's final destination, a stop is made at an intermediate point, provided the passenger does not change ships or aircraft at the intermediate point. Carriage of a passenger will be treated as beginning or ending at a U.S. or foreign intermediate point if the passenger changes ships or aircraft at that intermediate point. Income derived from the sale of a ticket for international carriage of a passenger will be treated as income derived from international operation of ships or aircraft even if the passenger does not begin or complete an international journey because of unanticipated circumstances.

(B) *Round trip travel on ships*. In the case of income from the carriage of a passenger on a ship that begins its voyage in the United States, calls on one or more foreign intermediate ports, and returns to the same or another U.S. port, such income from carriage of a passenger on the entire voyage will be treated as income derived from international operation of ships or aircraft under paragraph (f)(2)(i)(A) of this section. This result obtains even if such carriage includes one or more intermediate stops at a U.S. port or ports and even if the passenger does not disembark at the foreign intermediate point.

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

States, and correspondingly loads or unloads that cargo at a U.S. port, is not engaged in international operation of ships or aircraft. Income from the carriage of military cargo on a voyage that begins in the United States, stops at a foreign intermediate port or a military prepositioning location, and returns to the same or another U.S. port without unloading its cargo at the foreign intermediate point, will nevertheless be treated as derived from international operation of ships or aircraft.

(iii) *Bareboat charter of ships or dry lease of aircraft used in international operation of ships or aircraft*. If a qualified foreign corporation bareboat charters a ship or dry leases an aircraft to a lessee, and the lowest tier lessee in the chain of ownership uses such ship or aircraft for the international carriage of passengers or cargo for hire, as described in paragraphs (f)(2)(i) and (ii) of this section, then the amount of charter income attributable to the period the ship or aircraft is used by the lowest tier lessee is income from international operation of ships or aircraft. The foreign corporation generally must determine the amount of the charter income that is attributable to such international operation of ships or aircraft by multiplying the amount of charter income by a fraction, the numerator of which is the total number of days of uninterrupted travel on voyages or flights of such ship or aircraft between the United States and the farthest point or points where cargo or passengers are loaded en route to, or discharged en route from, the United States during the smaller of the taxable year or the particular charter period, and the denominator of which is the total number of days in the smaller of the taxable year or the particular charter period. For this purpose, the number of days during which the ship or aircraft is not generating transportation income, within the meaning of section 863(c)(2), are not included in the numerator or denominator of the fraction. However, the foreign corporation may adopt an alternative method for determining the amount of the charter income that is attributable to the international operation of ships or aircraft if it can establish that the alternative method more accurately reflects the amount of such income.

(iv) *Charter of ships or aircraft for hire*. For purposes of this section, if a foreign corporation time, voyage, or bareboat charters out a ship or aircraft, and the lowest-tier lessee uses the ship or aircraft to carry passengers or cargo on a fee basis, the ship or aircraft is considered used to carry passengers or cargo for hire, regardless of whether the ship or aircraft may be empty during a portion of the charter period due to a backhaul voyage or flight or for purposes of repositioning. If a foreign corporation time, voyage, or bareboat charters out a ship or aircraft, and the lowest-tier lessee uses the ship or aircraft for the carriage of proprietary goods, including an empty backhaul voyage or flight or repositioning related to such carriage of proprietary goods, the ship or aircraft similarly will be treated as used to carry cargo for hire.

(g) *Activities incidental to the international operation of ships or aircraft*—(1) *General rule*. Certain activities of a foreign corporation engaged in the international operation of ships or aircraft are so closely related to the international operation of ships or aircraft that they are considered incidental to such operation, and income derived by the foreign corporation from its performance of these incidental activities is deemed to be income derived from the international operation of ships or aircraft. Examples of such activities include—

(i) Temporary investment of working capital funds to be used in the international operation of ships or aircraft by the foreign corporation;

(ii) Sale of tickets by the foreign corporation engaged in the international operation of ships for the international carriage of passengers by ship on behalf of another corporation engaged in the international operation of ships;

(iii) Sale of tickets by the foreign corporation engaged in the international operation of aircraft for the international carriage of passengers by air on behalf of another corporation engaged in the international operation of aircraft;

(iv) Contracting with concessionaires for performance of services onboard during the international operation of the foreign corporation's ships or aircraft;

(v) Providing (either by subcontracting or otherwise) for the carriage of cargo preceding or following the international carriage of cargo under a through bill of lading, airway bill or similar document through a related corporation or through an unrelated person (and the rules of section 267(b) shall apply for purposes of determining whether a corporation or other person is related to the foreign corporation);

(vi) To the extent not described in paragraph (g)(1)(iii) of this section, the sale or issuance by the foreign corporation engaged in the international operation of aircraft of intraline, interline, or code-sharing tickets for the carriage of persons by air between a U.S. gateway and another U.S. city preceding or following international carriage of passengers, provided that all such flight segments are provided pursuant to the passenger's original invoice, ticket or itinerary and in the case of intraline tickets are a part of uninterrupted international air transportation (within the meaning of section 4262(c)(3));

(vii) Arranging for port city hotel accommodations within the United States for a passenger for the one night before or after the international carriage of that passenger by the foreign corporation engaged in the international operation of ships;

(viii) Bareboat charter of ships or dry lease of aircraft normally used by the foreign corporation in international operation of ships or aircraft but currently not needed, if the ship or aircraft is used by the lessee for international carriage of cargo or passengers;

(ix) Arranging by means of a space or slot charter for the carriage of cargo listed on a bill of lading or airway bill or similar document issued by the foreign corporation on the ship or aircraft of another corporation engaged in the international operation of ships or aircraft; and

(x) The provision of containers or other related equipment by the foreign corporation in connection with the international carriage of cargo for use by its customers, including short-term use within the United States immediately preceding or following the international carriage of cargo (and for this purpose, a period of five days or less shall be presumed to be short-term).

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

(i) The sale of or arranging for train travel, bus transfers, single day shore excursions, or land tour packages;

(ii) Arranging for hotel accommodations within the United States other than as provided in paragraph (g)(1)(vii) of this section;

(iii) The sale of airline tickets or cruise tickets other than as provided in paragraph (g)(1)(ii), (iii), or (vi) of this section;

(iv) The sale or rental of real property;

(v) Treasury activities involving the investment of excess funds or funds awaiting repatriation, even if derived from the international operation of ships or aircraft;

(vi) The carriage of passengers or cargo on ships or aircraft on domestic legs of transportation not treated as either international operation of ships or aircraft under paragraph (f) of this section or as an activity that is incidental to such operation under paragraph (g)(1) of this section;

(vii) The carriage of cargo by bus, truck or rail by a foreign corporation between a U.S. inland point and a U.S. gateway port or airport preceding or following the international carriage of such cargo by the foreign corporation; and

(viii) The provision of containers or other related equipment by the foreign corporation within the United States other than as provided in paragraph (g)(1)(x) of this section, including warehousing.

(3) *Services*—(i) *Ground services, maintenance and catering*. [Reserved]

(ii) *Other services.* [Reserved]

(4) *Activities involved in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture*. Notwithstanding paragraph (g)(1) of this section, an activity is considered incidental to the international operation of ships or aircraft by a foreign corporation, and income derived by the foreign corporation with respect to such activity is deemed to be income derived from the international operation of ships or aircraft, if the activity is performed by or pursuant to a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture in which such foreign corporation participates directly, or indirectly through a fiscally transparent entity under the income tax laws of the United States, provided that—

(i) Such activity is incidental to the international operation of ships or aircraft by the pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture, and provided that it is described in paragraph (e)(2)(i) of this section; or

(ii) Such activity would be incidental to the international operation of ships or aircraft by the foreign corporation, or fiscally transparent entity if it performed such activity itself, and provided the foreign corporation is engaged or the fiscally transparent entity would be considered engaged if it were a foreign corporation in the operation of ships or aircraft under paragraph (e)(1) of this section.

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

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

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

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

(2) *Determining equivalent exemptions for each category of income*. Whether a foreign country grants an equivalent exemption must be determined separately with respect to income from the international operation of ships and income from the international operation of aircraft for each category of income listed in paragraphs (h)(2)(i) through (v), (vii), and (viii) of this section. If an exemption is unavailable in the foreign country for a particular category of income, the foreign country is not considered to grant an equivalent exemption with respect to that category of income. Income in that category is not considered to be the subject of an equivalent exemption and, thus, is not eligible for exemption from income tax in the United States, even though the foreign country may grant an equivalent exemption for other categories of income. With respect to paragraph (h)(2)(vi) of this section, a foreign country may be considered to grant an equivalent exemption for one or more types of income described in paragraph (g)(1) of this section. The following categories of income derived from the international operation of ships or aircraft may be exempt from United States income tax if an equivalent exemption is available—

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

(ii) Time or voyage (full) charter income of a ship or wet lease income of an aircraft;

(iii) Bareboat charter income of a ship or dry charter income of an aircraft;

(iv) Incidental bareboat charter income or incidental dry lease income;

(v) Incidental container-related income;

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

(vii) Capital gains derived by a qualified foreign corporation engaged in the international operation of ships or aircraft from the sale, exchange or other disposition of a ship, aircraft, container or related equipment or other moveable property used by that qualified foreign corporation in the international operation of ships or aircraft; and

(viii) Income from participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement, international operating agency, or other joint venture described in paragraph (e)(2) of this section.

(3) *Special rules with respect to income tax conventions*— (i) *General rule*. Except as provided in paragraph (h)(3)(ii) of this section, if a corporation is organized in a foreign country that provides an exemption only through an income tax convention with the United States, the foreign corporation is not organized in a foreign country that grants an equivalent exemption.

Rather, the foreign corporation must satisfy the terms of that convention to receive a benefit under the convention, and the foreign corporation may not claim an exemption under section 883. If the corporation is organized in a foreign country that offers an exemption under an income tax convention and also by some other means, such as by diplomatic note or domestic statutory law, the foreign corporation may choose annually whether to claim an exemption under section 883 based upon the equivalent exemption provided by such other means or under the income tax convention. However, if a corporation chooses to claim an exemption under an income tax convention under the preceding sentence, it may simultaneously claim an exemption under section 883 with respect to any category of income listed in paragraphs (h)(2)(i) through (v), (vii), and (viii) of this section and to any type of income described in paragraph (h)(2)(vi) of this section, but only to the extent that such income also is exempt under the income tax convention. Any such choice will apply with respect to all qualified income of the corporation from the international operation of ships or aircraft and cannot be made separately with respect to different categories of such income. If a foreign corporation bases its claim for an exemption on section 883, the foreign corporation must satisfy all of the requirements of this section to qualify for an exemption from U.S. income tax. See §1.883–4(b)(3) for rules regarding satisfying the ownership test of paragraph (c)(2) of this section using shareholders resident in a foreign country that offers an exemption under an income tax convention.

(ii) *Participation in certain joint ventures*. Notwithstanding paragraph (h)(3)(i) of this section, if a corporation is organized in a foreign country that provides an exemption only through an income tax convention with the United States, the foreign corporation will be treated as organized in a foreign country that grants an equivalent exemption under section 883 with respect to a category of income derived through participation, directly or indirectly, in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture described in paragraph (e)(2) of this section, but only where treaty benefits would be available under the treaty but for the treatment of the pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture as not fiscally transparent with respect to that category of income under the income tax laws of the foreign country in which the foreign corporate interest holder is organized for purposes of §1.894–1(d)(3)(iii)(A).

(iii) *Independent interpretation of income tax conventions*. Nothing in this section and §§1.883–2 through 1.883–5 affects the rights or obligations under any income tax convention. The definitions provided in this section and §§1.883–2 through 1.883–5 shall neither give meaning to similar terms used in income tax conventions nor provide guidance regarding the scope of any exemption provided by such conventions, unless an income tax convention that entered into force after August 26, 2003, or its legislative history explicitly refers to section 883 and guidance thereunder for its meaning.

(4) *Exemptions not qualifying as equivalent exemptions*—(i) *General rule*. Certain types of exemptions provided to corporations organized in the United States by foreign countries do not satisfy the equivalent exemption requirements of this section. Paragraphs (h)(4)(ii) through (vii) of this section provide descriptions of some of the types of exemptions that do not qualify as equivalent exemptions for purposes of this section.

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

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

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

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

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

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

and vice versa. With respect to paragraph (h)(2)(vi) of this section, a foreign country may be considered to grant an equivalent exemption for one or more types of income described in paragraph (g)(1) of this section.

(i) *Treatment of possessions*. For purposes of this section, a possession of the United States will be treated as a foreign country. A possession of the United States will be considered to grant an equivalent exemption and will be treated as a qualified foreign country if it applies a mirror system of taxation. If a possession does not apply a mirror system of taxation, the possession may nevertheless be a qualified foreign country if, for example, it provides for an equivalent exemption through its internal law. A possession applies the mirror system of taxation if the U.S. Internal Revenue Code of 1986, as amended, applies in the possession with the name of the possession used instead of "United States" where appropriate.

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

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

§1.883–2 Treatment of publicly-traded corporations.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(i) One or more classes of stock of the corporation that, in the aggregate, represent more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation are listed on such market or markets during the taxable year; and

(ii) With respect to each class relied on to meet the more than 50 percent requirement of paragraph (d)(1)(i) of this section—

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

(B) The aggregate number of shares in each such class that are traded on such market or markets during the taxable year

are at least 10 percent of the average number of shares outstanding in that class during the taxable year (or, in the case of a short taxable year, a percentage that equals at least 10 percent of the average number of shares outstanding in that class during the taxable year multiplied by the number of days in the short taxable year, divided by 365).

(2) *Classes of stock traded on a domestic established securities market treated as meeting trading requirements*. A class of stock that is traded during the taxable year on an established securities market located in the United States shall be considered to meet the trading requirements of paragraph (d)(1)(ii) of this section if the stock is regularly quoted by dealers making a market in the stock. A dealer makes a market in a stock only if the dealer regularly and actively offers to, and in fact does, purchase the stock from, and sell the stock to, customers who are not related persons (as defined in section 954(d)(3)) with respect to the dealer in the ordinary course of a trade or business.

(3) *Closely-held classes of stock not treated as meeting trading requirements*—(i) *General rule*. Except as provided in paragraph (d)(3)(ii) of this section, a class of stock of a foreign corporation that otherwise meets the requirements of paragraph (d)(1) or (2) of this section shall not be treated as meeting such requirements for a taxable year if, for more than half the number of days during the taxable year, one or more persons who own at least 5 percent of the vote and value of the outstanding shares of the class of stock, as determined under paragraph (d)(3)(iii) of this section (each a 5-percent shareholder), own, in the aggregate, 50 percent or more of the vote and value of the outstanding shares of the class of stock. If one or more 5-percent shareholders own, in the aggregate, 50 percent or more of the vote and value of the outstanding shares of the class of stock, such shares held by the 5-percent shareholders will constitute a closely-held block of stock.

(ii) *Exception*. Paragraph (d)(3)(i) of this section shall not apply to a class of stock if the foreign corporation can establish that qualified shareholders, as defined in §1.883–4(b), applying the attribution rules of §1.883–4(c), own sufficient shares in the closely-held block of stock to preclude nonqualified shareholders in the closely-held block of stock from owning 50 percent or more of the total value of the class of stock of which the closely-held block is a part for more than half the number of days during the taxable year. Any shares that are owned, after application of the attribution rules in §1.883–4(c), by a qualified shareholder shall not also be treated as owned by a nonqualified shareholder in the chain of ownership for purposes of the preceding sentence. A foreign corporation must obtain the documentation described in §1.883–4(d) from the qualified shareholders relied upon to satisfy this exception. However, no person shall be treated for purposes of this paragraph (d)(3) as a qualified shareholder if such person holds an interest in the class of stock directly or indirectly through bearer shares.

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

(B) *Investment companies*. For purposes of this paragraph (d)(3), an investment company registered under the Investment Company Act of 1940, as amended (54 Stat. 789), shall not be treated as a 5-percent shareholder.

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

(5) *Example*. The closely-held test in paragraph (d)(3) of this section is illustrated by the following example:

Example. *Closely-held exception*—(i) *Facts*. X is a foreign corporation organized in a qualified foreign country and engaged in the international operation of ships. X has one class of stock, which is primarily traded on an established securities market in the qualified foreign country. The stock of X meets the regularly traded requirements of paragraph (d)(1)(ii) of this section without regard to paragraph (d)(3)(i) of this section. A, B, C and D are four members of the corporation's founding family who each own, during the entire taxable year, 25 percent of the stock of Hold Co, a company that issues registered shares. Hold Co, in turn, owns 60 percent of the stock of X during the entire taxable year. The remaining 40 percent of the stock of X is not owned by any 5-percent shareholder, as determined under paragraph (d)(3)(iii) of this section. A, B, and C are not residents of a qualified foreign country, but D is a resident of a qualified foreign country.

(ii) *Analysis*. Because Hold Co owns 60 percent of the stock of X for more than half the number of days during the taxable year, Hold Co is a 5-percent shareholder that owns 50 percent or more of the value of the stock of X. Thus, the shares owned by Hold Co constitute a closely-held block of stock. Under paragraph (d)(3)(i) of this section, the stock of X will not be regularly traded within the meaning of paragraph (d)(1) of this section unless X can establish, under paragraph (d)(3)(ii) of this section, that qualified shareholders within the closely-held block of stock own sufficient shares in the closely-held block of stock to preclude nonqualified shareholders in the closely-held block of stock from owning 50 percent or more of the value of the outstanding shares in the class of stock for more than half the number of days during the taxable year. A, B, and C are not qualified shareholders within the meaning of §1.883–4(b) because they are not residents of a qualified foreign country, but D is a resident of a qualified foreign country and therefore is a qualified shareholder. D owns 15 percent of the outstanding shares of X through Hold Co (25 percent x 60 percent = 15 percent) while A, B, and C in the aggregate own 45 percent of the outstanding shares of X through Hold Co. D, therefore, owns sufficient shares in the closely-held block of stock to preclude the nonqualified shareholders in the closely-held block of stock, A, B and C, from owning 50 percent or more of the value of the class of stock (60 percent - 15 percent = 45 percent) of which the closely-held block is a part. Provided that X obtains from D the documentation described in §1.883–4(d), X's sole class of stock meets the exception in paragraph (d)(3)(ii) of this section and will not be disqualified from the regularly traded test by virtue of paragraph (d)(3)(i) of this section.

(e) *Substantiation that a foreign corporation is publicly traded*—(1) *General rule*. A foreign corporation that relies

on the publicly traded test of this section to meet the stock ownership test of §1.883–1(c)(2) must substantiate that the stock of the foreign corporation is primarily and regularly traded on one or more established securities markets, as that term is defined in paragraph (b) of this section. If one of the classes of stock on which the foreign corporation relies to meet this test is closely-held within the meaning of paragraph (d)(3)(i) of this section, the foreign corporation must obtain an ownership statement described in §1.883–4(d) from each qualified shareholder and intermediary that it relies upon to satisfy the exception to the closely-held test, but only to the extent such statement would be required if the foreign corporation were relying on the qualified shareholder stock ownership test of §1.883–4 with respect to those shares of stock. The foreign corporation must also maintain and provide to the Commissioner upon request a list of its shareholders of record and any other relevant information known to the foreign corporation supporting its entitlement to an exemption under this section.

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

(f) *Reporting requirements*. A foreign corporation relying on this section to satisfy the stock ownership test of §1.883–1(c)(2) must provide the following information in addition to the information required in §1.883–1(c)(3) to be included in its Form 1120–F, "*U.S. Income Tax Return of a Foreign Corporation*," for the taxable year. The information must be current as of the end of the corporation's taxable year and must include the following—

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

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

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

(4) For each class of stock relied upon to meet the requirements of paragraph (d) of this section, if one or more 5-percent shareholders, as defined in paragraph (d)(3)(i) of this section, own in the aggregate 50 percent or more of the vote and value of the outstanding shares of that class of stock for more than half the number of days during the taxable year—

(i) The days during the taxable year of the corporation in which the stock was closely-held without regard to the exception in paragraph (d)(3)(ii) of this section and the percentage of the vote and value of the class of stock that is owned by 5-percent shareholders during such days;

(ii) For each qualified shareholder who owns or is treated as owning stock in the closely-held block upon whom the corporation intends to rely to satisfy the exception to the closely-held test of paragraph (d)(3)(ii) of this section—

(A) The name of each such shareholder;

(B) The percentage of the total value of the class of stock held by each such shareholder and the days during which the stock was held;

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

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

(5) Any other relevant information specified by Form 1120–F and its accompanying instructions.

§1.883–3 Treatment of controlled foreign corporations.

(a) *General rule*. A foreign corporation satisfies the stock ownership test of §1.883–1(c)(2) if it is a controlled foreign corporation (CFC), as defined in section 957(a), and satisfies the income inclusion test in paragraph (b) of this section and the substantiation and reporting requirements of paragraphs (c) and (d) of this section, respectively. A CFC that fails the income inclusion test of paragraph (b) of this section will not be a qualified foreign corporation unless it meets either the publicly traded test of §1.883–2(a) or the qualified shareholder stock ownership test of §1.883–4(a).

(b) *Income inclusion test*—(1) *General rule*. A CFC shall not be considered to satisfy the requirements of paragraph (a) of this section unless more than 50 percent of the CFC's adjusted net foreign base company income (as defined in §1.954–1(d) and as increased or decreased by section 952(c)) derived from the international operation of ships or aircraft is includible in the gross income of one or more United States citizens, individual residents of the United States or domestic corporations, pursuant to section 951(a)(1)(A) or another provision of the Internal Revenue Code, for the taxable years of such persons in which the taxable year of the CFC ends.

(2) *Examples*. The income inclusion test of paragraph (b)(1) of this section is illustrated in the following examples:

Example 1. Ship Co is a CFC organized in a qualified foreign country. All of Ship Co's income is foreign base company shipping income that is derived from the international operation of ships. All of its shares are owned by a domestic partnership that is a United States shareholder for purposes of section 951(b). All of the partners in the domestic partnership are citizens and residents of foreign countries. Ship Co fails the income inclusion test of paragraph (b)(1) of this section because no amount of Ship Co's subpart F income that is adjusted net foreign base company income derived from the international operation of ships is includible under any provision of the Internal Revenue Code in the gross income of one or more United States citizens, individual residents of the United States or domestic corporations. Therefore, Ship Co must satisfy the qualified shareholder stock ownership test of §1.883–4(a), in order to satisfy the stock ownership test of §1.883–1(c)(2) and to be considered a qualified foreign corporation.

Example 2. Ship Co is a CFC organized in a qualified foreign country. All of Ship Co's income is foreign base company shipping income that is derived from the international operation of ships. Corp A, a domestic corporation, owns 50 percent of the value of the stock of Ship Co. X, a domestic partnership, owns the remaining 50 percent of the value of the stock of Ship Co. A United States citizen is a partner owning a 10 percent income interest in X. Individual partners owning 90 percent of X are citizens and residents of foreign countries. There are no special allocations of partnership income. Ship Co satisfies the income inclusion test of paragraph (b)(1) of this section because 55 percent (50 percent + (10 percent x 50 percent)) of the subpart F income that is adjusted net foreign base company income derived from the international operation of ships would be includible in the gross income of U.S. citizens, individual residents of the United States or domestic corporations. If Ship Co satisfies the substantiation and reporting requirements of paragraphs (c) and (d) of this section, it will meet the stock ownership test of §1.883–1(c)(2).

(c) *Substantiation of CFC stock ownership*—(1) *General rule*. A foreign corporation that relies on this section to satisfy the stock ownership test of §1.883–1(c)(2) must substantiate all the facts necessary to satisfy the Commissioner that it qualifies under the income inclusion test of paragraph (b)(1) of this section. For purposes of the income inclusion test, if the CFC has one or more United States shareholders, as defined in section 951(b), that are domestic partnerships, estates, or trusts, the *pro rata* share of the subpart F income includible in the gross income of such shareholders will only be treated as includible in the income of any partner, beneficiary or other interest owner of such United States shareholder that is a United States citizen, resident of the United States or a domestic corporation if the CFC obtains the documentation described in paragraph (c)(2) of this section.

(2) *Documentation from certain United States shareholders*—(i) *General rule*. A CFC only meets the documentation requirements of paragraph (c)(1) of this section if the CFC obtains the following documentation with respect to each United States shareholder, as defined in section 951(b), that is a partnership, estate or trust, for the taxable year of the shareholder which ends with or within the taxable year of the CFC—

(A) A copy of the Form 5471, "*Information Return of U.S. Persons with Respect to Certain Foreign Corporations,*" filed with the controlling United States shareholder's return;

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

(*1*) The name, address from the CFC's corporate records (that is a specific street address and not a nonresidential address, such as a post office box or in care of a financial intermediary or stock transfer agent), and taxpayer identification number of the interest owner;

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

(*3*) The percentage of the value of shares of the CFC owned by each such interest owner pursuant to the attribution rules in §1.883–4(c); and

(C) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

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

(1) The name, address from the CFC's corporate records (that is a specific street address and not a nonresidential address, such as a post office box or in care of a financial intermediary or stock transfer agent), and taxpayer identification number of each United States shareholder, as defined in section 951(b), of the CFC;

(2) The percentage of the vote and value of the shares of the CFC that is owned by each United States shareholder, as defined in section 951(b);

(3) If one or more of the United States shareholders is a domestic partnership, estate or trust, the name, address, taxpayer identification number and the percentage of the value of shares of the CFC owned (as determined under §1.883–4(c)) by each interest owner of each such United States shareholder that is a United States citizen, individual resident of the United States or a domestic corporation; and

(4) Any other relevant information specified by Form 1120–F and its accompanying instructions.

§1.883–4 Qualified shareholder stock ownership test.

(a) *General rule*. A foreign corporation satisfies the stock ownership test of §1.883–1(c)(2) if more than 50 percent of the value of its outstanding shares is owned, or treated as owned by applying the attribution rules of paragraph (c) of this section, for at least half of the number of days in the foreign corporation's taxable year by one or more qualified shareholders, as defined in paragraph (b) of this section. A shareholder may be a qualified shareholder with respect to one category of income while not being a qualified shareholder with respect to another. A foreign corporation will not be considered to satisfy the stock ownership test of §1.883–1(c)(2) pursuant to this section unless the foreign corporation meets the substantiation and reporting requirements of paragraphs (d) and (e) of this section.

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

(i) With respect to the category of income for which the foreign corporation is seeking an exemption, is—

(A) An individual who is a resident, as described in paragraph (b)(2) of this section, of a qualified foreign country;

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

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

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

(E) An individual beneficiary of a pension fund (as defined in paragraph (b)(5)(iv) of this section) that is administered in or by a qualified foreign country, who is treated as a resident under paragraph (d)(3)(iii) of this section, of a qualified foreign country; or

(F) A shareholder of a foreign corporation that is an airline covered by a bilateral Air Services Agreement in force between the United States and the qualified foreign country in which the airline is organized, provided the United States has not waived the ownership requirement in the Air Services Agreement, or that the ownership requirement has not otherwise been made ineffective;

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

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

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

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

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

(ii) *Tax home*. For purposes of this section, an individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of his business (or lack of a business), then the individual's tax home is located at his regular place of abode in a real and substantial sense. If an individual has no regular or principal place of business and no regular place of abode in a real and substantial sense in a qualified foreign country for 183 days or more of the taxable year, that individual does not have a tax home for purposes of this section. A foreign estate or trust, as defined in section 7701(a)(31), does not have a tax home for purposes of this section. See paragraph (c)(3) of this section for alternative rules in the case of trusts or estates.

(3) *Certain income tax convention restrictions applied to shareholders*. For purposes of paragraph (b)(1) of this section, a shareholder described in paragraph (b)(1) of this section may be considered a resident of, or organized in, a qualified foreign country if that foreign country provides an exemption by means of an income tax convention with the United States, but only if the shareholder demonstrates that it is treated as a resident of that country under the convention and qualifies for benefits under any Limitation on Benefits article, and that the convention provides an exemption for the relevant category of income. If the convention has a requirement in the shipping and air transport article other than residence, such as place of registration or documentation of the ship or aircraft, the shareholder is not required to demonstrate that the corporation seeking qualified foreign corporation status could satisfy any such additional requirement.

(4) *Not-for-profit organizations*. The term *not-for-profit organization* means an organization that meets the following requirements—

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

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

(iii) Either—

(A) More than 50 percent of its annual support is expended on behalf of individuals described in paragraph (b)(1)(i)(A) of this section (see paragraph (d)(3)(v) of this section for special rules to substantiate the residence of individual beneficiaries of not-for-profit organizations) and on behalf of U.S. exempt organizations that have received determination letters under section 501(c)(3); or

(B) More than 50 percent of its annual support is derived from individuals described in paragraph (b)(1)(i)(A) of this section (see paragraph (d)(3)(v) of this section for special rules to substantiate the residence of individual supporters of not-for-profit organizations).

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

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

(iii) *Nongovernment pension funds*. A nongovernment pension fund is a pension fund that—

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

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

(C) Has 100 or more beneficiaries; and

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

(iv) *Beneficiary of a pension fund*. The term *beneficiary of a pension fund* shall mean any person who has made contributions to a pension fund, as that term is defined in paragraph (b)(5)(i) of this section, or on whose behalf contributions have been made, and who is currently receiving retirement, disability, or death benefits from the pension fund or can reasonably be expected to receive such benefits in the future, whether or not the person's right to receive benefits from the fund has vested. See paragraph (c)(7) of this section for rules regarding the computation of stock ownership through nongovernment pension funds.

(c) *Rules for determining constructive ownership*—(1) *General rules for attribution*. For purposes of applying paragraph

(a) of this section and the exception to the closely-held test in §1.883–2(d)(3)(ii), stock owned by or for a corporation, partnership, trust, estate, or mutual insurance company or similar entity shall be treated as owned proportionately by its shareholders, partners, beneficiaries, grantors, or other interest holders, as provided in paragraphs (c)(2) through (7) of this section. The proportionate interest rules of this paragraph (c) shall apply successively upward through a chain of ownership, and a person's proportionate interest shall be computed for the relevant days or period taken into account in determining whether a foreign corporation satisfies the requirements of paragraph (a) of this section. Stock treated as owned by a person by reason of this paragraph (c) shall be treated as actually owned by such person for purposes of this section. An owner of an interest in an association taxable as a corporation shall be treated as a shareholder of such association for purposes of this paragraph (c). No attribution will apply to an interest held directly or indirectly through bearer shares.

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

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

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

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

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

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

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

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

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

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

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

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

(5) *Taxable nonstock corporations*. A taxable nonstock corporation that is entitled in its country of organization to deduct from its taxable income amounts distributed for charitable purposes may deem a recipient of such charitable distributions to be a shareholder of such taxable nonstock corporation in the same proportion as the amount that such beneficiary receives in the taxable year bears to the total income of such taxable nonstock corporation in the taxable year. Whether each such recipient is a qualified shareholder may then be determined under paragraph (b) of this section or under the special rules of paragraph (d)(3)(vii) of this section.

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

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

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

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

(iii) Either—

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

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

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

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

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

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

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

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

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

(ii) *Three-year period of validity*. The ownership statements required in paragraph (d)(2)(i) of this section shall remain valid until the earlier of the last day of the third calendar year following the year in which the ownership statement is signed, or the day that a change of circumstance occurs that makes any information on the ownership statement incorrect. For example, an ownership statement signed on September 30, 2000, remains valid through December 31, 2003, unless a change of circumstance occurs that makes any information on the ownership statement incorrect.

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

(ii) *Special rule for registered shareholders owning less than one percent of widely-held corporations*. A foreign corporation with at least 250 registered shareholders, that is not a publicly-traded corporation, as described in §1.883–2 (a widely-held corporation), is not required to obtain an ownership statement from an individual shareholder owning less than one percent of the widely-held corporation at all times during the taxable year if the requirements of paragraphs (d)(3)(ii)(A) and (B) of this section are satisfied. If the widely-held foreign corporation is the foreign corporation seeking qualified foreign corporation status, or an intermediary that meets the documentation requirements of paragraphs (d)(4)(v)(A) and (B) of this section,

the widely-held foreign corporation may treat the address of record in its ownership records as the residence of any less than one percent individual shareholder if—

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

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

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

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

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

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

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

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

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

(vi) *Special rule for a foreign airline covered by an air services agreement*. A foreign airline that is covered by a bilateral Air Services Agreement in force between the United States and the qualified foreign country in which the airline is organized may rely exclusively on the Air Services Agreement currently in effect and will not have to otherwise substantiate its ownership under this section, provided that the United States has not waived the ownership requirements in the agreement or that the ownership requirements have not otherwise been made ineffective. Such an airline will be treated as owned by qualified shareholders resident in the country where the foreign airline is organized.

(vii) *Special rule for taxable nonstock corporations*. Any stock in a foreign corporation seeking qualified foreign corporation status that is owned by a taxable nonstock corporation will be treated as owned, in any taxable year, by the recipients of distributions made during that taxable year, as set out in paragraph (c)(5) of this section. The taxable nonstock corporation may treat the address of record in its distribution records as the residence of any recipient if—

(A) An individual recipient's address is in a qualified foreign country and is a specific street address and not a nonresidential address, such as a post office box or in care of a financial intermediary or stock transfer agent;

(B) The address of a nonindividual recipient's principal place of business is in a qualified foreign country;

(C) The officers and directors of the taxable nonstock corporation neither know nor have reason to know that the recipients do not reside or have their principal place of business at such addresses; and

(D) The foreign corporation receives the statement described in paragraph (d)(4)(v)(D) of this section from the taxable nonstock corporation intermediary.

(viii) *Special rule for closely-held corporations traded in the United States*. To demonstrate that a class of stock is not closely-held for purposes of §1.883–2(d)(3)(i), a foreign corporation whose stock is traded on an established securities market in the United States may rely on current Schedule 13D and Schedule 13G filings with the Securities and Exchange Commission to identify its 5-percent shareholders in each class of stock relied upon to meet the regularly traded test, without having to make any independent investigation to determine the identity of the 5-percent shareholder. However, if any class of stock is determined to be closely-held within the meaning of §1.883–2(d)(3)(i), the publicly traded corporation cannot satisfy the requirements of §1.883–2(e) unless it obtains sufficient documentation described in this paragraph (d) to demonstrate that the requirements of §1.883–2(d)(3)(ii) are met with respect to the 5-percent shareholders.

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

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

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

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

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

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

(F) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

(A) Signed by any one of the following—

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

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

(*3*) An income tax return preparer that, for purposes of this paragraph (d)(4)(ii) only, shall mean a firm of licensed or certified public accountants, a law firm whose principals or members are admitted to practice in one or more states, territories or possessions of the United States or the country of such government, or a bank or other financial institution licensed to do business in such foreign country and having assets at least equivalent to 50 million U.S. dollars and who is authorized to represent the government or governmental authority; and

(B) That provides—

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

(*2*) The name and address of the government authority, agency or office that has supervisory authority and, if applicable, the income tax preparer which has prepared such ownership statement;

(*3*) The information described in paragraphs (d)(4)(i)(C) through (E) of this section (as if the language applied "government" instead of "individual") with respect to the government's direct or indirect ownership of stock in the corporation seeking qualified resident status;

(*4*) In the case of an ownership statement prepared by an income tax return preparer, a statement under penalties of perjury identifying the documentation relied upon in the conduct of due diligence for the taxable year to determine the aggregate government investment in the stock of the shipping or aircraft company in preparation of such ownership statement attached to a valid power of attorney to represent the taxpayer for the taxable year; and

(*5*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

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

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

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

(D) For each class of stock relied upon to meet the requirements of §1.883–2(d)(1), if one or more 5-percent shareholders, as defined in §1.883–2(d)(3)(i), own in the aggregate 50 percent or more of the vote and value of the outstanding shares of that class of stock for more than half the number of days during the taxable year—

(*1*) The days during the taxable year of the corporation in which the stock was closely-held without regard to the exception in paragraph (d)(3)(ii) of this section and the percentage of the vote and value of the class of stock that is owned by 5-percent shareholders during such days;

(*2*) For each qualified shareholder who owns or is treated as owning stock in the closely-held block upon whom the corporation intends to rely to satisfy the exception to the closely-held test of §1.883–2(d)(3)(ii)—

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

(*ii*) The percentage of the total value of the class of stock held by each such shareholder and the days during which the stock was held;

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

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

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

(F) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

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

(B) The information described in paragraphs (d)(4)(i)(C) through (E) of this section (as if the language applied "not-for-profit organization" instead of "individual");

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

(D) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(v) *Ownership statements from intermediaries*—(A) *General rule*. The foreign corporation seeking qualified foreign corporation status under the shareholder stock ownership test must obtain an intermediary ownership statement from each intermediary standing in the chain of ownership between it and the qualified shareholders on whom it relies to meet this test. An intermediary ownership statement is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or a person who would be authorized to sign a tax return on behalf of the intermediary (if the intermediary is not an individual) containing the following information—

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

(*2*) The information described in paragraphs (d)(4)(i)(C) through (E) of this section (as if the language applied "intermediary" instead of "individual");

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

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

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

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

(*7*) If the intermediary is a taxable nonstock corporation, within the meaning of paragraph (c)(5) of this section, the statement set out in paragraph (d)(4)(v)(D) of this section, relating to ownership statements from intermediaries that are taxable nonstock corporations; and

(*8*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

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

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

(*3*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

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

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

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

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

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

(*vi*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

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

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

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

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

(*v*) The aggregate percentage interest of beneficiaries by country of residence based on addresses shown on the books and records of the fund, provided the addresses are not nonresidential addresses, such as a post office box or an address in care of a financial intermediary, and provided none of the trustees, directors or other administrators of the pension fund know, or have reason to know, that the beneficiary is not a resident of such foreign country;

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

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

(*viii*) A representation that any overfunding of the pension fund would be payable, pursuant to the governing instrument or the laws of the foreign country in which the pension fund is administered, only to, or for the benefit of, one or more corporations that are organized in the country in which the pension fund is administered, individual beneficiaries of the pension fund or their designated beneficiaries, or social or charitable causes (the reduction of the obligation of the sponsoring company or companies to make future contributions to the pension fund by reason of overfunding shall not itself result in such overfunding being deemed to be payable to or for the benefit of such company or companies); or that the foreign country in which the pension fund is administered has laws that are designed to prevent overfunding of a pension fund and the funding of the pension fund is within the guidelines of such laws; or that the pension fund is maintained to provide benefits to employees in a particular industry, profession, or group of industries or professions, and that employees of at least 10 companies (other than companies that are owned or controlled, directly or indirectly, by the same interests) contribute to the pension fund or receive benefits from the pension fund; and

(*ix*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

(D) *Ownership statements from taxable nonstock corporations*. An ownership statement from an intermediary that is a taxable nonstock corporation must provide the following information in addition to the information required in paragraph (d)(4)(v)(A) of this section—

(*1*) With respect to paragraph (d)(4)(v)(A)(*7*) of this section, for each beneficiary that is treated as a qualified shareholder, the name, address of residence (in the case of an individual beneficiary, the address must be a specific street address and not a nonresidential address, such as a post office box or in care of a financial intermediary; in the case of a nonindividual beneficiary, the address of the principal place of business) and percentage that is the same proportion as the amount that the beneficiary receives in the tax year bears to the total net income of the taxable nonstock corporation in the tax year;

(*2*) A representation that the officers and directors of the taxable nonstock corporation neither know nor have reason to know that the individual beneficiaries do not reside at the address listed in paragraph (d)(4)(v)(D)(*1*) of this section or that any other nonindividual beneficiary does not conduct its primary activities at such address or in such country of residence; and

(*3*) Any other information as specified in guidance published by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

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

(e) *Reporting requirements*. A foreign corporation relying on the qualified shareholder stock ownership test of this section to meet the stock ownership test of §1.883–1(c)(2) must provide the following information in addition to the information required in §1.883–1(c)(3) to be included in its Form 1120–F, *"U.S. Income Tax Return of a Foreign Corporation,"* for each taxable year. The information should be current as of the end of the corporation's taxable year. The information must include the following—

(1) A representation that more than 50 percent of the value of the outstanding shares of the corporation is owned (or treated as owned by reason of paragraph

(c) of this section) by qualified shareholders for each category of income for which the exemption is claimed;

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

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

(4) Any other relevant information specified by the Form 1120–F and its accompanying instructions.

§1.883–5 Effective dates.

(a) *General rule*. Sections 1.883–1 through 1.883–4 apply to taxable years of a foreign corporation seeking qualified foreign corporation status beginning 30 days or more after August 26, 2003.

(b) *Election for retroactive application*. Taxpayers may elect to apply §§1.883–1 through 1.883–4 for any open taxable year of the foreign corporation beginning after December 31, 1986, except that the substantiation and reporting requirements of §1.883–1(c)(3) (relating to the substantiation and reporting required to be treated as a qualified foreign corporation) or §§1.883–2(f), 1.883–3(d) and 1.883–4(e) (relating to additional information to be included in the return to demonstrate whether the foreign corporation satisfies the stock ownership test) will not apply to any year beginning before September 25, 2003. Such election shall apply to the taxable year of the election and to all subsequent taxable years beginning before September 25, 2003.

(c) *Transitional information reporting rule*. For taxable years of the foreign corporation beginning 30 days or more after August 26, 2003, and until such time as the Form 1120–F, *"U.S. Income Tax Return of a Foreign Corporation,"* or its instructions are revised to provide otherwise, the information required in §1.883–1(c)(3) and §1.883–2(f), §1.883–3(d) or §1.883–4(e), as applicable, must be included on a written statement attached to the Form 1120–F and filed with the return.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In §602.101, paragraph (b) is amended by adding entries in numerical order to the table to read as follows:

§602.101 OMB control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.883–1	1545–1677
1.883–2	1545–1677
1.883–3	1545–1677
1.883–4	1545–1677
1.883–5	1545–1677
* * * * *	

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Pamela F. Olson,
Assistant Secretary of the Treasury (Tax Policy).

Approved July 11, 2003.

(Filed by the Office of the Federal Register on August 25, 2003, 8:45 a.m., and published in the issue of the Federal Register for August 26, 2003, 68 F.R. 51393)

Section 897.—Disposition of Investment in United States Real Property

26 CFR 1.897–3: Election by foreign corporation to be treated as a domestic corporation under section 897(i).

T.D. 9082

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301 and 602

Revision of Income Tax Regulations Under Sections 897, 1445, and 6109 to Require Use of Taxpayer Identifying Numbers on Submissions Under the Section 897 and 1445 Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations to require the use of taxpayer identifying numbers on submissions under sections 897 and 1445. The regulations are necessary to properly identify foreign taxpayers for which submissions are made for the reduction or elimination of tax under sections 897 and 1445. The regulations also address certain additional issues under section 1445.

DATES: *Effective Date*: These regulations are effective August 6, 2003.

Applicability Date: For dates of applicability, see §§1.897–3(h), 1.897–5(e), 1.1445–1(h), 1.1445–2(b)(2)(iii), 1.1445–2(d)(2)(iv), 1.1445–2(e), 1.1445–3(h), 1.1445–5(b)(8)(iii), 1.1445–5(h), and 1.1445–6(h).

FOR FURTHER INFORMATION CONTACT: Robert W. Lorence, Jr. (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 1545–1797. The collection of information in these final regulations are in §§1.1445–2(d)(2) and 1.1445–3. These collections of information are required to notify the IRS of dispositions of U.S. real property interests by foreign persons that otherwise are subject to taxation under section 897 and the collection of a withholding tax under section 1445.

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

The estimated annual burden per respondent varies from 3 to 5 hours, depending on individual circumstances, with an estimated average of 4 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, W:CAR:MP:T:T:SP, 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 these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR parts 1 and 301. On July 26, 2002, a notice of proposed rule-making (REG–106876–00, 2002–2 C.B. 392 [67 FR 48823]), relating to the use of taxpayer identifying numbers on submissions under sections 897 and 1445 of the Internal Revenue Code (Code), was published in the **Federal Register**. No public hearing was requested or held. Written comments responding to the notice of proposed rule-making were received. After consideration of the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Summary of Public Comments and Explanation of Revisions

A. *Use of Taxpayer Identifying Number.*

This document contains final regulations under sections 897, 1445, and 6109 that require foreign transferors of U.S. real property interests (and transferees where applicable) to provide their taxpayer identifying numbers (TINs) on withholding tax returns, applications for withholding certificates, and other notices and elections under sections 897 and 1445 and the regulations thereunder. TINs are required so that the IRS can identify foreign taxpayers and more easily match applications, withholding tax returns, notices, and elections with the transferors' income tax returns.

Applications for withholding certificates, and other notices and elections under section 897 and 1445 will be considered incomplete and generally will not be processed by the IRS unless the TIN of the transferor is provided. Amounts withheld under section 1445 must still be reported and paid to the IRS on withholding tax returns (Form 8288, *"U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests"*, and Form 8288–A, *"Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests"*) if the appropriate TINs are not provided. The final regulations provide that although such amounts have been paid, if the transferor's TIN is not included, a receipt (Form 8288–A) for withholding tax paid to the Service will not be stamped to show receipt and will not be mailed to the transferor.

In many cases, the foreign taxpayer will already have a TIN, because the taxpayer will have already filed a U.S. tax return. If the taxpayer does not already have a TIN, the TIN requirement under the regulations merely accelerates the time to obtain a TIN, because the foreign taxpayer must have a TIN to file its U.S. income tax return for the year of the disposition of the U.S. real property interest. In the case of foreign entities (such as foreign corporations) that are required to have employee identification numbers (EINs), the EINs

can be obtained without delay through existing procedures.

Commentators have expressed concern about the time it takes nonresident alien individuals to obtain TINs and how it could effect the timing of transactions. The IRS is aware of this concern and is exploring approaches for addressing it. For example, the IRS is considering implementing a program in which applications for withholding certificates will be processed in conjunction with applications for TINs. The need to obtain a TIN generally should not delay the time it takes to get a withholding certificate under §1.1445–3. In addition, the portion of these regulations that imposes a requirement concerning TINs, will not be applicable until 90 days after the date of publication in the **Federal Register** in order to permit taxpayers that currently own real property additional time to obtain a TIN, if necessary.

B. *Section 1031 Like-Kind Exchanges.*

Section 1031(a) provides for the nonrecognition of gain or loss on the exchange of like-kind property which is held for productive use in a trade or business or held for investment. Section 1031(a)(3) provides for the exchange of like-kind property in deferred exchanges, where the taxpayer has 45 days after it relinquishes the property to the transferee to identify replacement property and the transferee has until the earlier of 180 days or the due date of the tax return for the year of transfer to deliver such property to the transferor.

Notices of nonrecognition under §1.1445–2(d) are limited to exchanges (including section 1031 exchanges) that qualify for nonrecognition treatment in their entirety (thus, a notice of nonrecognition may not be used if the transferor receives money or other property, *i.e.*, boot). Consistent with the proposed regulations, these final regulations provide that in the case of a simultaneous exchange of like-kind U.S. real property interests (where there is no boot), the foreign transferor can provide a notice of nonrecognition under §1.1445–2(d)(2) to the transferee, and the transferee can rely on such notice, because the like-kind exchange will be fully completed on the day of the exchange. In the case of a deferred like-kind exchange of U.S. real property interests, the transferee cannot rely on a notice of nonrecognition, because the transferee cannot be assured that the exchange will qualify for nonrecognition treatment under section 1031 (*e.g.*, that the property to be received by the foreign transferor will be identified within the 45-day period required under section 1031(a)), or even if the exchange qualifies under section 1031, that the foreign transferor will not receive boot in the transaction. Although a notice of nonrecognition is not available in a deferred like-kind exchange, the transferee may withhold a reduced amount based on a claim of nonrecognition upon receipt of a withholding certificate pursuant to the procedures of §1.1445–3.

Commentators have proposed that using a notice of nonrecognition for deferred like-kind exchanges should be permitted if a "claim of intent" to engage in an exchange qualifying for nonrecognition under section 1031 is provided. The IRS continues to believe that notices of nonrecognition are inappropriate for deferred like-kind exchanges. In a deferred like-kind exchange, until the replacement property has been identified and a contract for its purchase is executed, the transferor does not know with certainty that the exchange will qualify for nonrecognition under section 1031. Moreover, it is uncertain whether boot will be received in the exchange if the replacement property is not identified at the time the relinquished property is transferred to the transferee. Accordingly, the regulations do not permit a notice of nonrecognition in the case of a deferred like-kind exchange and require the taxpayer to obtain a withholding certificate.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It 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. These regulations impose no new collection of information on small entities; therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were 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 Robert W. Lorence, Jr., Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301 and 602 are amended as follows:

PART 1— INCOME TAXES

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

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

§1.897–1 [Amended]

Par. 2. In §1.897–1, paragraph (p), the first sentence is amended by adding the language "or the identification number assigned by the Internal Revenue Service (see §301.6109–1 of this chapter)" immediately after the language "United States social security number".

§1.897–2 [Amended]

Par. 3. Section 1.897–2 is amended as follows:

For each of the paragraphs listed in the first column, remove the language in the second column and add in its place the language in the third column:

Paragraphs	Remove	Add
(g)(1)(i)(B)	Director, Foreign Operations District ("Director")	Commissioner, Small Business/Self Employed Division (SB/SE)
(g)(1)(i), fourth sentence of concluding text immediately following paragraph (g)(1)(i)(B)	Director	Commissioner
(g)(1)(iii) heading	Director	Commissioner
(g)(1)(iii)(A), first, fourth, and last sentences	Director	Commissioner
(g)(1)(iii)(A), third sentence	Director, Foreign Operations District; 1325 K St., N.W.; Washington, D.C. 20225	Commissioner, Small Business/Self Employed Division (SB/SE); S C3-413 NCFB, 500 Ellin Road, Lanham, MD 20706
(g)(1)(iii)(B) heading	Director's	Commissioner's
(g)(1)(iii)(B) introductory text	Director	Commissioner
(g)(1)(iii)(B) concluding text immediately following (g)(1)(iii)(B)(*2*)	Director	Commissioner
(g)(1)(iii)(C) both places it appears	Director	Commissioner
(g)(1)(iii)(D) heading	Director	Commissioner
(g)(1)(iii)(D)	Director	Commissioner
(g)(2)(i)(B)	Director	Commissioner
(g)(2)(iii) heading	Director	Commissioner
(g)(2)(iii)(A), first, fourth, and fifth sentence (both places it appears).	Director	Commissioner
(g)(2)(iii)(A), third sentence	Director, Foreign Operations District; 1325 K St. N.W.; Washington, D.C. 20225	Commissioner, Small Business/Self Employed Division (SB/SE); S C3-413 NCFB, 500 Ellin Road, Lanham, MD 20706
(g)(2)(iii)(B) heading	Director's	Commissioner's
(g)(2)(iii)(B) introductory text	Director	Commissioner
(g)(2)(iii)(B) concluding text immediately following (g)(2)(iii)(B)(*2*)	Director	Commissioner
(g)(2)(iii)(C), first and second sentences	Director	Commissioner
(g)(2)(iii)(D) heading	Director	Commissioner
(g)(2)(iii)(D)	Director	Commissioner
(g)(2)(iv), fourth sentence	Director	Commissioner

(h)(2)(v), third sentence	Assistant Commissioner (International), Director, Office of Compliance, OP:I:C:E:666, 950 L'Enfant Plaza South, SW, COMSAT Building, Washington, D.C. 20024	Director, Philadelphia Service Center, P.O. Box 21086, Drop Point 8731, FIRPTA Unit, Philadelphia, PA 19114-0586
(h)(4)(ii), first sentence	Assistant Commissioner (International), Director, Office of Compliance, OP:I:C:E:666, 950 L'Enfant Plaza South, SW, COMSAT Building, Washington, D.C. 20024	Director, Philadelphia Service Center, P.O. Box 21086, Drop Point 8731, FIRPTA Unit, Philadelphia, PA 19114-0586

Par. 4. Section 1.897–3 is amended as follows:

1. For each of the paragraphs listed in the first column, remove the language in the second column and add in its place the language in the third column:

Paragraphs	Remove	Add
(c), introductory text	Director of the Foreign Operations District, 1325 K St., N.W., Washington, D.C. 20225	Director, Philadelphia Service Center, P.O. Box 21086, Drop Point 8731, FIRPTA Unit, Philadelphia, PA 19114-0586
(c)(1), introductory text, last sentence	which must set forth	which must contain all the following information
(d)(1), fourth sentence	Foreign Operations District	Philadelphia Service Center
(d)(2)(i), penultimate sentence	Director, Foreign Operations District	U.S. Treasury
(f)(1), second sentence	Director, Foreign Operations District, 1325 K St., N.W., Washington, D.C. 20225	Director, Philadelphia Service Center, P.O. Box 21086, Drop Point 8731, FIRPTA Unit, Philadelphia, PA 19114-0586
(f)(1), fifth sentence	Foreign Operations District	Philadelphia Service Center
(g)(1), second sentence	Director of the Foreign Operations District	Director, Philadelphia Service Center

2. In paragraph (c)(1)(i), remove the parenthetical "(if any)" after the words "identifying number".

3. Paragraph (h) is added to read as follows:

§1.897–3 Election by foreign corporation to be treated as a domestic corporation under section 897(i).

* * * * *

(h) *Effective date*. The requirement in paragraph (c)(1)(i) of this section that the statement making the section 897(i) election contain the identifying number of the foreign corporation (in all cases) is applicable November 4, 2003.

Par. 5. Section 1.897–5 is added to read as follows:

§1.897–5 Corporate Distributions.

(a) through (d)(1)(iii)(E) [Reserved]. For further guidance, see §1.897–5T(a) through (d)(1)(iii)(E).

(d)(1)(iii)(F) Identification by name and address of the distributee or transferee, including the distributee's or transferee's taxpayer identification number;

(d)(1)(iii)(G) through (d)(4) [Reserved]. For further guidance, see §1.897–5T(d)(1)(iii)(G) through (d)(4).

(e) *Effective date*. This section is applicable to transfers and distributions after November 4, 2003.

Par. 6. In §1.897–5T, paragraph (d)(1)(iii)(F) is revised to read as follows:

§1.897–5T Corporate distributions (temporary).

* * * * *

(d) * * * (1) * * *

(iii) * * *

(F) [Reserved]. For further guidance, see §1.897–5(d)(1)(iii)(F).

* * * * *

§1.897–6T [Amended]

Par. 7. Section 1.897–6T is amended as follows:

1. In paragraph (a)(2), second sentence, the language ", 1034" is removed.

2. Paragraph (a)(5) is removed and reserved.

3. Paragraph (a)(7), *Example 2* and *Example 3* are removed and reserved.

Par. 8. Section 1.1445–1 is amended as follows:

1. In paragraph (c)(1), second sentence, remove the language "filed with the Internal Revenue Service Center, Philadelphia, PA 19255" and add in its place the language "filed at the location as provided in the instructions to Forms 8288 and 8288–A".

2. In paragraph (c)(1), two sentences are added at the end.

3. In paragraph (c)(2)(i)(B), second sentence, remove the phrase ",if any," after the words "taxpayer identification number".

4. In paragraphs (d)(1)(i) and (d)(1)(ii), remove the parenthetical "(if any)" after the words "identifying number".

5. In paragraphs (d)(2)(i), (d)(2)(iv)(B), and (d)(2)(vi)(B), remove the parenthetical "(if any)" after the words "identifying number".

6. In paragraph (f)(2), the first sentence is revised, and a sentence is added after the first sentence.

7. In paragraph (f)(3)(i), the last sentence is revised.

8. Paragraphs (g)(9) and (g)(10) are revised.

9. Paragraph (h) is added.

The additions and revisions read as follows:

§1.1445–1 Withholding on dispositions of U.S. real property interests by foreign persons: In general.

* * * * *

(c) * * *

(1) * * * Forms 8288 and 8288–A are required to include the identifying numbers of both the transferor and the transferee, as provided in paragraph (d) of this section. If any identifying number as required by such forms is not provided, the transferee must still report and pay over any tax withheld on Form 8288, although the transferor cannot obtain a credit or refund of tax on the basis of a Form 8288–A that does not include the transferor's identifying number (see paragraph (f)(2) of this section).

* * * * *

(f) * * *

(2) * * * A stamped copy of Form 8288–A will be provided to the transferor by the Service (under paragraph (c) of this section) if the Form 8288–A is complete, including the transferor's identifying number. Except as provided in paragraph (f)(3) of this section, a stamped copy of Form 8288–A must be attached to the transferor's return to establish the amount withheld that is available as a credit. * * *

(3) * * *

(i) * * * Such a transferor must attach to its return a statement which supplies all of the information required by §1.1445–1(d), including the transferor's identifying number.

* * * * *

(g) * * *

(9) *Identifying number*. Pursuant to §1.897–1(p), an individual's identifying number is the social security number or the identification number assigned by the Internal Revenue Service (see §301.6109–1 of this chapter). The identifying number of any other person is its United States employer identification number.

(10) *Address of the Director, Philadelphia Service Center*. Any written communication directed to the Director, Philadelphia Service Center is to be addressed as follows: P.O. Box 21086, Drop Point 8731, FIRPTA Unit, Philadelphia, PA 19114–0586.

(h) *Effective date for taxpayer identification numbers*. The requirement in paragraphs (c)(2)(i)(B), (d)(1)(i) and (ii), (d)(2)(i), (d)(2)(iv)(B), and (d)(2)(vi)(B) of this section that taxpayer identification numbers be provided (in all cases) is applicable for dispositions of U.S. real property interests occurring after November 4, 2003.

Par. 9. Section 1.1445–2 is amended as follows:

1. Paragraph (b)(2)(iii) is redesignated as paragraph (b)(2)(iv), and new paragraph (b)(2)(iii) is added.

2. Newly designated paragraph (b)(2)(iv)(B) is revised.

3. In paragraph (d)(2)(i)(B), the language "Assistant Commissioner (International)" is removed, and "Director, Philadelphia Service Center" is added in its place, and the parenthetical "(if any)," is removed after the words "identifying number".

4. Paragraphs (d)(2)(iii) and (d)(2)(iv) are added immediately following the concluding text following paragraph (d)(2)(ii)(B).

5. In paragraphs (d)(3)(iii)(A)(*2*) and (d)(3)(iii)(A)(*3*), the parenthetical "(if any)" is removed after the words "identifying number".

6. Paragraph (e) is added.

The revision and additions read as follows:

§1.1445–2 Situations in which withholding is not required under section 1445(a).

* * * * *

(b) * * *

(2) * * *

(iii) *Disregarded entities*. A disregarded entity may not certify that it is the transferor of a U.S. real property interest, as the disregarded entity is not the transferor for U.S. tax purposes, including sections 897 and 1445. Rather, the owner of the disregarded entity is treated as the transferor of property and must provide a certificate of non-foreign status to avoid withholding under section 1445. A disregarded entity for these purposes means an entity that is disregarded as an entity separate from its owner under §301.7701–3 of this chapter, a qualified REIT subsidiary as defined in section 856(i), or a qualified subchapter S subsidiary under section 1361(b)(3)(B). Any domestic entity must include in its certification of non-foreign status with respect to the transfer a certification that it is not a disregarded entity. This paragraph (b)(2)(iii) and the sample certification provided in paragraph (b)(2)(iv)(B) of this section (to the extent it addresses disregarded entities) is applicable for dispositions occurring on or after September 5, 2003.

(iv) * * *

(B) *Entity transferor*.

"Section 1445 of the Internal Revenue Code provides that a transferee of a U.S. real property interest must withhold tax if the transferor is a foreign person. For U.S. tax purposes (including section 1445), the owner of a disregarded entity (which has legal title to a U.S. real property interest under local law) will be the transferor of the property and not the disregarded entity. To inform the transferee that withholding of tax is not required upon the disposition of a U.S. real property interest by [name of transferor] , the undersigned hereby certifies the following on behalf of [name of the transferor]:

1. [Name of transferor] is not a foreign corporation, foreign partnership, foreign trust, or foreign estate (as those terms are defined in the Internal Revenue Code and Income Tax Regulations);

2. [Name of transferor] is not a disregarded entity as defined in §1.1445–2(b)(2)(iii);

3. [Name of transferor]'s U.S. employer identification number is _____; and

4. [Name of transferor]'s office address is

[Name of transferor] understands that this certification may be disclosed to the Internal Revenue Service by transferee and that any false statement contained herein could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete, and I further declare that I have authority to sign this document on behalf of [name of transferor].

[Signature(s) and date]

[Title(s)]"

* * * * *

(d) * * *

(2) * * *

(iii) *Contents of the notice*. No particular form is required for a transferor's notice to a transferee that the transferor is not required to recognize gain or loss with respect to a transfer. The notice must be verified as true and signed under penalties of perjury by the transferor, by a responsible officer in the case of a corporation, by a general partner in the case of a partnership, and by a trustee or equivalent fiduciary in the case of a trust or estate. The following information must be set forth in paragraphs labeled to correspond with the designation set forth as follows—

(A) A statement that the document submitted constitutes a notice of a nonrecognition transaction or a treaty provision pursuant to the requirements of §1.1445–2(d)(2);

(B) The name, identifying number, and home address (in the case of an individual) or office address (in the case of an entity) of the transferor submitting the notice;

(C) A statement that the transferor is not required to recognize any gain or loss with respect to the transfer;

(D) A brief description of the transfer; and

(E) A brief summary of the law and facts supporting the claim that recognition of gain or loss is not required with respect to the transfer.

(iv) *No notice allowed*. The provisions of this paragraph (d)(2) do not apply to exclusions from income under section 121, to simultaneous like-kind exchanges under section 1031 that do not qualify for nonrecognition treatment in their entirety (see paragraph (d)(2)(ii)(A) of this section), and to non-simultaneous like-kind exchanges under section 1031 where the transferee cannot determine that the exchange has been completed and all the conditions for nonrecognition have been satisfied at the time it is otherwise required to pay the section 1445 withholding tax and file the withholding tax return (Form 8288, *"U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests"*). In these cases, the transferee is excused from withholding only upon the timely application for and receipt of a withholding certificate under §1.1445–3 (see §1.1445–3(b)(5) and (6) for specific rules applicable to transactions under sections 121 and 1031). This paragraph (d)(2)(iv) is applicable for dispositions and exchanges occurring on or after September 5, 2003.

* * * * *

(e) *Effective date for taxpayer identification numbers*. The requirement in paragraphs (d)(2)(i)(B), (d)(2)(iii)(B), and (d)(3)(iii)(A)(*2*) and (*3*) of this section that taxpayer identification numbers be provided (in all cases) is effective for dispositions of U.S. real property interests occurring after November 4, 2003.

* * * * *

Par. 10. Section 1.1445–3 is amended as follows:

1. In paragraph (a), after the seventh sentence, one sentence is added.

2. For each of the paragraphs listed in the column below, remove the language "Assistant Commissioner (International)", and add "Director, Philadelphia Service Center" in its place.

Paragraphs

(b)(1), first sentence

(f)(1), first sentence

(f)(2)(iii), heading

(f)(2)(iii), first sentence

(g), third sentence, introductory text

3. In paragraph (b)(1), last sentence, remove the language "of this section" and add ", and to the extent applicable, paragraph (b)(5) or (6) of this section" in its place.

4. Paragraph (b)(2) is revised.

5. Paragraphs (b)(5) and (b)(6) are added.

6. In paragraphs (f)(3)(i) and (g)(1), remove the parenthetical "(if any)" after the words "identifying number".

7. Paragraph (h) is added.

The revision and additions read as follows:

§1.1445–3 Adjustments to amount required to be withheld pursuant to withholding certificate.

(a) * * * In no event, however, will a withholding certificate be issued without the transferor's identifying number. * * *

(b) * * *

(2) *Parties to the transaction*. The application must set forth the name, address, and identifying number of the person submitting the application (specifying whether that person is the transferee or transferor), and the name, address, and identifying number of other parties to the transaction (specifying whether each such party is a transferee or transferor). The Service will deny the application if complete information, including the identifying numbers of all the parties, is not provided. Thus, for example, the applicant should determine if an identifying number exists for each party, and, if none exists for a particular party, the applicant should notify the particular party of the obligation to get an identifying number before the application can be submitted to the Service. The address provided in the case of an individual must be that individual's home address, and the address provided in the case of an entity must be that entity's office address. A mailing address may be provided in addition to, but not in lieu of, a home address or office address.

* * * * *

(5) *Special rule for exclusions from income under section 121*. A withholding certificate may be sought on the basis of a section 121 exclusion as a reduction in the amount of tax due under paragraph (c)(2)(v) of this section. The application must include information establishing that the transferor, who is a nonresident alien individual at the time of the sale (and is therefore subject to sections 897 and 1445) is entitled to claim the benefits of section 121. For example, a claim for reduced withholding as a result of section 121 must include information that the transferor occupied the U.S. real property interest as his or her personal residence for the required period of time.

(6) *Special rule for like-kind exchanges under Section 1031*. A withholding certificate may be requested with respect to a like-kind exchange under section 1031 as a transaction subject to a nonrecognition provision under paragraph (c)(2)(ii) of this section. The application must include information substantiating the requirements of section 1031. The IRS may require additional information during the course of the application process to determine that the requirements of section 1031 are satisfied. In the case of a deferred like-kind exchange, the withholding agent is excused from reporting and paying the withholding tax to the IRS within 20 days after the transfer only if an application for a withholding certificate is submitted prior to or on the date of transfer. See §1.1445–1(c)(2) for rules concerning delayed reporting and payment where an application for a withholding certificate has been submitted to the IRS prior to or on the date of transfer.

* * * * *

(h) *Effective date for taxpayer identification numbers*. The requirement in paragraphs (b)(2), (f)(3)(i), and (g)(1) of this section that taxpayer identification numbers be provided (in all cases) is applicable for dispositions of U.S. real property interests occurring after November 4, 2003.

* * * * *

§1.1445–4 [Amended]

Par. 11. In §1.1445–4, paragraph (c)(2), second sentence, is amended by removing the language "Assistant Commissioner (International)" and adding "Director, Philadelphia Service Center" in its place.

Par. 12. Section 1.1445–5 is amended as follows:

1. In paragraph (b)(2)(ii), first sentence, remove the language "Assistant Commissioner (International)" and add "Director, Philadelphia Service Center" in its place.

2. In paragraphs (b)(2)(ii)(B) and (b)(2)(ii)(C), remove the parenthetical "(if any)" after the words "identifying number".

3. In paragraph (b)(5)(i), second sentence, remove the language "filed with the Internal Revenue Service Center, Philadelphia, PA 19255" and add in its place the language "filed at the location as provided in the instructions to Forms 8288 and 8288–A".

4. In paragraph (b)(5)(i), the fifth sentence is revised.

5. In paragraph (b)(7), the fifth sentence is revised.

6. Paragraph (b)(8)(iii) is revised.

7. In paragraph (c)(3)(v), first and fifth sentences, remove the language "Assistant Commissioner (International)" and add "Director, Philadelphia Service Center" in its place.

8. Paragraph (e)(1)(ii) is revised.

9. Paragraph (e)(2) is redesignated as paragraph (e)(3), and new paragraph (e)(2) is added,

10. In newly designated paragraph (e)(3)(iii)(B), remove the language "§1.1445–5(e)(2)(iii)(B)" and add "§1.1445–5(e)(3)(iii)(B)" in its place; and remove the language "paragraph (e)(2)(iii)(B)" and add "paragraph (e)(3)(iii)(B)" in its place.

11. Paragraph (h) is added.

The revisions and additions read as follows:

§1.1445–5 Special rules concerning distributions and other transactions by corporations, partnerships, trusts and estates.

* * * * *

(b) * * *

(5) * * *

(i) * * * Form 8288–A will be stamped by the Internal Revenue Service to show receipt, and a stamped copy will be mailed by the Service to the interest holder if the Form 8288 is complete, including the transferor's identifying number, at the address shown on the form, for the interest-holder's use. * * *

(7) * * * Such an interest-holder must attach to its return a statement which supplies all of the information required by §1.1445–1(d)(2). * * *

(8) * * *

(iii) *Distributions by certain domestic corporations to foreign shareholders*. The provisions of section 1445(e)(3) and paragraph (e)(1) of this section, requiring withholding upon distributions in redemption

of stock under section 302(a) or liquidating distributions under Part II of subchapter C of the Internal Revenue Code by U.S. real property holding corporations to foreign shareholders, shall apply to distributions made on or after January 1, 1985. The provisions of section 1445(e)(3) and paragraph (e)(1) of this section requiring withholding on distributions under section 301 by U.S. real property holding corporations to foreign shareholders shall apply to distributions made after August 20, 1996. The provisions of paragraph (e) of this section providing for the coordination of withholding between sections 1445 and 1441 (or 1442 or 1443) for distributions under section 301 by U.S. real property holding corporations to foreign shareholders apply to distributions after December 31, 2000 (see §1.1441–3(c)(4) and (h)).

* * * * *

(e) * * * (1) * * *

(ii) There is a distribution of property in redemption of stock treated as an exchange under section 302(a), in liquidation of the corporation pursuant to the provisions of Part II of subchapter C of the Internal Revenue Code (sections 331 through section 346), or with respect to stock under section 301 that is not made out of earnings and profits of the corporation.

(2) *Coordination rules for Section 301 distributions*. If a domestic corporation makes a distribution of property under section 301 to a foreign person whose interest in such corporation constitutes a U.S. real property interest under the provisions of section 897 and the regulations thereunder, then see §1.1441–3(c)(4) for rules coordinating withholding obligations under sections 1445 and 1441 (or 1442 or 1443)).

* * * * *

(h) *Effective date for taxpayer identification numbers*. The requirement in paragraphs (b)(2)(ii)(B) and (C) of this section that taxpayer identification numbers be provided (in all cases) is applicable for dispositions of U.S. real property interests occurring after November 4, 2003.

* * * * *

Par. 13. Section 1.1445–6 is amended as follows:

1. In paragraph (a), after the seventh sentence, one sentence is added.

2. Paragraph (b)(3) is revised.

3. For each of the paragraphs listed in the column below, remove the language "Assistant Commissioner (International)" and add "Director, Philadelphia Service Center" in its place.

Paragraphs

(f)(1), first sentence

(f)(2)(iii), heading

(f)(2)(iii)

(g), introductory text, second sentence

4. Paragraphs (f)(3)(i) and (g)(1) are amended by removing the parenthetical "(if any)" after the words "identifying number".

5. Paragraph (h) is added.

The revision and additions read as follows:

§1.1445–6 Adjustments pursuant to withholding certificate of amount required to be withheld under section 1445(e).

* * * * *

(a) * * * In no event, however, will a withholding certificate be issued without the transferor's identifying number.* * *

(b) * * *

(3) *Relevant taxpayers*. An application for withholding certificate pursuant to this section must include all of the following information: the name, identifying number, and home address (in the case of an individual) or office address (in the case of an entity) of each relevant taxpayer with respect to which adjusted withholding is sought.

* * * * *

(h) *Effective date for taxpayer identification numbers*. The requirement in paragraphs (b)(3), (f)(3)(i), and (g)(1) of this section that taxpayer identification numbers be provided (in all cases) is applicable for dispositions of U.S. real property interests occurring after November 4, 2003.

* * * * *

§1.1445–9T [Removed]

Par. 14. Section 1.1445–9T is removed.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 15. The authority for part 301 continues to read in part as follows:

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

Par. 16. Section 301.6109–1 is amended as follows:

1. In paragraph (b)(2)(v), remove the word "and".

2. In paragraph (b)(2)(vi), remove the period at the end of the paragraph and add "; and" in its place.

3. Paragraph (b)(2)(vii) is added.

4. In paragraph (c), first and third sentences, remove the language "or (vi) of this section" and add "(vi), or (vii) of this section" in its place.

The addition reads as follows:

§301.6109–1 Identifying numbers.

* * * * *

(b) * * *

(2) * * *

(vii) A foreign person whose taxpayer identifying number is required to be furnished on any return, statement, or other document as required by the income tax regulations under section 897 or 1445. This paragraph (b)(2)(vii) applies after November 4, 2003.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 17. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 18. In §602.101, paragraph (b) is amended by revising the entries for 1.1445–2 and 1.1445–3 to read as follows:

§601.601 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1445–2	1545–0902
	1545–1060
	1545–1797
1.1.445–3	1545–0902
	1545–1060
	1545–1797
* * * * *	

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Approved July 9, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 4, 2003, 8:45 a.m., and published in the issue of the Federal Register for August 5, 2003, 68 F.R. 46081)

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, 642, 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 382, 1274, 1288, and other sections of the Code, tables set forth the rates for October 2003.

Rev. Rul. 2003–107

This revenue ruling provides various prescribed rates for federal income tax purposes for October 2003 (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 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. 2003–107 TABLE 1

Applicable Federal Rates (AFR) for October 2003

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	1.68%	1.67%	1.67%	1.66%
110% AFR	1.85%	1.84%	1.84%	1.83%
120% AFR	2.01%	2.00%	2.00%	1.99%
130% AFR	2.18%	2.17%	2.16%	2.16%
Mid-Term				
AFR	3.65%	3.62%	3.60%	3.59%
110% AFR	4.02%	3.98%	3.96%	3.95%
120% AFR	4.39%	4.34%	4.32%	4.30%
130% AFR	4.77%	4.71%	4.68%	4.66%
150% AFR	5.50%	5.43%	5.39%	5.37%
175% AFR	6.44%	6.34%	6.29%	6.26%
Long-Term				
AFR	5.23%	5.16%	5.13%	5.11%
110% AFR	5.76%	5.68%	5.64%	5.61%
120% AFR	6.29%	6.19%	6.14%	6.11%
130% AFR	6.82%	6.71%	6.65%	6.62%

REV. RUL. 2003–107 TABLE 2

Adjusted AFR for October 2003

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	1.36%	1.36%	1.36%	1.36%
Mid-term adjusted AFR	2.98%	2.96%	2.95%	2.94%
Long-term adjusted AFR	4.74%	4.69%	4.66%	4.64%

REV. RUL. 2003–107 TABLE 3

Rates Under Section 382 for October 2003

Adjusted federal long-term rate for the current month	4.74%
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.)	4.74%

REV. RUL. 2003–107 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for October 2003	
Appropriate percentage for the 70% present value low-income housing credit	8.03%
Appropriate percentage for the 30% present value low-income housing credit	3.44%

REV. RUL. 2003–107 TABLE 5	
Rate Under Section 7520 for October 2003	
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	4.4%

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2003. See Rev. Rul. 2003-107, page 815.

Section 1445.—Withholding of Tax on Dispositions of United States Real Property Interests

Final and temporary regulations under sections 897 and 1445 of the Code require the use of taxpayer identifying numbers on submissions. See T.D. 9082, page 807.

Section 6109.—Identifying Numbers

Final and temporary regulations under sections 897 and 1445 of the Code require the use of taxpayer identifying numbers on submissions. See T.D. 9082, page 807.

Section 7122.—Compromises

26 CFR 300.3: Offer to compromise fee.

T.D. 9086

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 300

User Fees for Processing Offers to Compromise

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains amendments to the regulations relating to user fees to provide for the imposition of user fees for the processing of offers to compromise. The charging of user fees implements the Independent Offices Appropriations Act.

EFFECTIVE DATE: **NOVEMBER 1, 2003.**

FOR FURTHER INFORMATION CONTACT: Concerning cost methodology, Eva Williams, 301–492–5395; concerning the regulations, G. William Beard, 202–622–3620 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document amends the regulations relating to user fees to provide for the imposition of user fees for the processing of offers to compromise. The charging of user fees implements the Independent Offices Appropriations Act (IOAA), which is codified at 31 U.S.C. 9701. On November 6, 2002, a notice of proposed rulemaking (REG–103777–02, 2002–2 C.B. 889) was published in the **Federal Register**. Approximately 149 comments were received. A public hearing on the regulations was held on February 13, 2003. The final regulations adopt the rules of the proposed regulations.

Offers to Compromise

Section 7122 of the Internal Revenue Code (Code) gives the IRS the authority to compromise any civil or criminal case arising under the internal revenue laws, prior to the referral of that case to the Department of Justice. Section 7122 also directs the IRS to prescribe guidelines for officers and employees of the IRS to determine whether an offer to compromise is adequate and should be accepted. Guidelines are contained in §301.7122–1. Pursuant to §301.7122–1(b), an offer may be accepted if there is doubt as to liability, if there is doubt as to collectibility, or if acceptance will promote effective tax administration. Pursuant to §301.7122–1(b)(3), offers may be accepted to promote effective tax administration if either: (1) the IRS determines that, although collection in full could be achieved, collection of the full liability would cause the taxpayer economic hardship within the meaning of §301.6343–1, or (2) there are no other grounds for compromise and there are compelling public policy or equity considerations.

When an offer to compromise is received, an initial determination is made as to whether the offer is processable. Currently, an offer is returned as nonprocessable if the taxpayer is in bankruptcy, has not filed required tax returns, or has not submitted the offer to compromise on the proper form. Absent these conditions, the offer is accepted for processing and cannot be rejected without an independent administrative review of the decision to reject and, if the taxpayer chooses to appeal the rejection, independent review by the Office of Appeals. Even though an offer accepted for processing may later be returned to the taxpayer if the taxpayer fails to provide requested information or the IRS determines that the offer was submitted solely to delay collection, such an

offer may not be returned before a managerial review of the proposed return is completed pursuant to §301.7122–1(f)(5)(ii).

Explanation of Provisions

The final regulations establish a $150 user fee for the processing of certain offers to compromise tax liabilities pursuant to §301.7122–1. The user fee will not apply to offers based solely on doubt as to liability and offers made by low income taxpayers whose incomes are at or below the poverty guidelines set by the Department of Health and Human Services (DHHS), or such other measure the IRS may adopt.

Offers based on doubt as to liability are excepted from the user fee based on the inequity of the IRS charging a fee to compromise an uncertain liability when a compromise is based upon a redetermination or reevaluation of the taxpayer's liability for a tax (and the agreed upon amount may, in fact, provide for the full payment of the amount actually owed).

Offers from low income taxpayers are excepted from the fee in light of section 7122(c)(3)(A), which prohibits the IRS from rejecting an offer from a low income taxpayer solely on the basis of the amount offered. Section 7122(c)(3)(A) literally applies to the rejection of an offer, rather than the return of an offer for failure to pay a user fee. Requiring payment of a user fee from a low income taxpayer would undermine section 7122(c)(3)(A) in cases where the taxpayer does not have the ability to pay the fee. Offers from low income taxpayers are therefore excepted.

Taxpayers with offers that do not fall within the doubt as to liability or low income exceptions will submit the user fee along with the offer to compromise. If the offer is accepted to promote effective tax administration or is accepted based on doubt as to collectibility and a determination that collecting more than the amount offered would create economic hardship within the meaning of §§301.6343–1, the fee will be applied to the amount of the offer or, if the taxpayer requests, refunded to the taxpayer. In other cases, the payment of the fee will be taken into account in determining the acceptable amount of the offer and therefore the taxpayer in total will pay no more than the taxpayer would have paid without the fee. While the fee will not be refunded if an offer is withdrawn, rejected, or returned as nonprocessable after acceptance for processing, no additional fee will be charged if a taxpayer resubmits an offer the IRS determines to have been rejected or returned in error.

Comments on the Proposed Regulation

Most of the comments on the proposed regulations did not favor the fee. The comments focused on three concerns: the fee would create an additional financial hardship on taxpayers who are already experiencing hardship; the income level for the low income exception to the fee was too low; and the fee should not be imposed until the offer to compromise is administered more effectively and efficiently. For the following reasons, these final regulations follow the proposed regulations without change.

The most frequent concern in the comments was that the fee would cause additional financial hardship for taxpayers who are already experiencing financial hardship. The exception for low income taxpayers, however, excludes those taxpayers most likely to be disadvantaged by the user fee. Further, the imposition of the fee on other taxpayers will not change the net amount paid by the taxpayer to reach a compromise; the fee will be taken into account when considering whether the amount offered is acceptable. Although taxpayers who must pay the fee will not receive a refund if the offer is withdrawn, rejected, or returned after being accepted for processing, the IRS will work closely with taxpayers to perfect incomplete or inadequate offers before returning or rejecting them.

A number of commentators were concerned that the DHHS poverty guidelines used for purposes of the low income exception are too low and recommended that the exception for low income taxpayers should be extended to 250% of the DHHS guidelines. The 250% level corresponds to one of the criteria used for funding low income taxpayer clinics: in order to receive funding pursuant to section 7526 of the Code, 90% of a clinic's clients must fall below 250% of the DHHS poverty level. The commentators pointed to the relationship between section 7526 and offers to compromise. Section 7526 was enacted contemporaneously with section 7122(c)(3), which prohibits the IRS from rejecting an offer from a low income taxpayer based on the amount of the offer. Commentators argued that imposing a user fee on taxpayers whose incomes are within 250% of the poverty level thwarts the objective of section 7526 to assist such taxpayers.

The DHHS poverty guidelines are retained as the measure of the exception for the low income taxpayer. The 250% criteria in section 7526 only applies for purposes of that section; it does not extend to offers to compromise under section 7122. Had Congress intended to extend the 250% criteria to offers in compromise under section 7122, it could have done so. The DHHS poverty guidelines are a reasonable standard for offers to compromise in light of the fact that the amount of the fee will be reflected in the amount of the offer. Although some taxpayers may not be able to pay the fee because the fee exceeds their collectible assets and income, the DHHS standard will generally cover such taxpayers. Further, the IRS retains the authority under the final regulations to adjust the definition of low income taxpayer. The IRS could, therefore, change the low income standard if, in practice, there are a significant number of taxpayers with incomes above the DHHS standard who are experiencing hardship as a result of the fee.

A number of commentators urged that the fee should not be imposed until inefficiencies and errors in the processing of offers to compromise are eliminated. In the past year, however, the IRS made substantial improvements to its offer in compromise program and is now able to process offers to compromise much more accurately, effectively and efficiently. The IRS acknowledges that further improvements are needed and is taking steps to achieve greater accuracy and efficiency, but the user fee is an integral part of that effort. The user fee should help reduce the number of frivolous offers and the number of offers that are either withdrawn, returned, or rejected because the offeror would not provide adequate information for the IRS to process the offer or would not offer an amount that reflects the taxpayer's ability to pay. Limiting the number of offers that will be withdrawn, returned, or rejected will enable the IRS to direct its resources towards the timely and efficient processing of acceptable offers. In addition, the final regulation was amended to make clear

that no additional fee will be charged if a taxpayer resubmits an offer the IRS determines to have been rejected or returned in error after acceptance for processing.

Authority

The IOAA authorizes agencies to prescribe regulations that establish charges for services provided by the agency (user fees). The charges must be fair and be based on the costs to the Government, the value of the service to the recipient, the public policy or interest served, and other relevant facts. The IOAA provides that regulations implementing user fees are subject to policies prescribed by the President, which are currently set forth in OMB Circular A–25, 58 FR 38142 (July 15, 1993).

The OMB Circular encourages user fees for Government-provided services that confer benefits on identifiable recipients over and above those benefits received by the general public. Under the OMB Circular, an agency that seeks to impose a user fee for Government-provided services must calculate its full cost of providing those services. In general, the amount of a user fee should recover the cost of providing the special service, unless the Office of Management and Budget grants an exception. Pursuant to the guidelines in the OMB Circular, the IRS calculated its cost of providing services under the offer in compromise program. The IRS determined that the full cost of investigating doubt as to collectibility and effective tax administration offers averages $471 when streamlined procedures are used to investigate the financial condition of the taxpayer, and $3,983 when more detailed investigations are used. The IRS estimates that 70% of offers are processed under streamlined procedures. OMB granted an exception to the "full cost" requirement of the OMB Circular.

The Treasury, Postal Service, and General Government Appropriations Act of 1995, Public Law 103–329 (108 Stat. 2382) (the 1995 Appropriations Act) provides that the Secretary may establish new fees for services provided by the IRS where such fees are authorized by another law, such as the IOAA.

The user fees are implemented under the authority of the IOAA, the OMB Circular, and the 1995 Appropriations Act.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based on the information that follows. The economic impact of these regulations on any small entity will result from the entity being required to pay a fee prescribed by these regulations in order to obtain a particular service. The dollar amount of the fee is not, however, substantial enough to have a significant economic impact on any entity subject to the fee. Pursuant to section 7805(f) of the Code, the preceding notice of proposed rulemaking 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 G. William Beard, Office of Associate Chief Counsel (Procedure and Administration), Collection, Bankruptcy and Summonses Division.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 300 is amended as follows:

PART 300—USER FEES

Paragraph 1. The authority citation for part 300 continues to read as follows:

Authority: 31 U.S.C. 9701.

Par. 2. Section 300.0 is amended as follows:

1. Paragraph (b)(3) is added.

2. Paragraph (c) is revised.

The addition and revision read as follows:

§300.0 User fees; in general.

* * * * *

(b) * * *

(3) Processing an offer to compromise.

(c) *Effective Date*. This part 300 is applicable March 16, 1995, except that the user fee for processing offers to compromise is applicable **NOVEMBER 1, 2003**.

Par. 3. Section 300.3 is added to read as follows:

§300.3 Offer to compromise fee.

(a) *Applicability*. This section applies to the processing of offers to compromise tax liabilities pursuant to §301.7122–1 of this chapter. Except as provided in this section, this fee applies to all offers to compromise accepted for processing.

(b) *Fee*. (1) The fee for processing an offer to compromise is $150.00, except that no fee will be charged if an offer is—

(i) Based solely on doubt as to liability as defined in §301.7122–1(b)(1) of this chapter; or

(ii) Made by a low income taxpayer, that is, an individual who falls at or below the dollar criteria established by the poverty guidelines updated annually in the **Federal Register** by the U.S. Department of Health and Human Services under authority of section 673(2) of the Omnibus Budget Reconciliation Act of 1981 (95 Stat. 357, 511) or such other measure that is adopted by the Secretary.

(2) The fee will be applied against the amount of the offer, unless the taxpayer requests that it be refunded, if the offer is—

(i) Accepted to promote effective tax administration pursuant to §301.7122–1(b)(3) of this chapter; or

(ii) Accepted based on doubt as to collectibility and a determination that collection of an amount greater than the amount offered would create economic hardship within the meaning of §301.6343–1 of this chapter.

(3) Except as otherwise provided in this paragraph (b), the fee will not be refunded to the taxpayer if the offer is accepted, rejected, withdrawn, or returned as nonprocessable after acceptance for processing.

(4) No additional fee will be charged if a taxpayer resubmits an offer the Secretary determines to have been rejected in error or returned in error after acceptance for processing.

(c) *Person liable for the fee*. The person liable for the processing fee is the taxpayer whose tax liabilities are the subject of the offer.

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Approved July 17, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on August 14, 2003, 8:45 a.m., and published in the issue of the Federal Register for August 15, 2003, 68 F.R. 48785)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2003. See Rev. Rul. 2003-107, page 815.

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 October 2003. See Rev. Rul. 2003-107, page 815.

Part II. Treaties and Tax Legislation

Subpart A.—Tax Conventions and Other Related Items

Supplemental Tables of Income Tax Rates Under New Income Tax Conventions

Announcement 2003–62

The United States recently exchanged instruments of ratification for a new income tax treaty with the United Kingdom and new protocols for the income tax treaties with Australia and Mexico. The effective dates are as follows:

United Kingdom. The provisions for withholding tax at source are effective for amounts paid or credited after May 1, 2003. For all other taxes, the treaty is effective for tax periods beginning on or after January 1, 2004. Students who have claimed treaty benefits under Article 21 of the former treaty can continue to apply those provisions.

A person entitled to benefits under the previous treaty with the United Kingdom can elect to have that treaty apply in its entirety for a twelve-month period following the date the new treaty would otherwise apply.

Australia. The provisions for withholding tax at source are effective for amounts paid or credited after July 1, 2003. For all other taxes, the protocol is effective for tax periods beginning on or after January 1, 2004.

Mexico. The provisions for withholding tax on dividends are effective for amounts paid or credited on or after September 1, 2003. For all other taxes, the treaty is effective for tax periods beginning on or after January 1, 2004.

The tables below replace the entries in Tables 1 and 2 in Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities (For Withholding in 2003)*, and in Publication 901, *U.S. Tax Treaties*. The footnotes in those publications that relate to the column headings in these tables generally apply to these replacement entries.

The complete text of the U.K. treaty and the Australia and Mexico protocols are available on the IRS website at *www.irs.gov*.

Table 1. **Withholding Tax Rates on Income Other Than Personal Services** (The effective dates are shown earlier.)

Income code number		1	2	3	6	7	9	10	11	12	13	14
Country/Code												
Australia	AS	10 a,b,j	10 a,b,f,j	10 a,b,j	15 a,c	5 a,c,h	30	0 a	5 a	5 a	30	0 d
Mexico	MX	15 a,l	15 a,f,l	15 a	10 a,c,m	5 a,c,h,m	0 a	10 a	10 a	10 a	30	0 d
United Kingdom	UK	0 a,e,g	0 a,e,f,g	0 a,e,g	15 a	5 a,h	0 a	0 a,e	0 a,e	0 a,e	30	0 d,i,k

Income Codes

1 Interest paid by U.S. obligors — General
2 Interest on real property mortgages
3 Interest paid to controlling foreign corporations
6 Dividends paid by U.S. corporations — General
7 Dividends qualifying for direct dividend rate
9 Capital gains
10 Industrial royalties
11 Copyright royalties — Motion pictures and television
12 Copyright royalties — Other
13 Real property income and Natural resources royalties
14 Pensions and annuities

Footnotes

a The exemption or reduction in rate does not apply if the recipient has a permanent establishment in the United States and the property giving rise to the income is effectively connected with this permanent establishment. Under certain treaties, the exemption or reduction in rate also does not apply if the property giving rise to the income is effectively connected with a fixed base in the United States from which the recipient performs independent personal services. Even with the treaty, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a permanent establishment in the United States under IRC section 894(b).

b Interest paid to a financial institution is exempt.

c The rate in column 6 applies to dividends paid by a regulated investment company (RIC) or real estate investment trust (REIT). However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is (a) an individual holding not more than a 10% interest in the REIT, (b) a person holding not more than 5% of any class of the REIT's stock and the dividends are paid on stock that is publicly traded, or (c) a person holding not more than a 10% interest in the REIT and the REIT is diversified.

d Exemption does not apply to U.S. Government (federal, state, or local) pensions and annuities; a 30% rate applies to these pensions and annuities. U.S. Government pensions paid to an individual who is both a resident and national of Mexico or the United Kingdom are exempt from U.S. tax.

e Exemption does not apply to amount paid under, or as part of, a conduit arrangement.

f Exemption or reduced rate does not apply to an excess inclusion for a residual interest in a real estate mortgage investment conduit (REMIC).

g The rate is 15% for interest determined with reference to (a) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (b) any change in the value of any property of the debtor or a related person, or (c) any dividend, partnership distribution or similar payment made by the debtor to a related person.

h Dividends paid by an 80–percent-owned corporate subsidiary are exempt if certain conditions are met.

i Includes alimony.

j The rate is 15% for interest determined with reference to the profits of the issuer or one of its associated enterprises.

k Does not apply to annuities.

l The rate is 4.9% for interest derived from (a) loans granted by banks and insurance companies and (b) bonds or securities that are regularly and substantially traded on a recognized securities market. The rate is 10% for interest not described in the preceding sentence and paid by (a) banks, or (b) the buyer of machinery and equipment to the seller due to a sale on credit.

m Dividends paid by a trust, company, or other organization operated exclusively to administer or provide pension, retirement, or other employee benefits generally are exempt if certain conditions are met.

Table 2. **Compensation for Personal Services Performed in United States Exempt from Withholding and U.S. Income Tax Under Income Tax Treaties** (The effective dates are shown earlier.)

Country	Code	Category of personal services Purpose	Maximum presence in U.S.	Required Employer or Payer	Maximum Amount of Compensation	Article No.
Australia		NO CHANGES — See Publication 515.				
Mexico		NO CHANGES — See Publication 515.				
United Kingdom	16	Independent personal services 6,7				
	17	Dependent personal services 1,2	183 days	Any foreign resident	No limit	14
	20	Public entertainment	No limit	Any U.S or foreign resident	$20,000 p.a.	16
	18	Teaching 3	2 years	U.S. educational institution	No limit	20A
	19	Studying and training: Remittances or allowances 4	No limit 5	Any foreign resident	No limit	20

Footnotes

1 The exemption does not apply if the employee's compensation is borne by a permanent establishment that the employer has in the United States.
2 Fees paid to a resident of the treaty country for services performed in the United States as a director of a U.S. corporation are subject to U.S. tax.
3 Does not apply to income for research work primarily for private benefit.
4 Applies only to full-time student or trainee.
5 Exemption applies to business apprentice only for a period not exceeding one year from the date of arrival in the U.S.
6 Treated as business profits under Article 7 of the treaty.
7 Does not apply to compensation paid to public entertainers if the gross receipts (including reimbursements) are more than $20,000 in any year.

Part III. Administrative, Procedural, and Miscellaneous

Section 45D.—New Markets Tax Credit

Notice 2003–68

PURPOSE

The purpose of this notice is to announce that the Treasury Department and the Internal Revenue Service will clarify and amend the definition of a qualified low-income community investment under § 1.45D–1T(d)(1)(ii) of the temporary Income Tax Regulations.

BACKGROUND

Section 45D(a)(1) of the Internal Revenue Code provides a new markets tax credit on certain credit allowance dates described in § 45D(a)(3) with respect to a qualified equity investment in a qualified community development entity (CDE) described in § 45D(c).

Section 45D(b)(1) provides that an equity investment in a CDE is a "qualified equity investment" if, among other requirements: (A) the investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash; (B) substantially all of the cash is used by the CDE to make qualified low-income community investments; and (C) the investment is designated for purposes of § 45D by the CDE.

Section 45D(b)(2) provides that the maximum amount of equity investments issued by a CDE that may be designated by the CDE as qualified equity investments shall not exceed the portion of the new markets tax credit limitation set forth in § 45D(f)(1) that is allocated to the CDE by the Secretary under § 45D(f)(2).

Section 45D(c)(1) provides that an entity is a CDE only if, among other requirements, the entity is certified by the Secretary of the Treasury Department as a CDE.

Section 45D(d)(1) provides that the term "qualified low-income community investment" means: (A) any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in § 45D(d)(2)); (B) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; (C) financial counseling and other services to businesses located in, and residents of, low-income communities; and (D) any equity investment in, or loan to, any CDE.

Section 1.45D–1T(d)(1)(ii) provides that the term qualified low-income community investment includes the purchase from another CDE (whether or not that CDE has received an allocation from the Secretary under § 45D(f)(2)) of any loan made by such entity that is a qualified low-income community investment. Section 1.45D–1T(d)(1)(ii) further provides that a loan purchased from another CDE is a qualified low-income community investment if it qualifies as a qualified low-income community investment either: (A) at the time the selling CDE made the loan; or (B) at the time the loan is purchased from the selling CDE.

DISCUSSION

Comments have been received requesting clarification of whether, under § 1.45D–1T(d)(1)(ii), the purchase of a loan may be a qualified low-income community investment if the loan was made by an entity before the entity became a CDE. In response to these comments, § 1.45D–1T(d)(1)(ii) will be amended to provide that, for purposes of § 45D(d)(1)(B), a loan by an entity is treated as made by a CDE, notwithstanding that the entity was not a CDE at the time it made the loan, if the entity is a CDE at the time it sells the loan.

Comments have also been received requesting guidance on whether the purchase of a loan by a CDE (the ultimate CDE) from a second CDE may be a qualified low-income community investment under § 45D(d)(1)(B) if the loan was made by a third CDE (the originating CDE). In response to these comments, § 1.45D–1T(d)(1)(ii) will be amended to provide that, for purposes of § 45D(d)(1)(B):

1. The purchase of a loan by the ultimate CDE from a second CDE that purchased the loan from the originating CDE (or from another CDE) is treated as a purchase of the loan by the ultimate CDE from the originating CDE, provided that each entity that sold the loan was a CDE at the time it sold the loan; and

2. A loan purchased by the ultimate CDE from another CDE is a qualified low-income community investment if it qualifies as a qualified low-income community investment either (A) at the time the loan was made or (B) at the time the ultimate CDE purchases the loan.

The temporary regulations will be revised to incorporate the guidance set forth in this notice. Taxpayers may rely on this notice prior to the issuance of the revised temporary regulations.

DRAFTING INFORMATION

The principal author of this notice is Paul Handleman of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Handleman at (202) 622–3040 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Property Exempt From Levy

REG–140378–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to regulations relating to property exempt from levy, currently published under Internal Revenue Code section 6334. The regulation has been revised to provide guidance with respect to the following items and reflect changes made by the IRS Restructuring and Reform Act of 1998 (RRA 98): procedures for obtaining prior judicial approval of certain principal residence levies; exemption from levy for certain residences in small deficiency cases and for certain business assets in the absence of administrative approval or jeopardy; applicable dollar amounts for certain exemptions and the relevant dates for calculating the inflation adjustment for certain exemptions; and changes in titles of certain employees as a result of the reorganization of the IRS mandated by that Act. The proposed regulations also permit levy on certain specified payments with the prior approval of the Secretary, reflecting changes made by the Taxpayer Relief Act of 1997.

DATES: Written comments and requests for a public hearing must be received by November 17, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–140378–01), Room 5226, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to CC:PA:RU (REG–140378–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS Internet site at: *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Robin Ferguson at (202) 622–3610 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations amending the Procedure and Administration Regulations (26 CFR part 301) under section 6334 of the Internal Revenue Code of 1986. The proposed regulations provide guidance on the amendments to section 6334 made by the IRS Restructuring and Reform Act of 1998 (Public Law 105–206) (RRA 98), and the Taxpayer Relief Act of 1997 (Public Law 105–34) (TRA 97).

Explanation of Provisions

Overview

Section 6334 enumerates items of property exempt from levy and provides special rules for levies. In RRA 98, Congress amended section 6334 and created new requirements for levy upon certain residential property and business assets. Specifically, section 6334 was amended to provide for an exemption, in small deficiency cases, from levy for certain real property used as a residence by any individual; to require judicial approval of the levy of certain principal residences; to require administrative approval of the levy of certain business assets; to increase certain exemption amounts; and to make certain conforming amendments. RRA 98 also mandated an IRS reorganization, which changed or eliminated certain position titles. TRA 97 amended section 6334 to provide that certain payments shall not be exempt from levy if the Secretary approves. The proposed regulations provide guidance on each of these provisions.

Levy Exemption for Residences in Small Deficiency Cases

As amended, section 6334(a)(13) provides an exemption from levy for any real property used as a residence by the taxpayer or any other individual (except for real property that is rented) if the amount of the levy does not exceed $5,000. The proposed regulations provide guidance on this exemption.

Judicial Approval for Levies of Certain Principal Residences

Prior to RRA 98, section 6334(a)(13) provided that the principal residence of the taxpayer, within the meaning of section 121, was exempt from levy in the absence of jeopardy or certain approval. Section 6334(e) permitted levy if an IRS district director or assistant district director personally approved, in writing, the levy of property, or the Secretary determined that the collection of tax was in jeopardy.

As amended, section 6334(a)(13)(B)(i) provides that the principal residence of the taxpayer, within the meaning of section 121, is exempt from levy except to the extent provided in section 6334(e). Section 6334(e)(1)(A) provides that a principal residence shall not be exempt from levy if a judge or magistrate of a district court of the United States approves, in writing, the levy of such residence. Section 6334(e)(1)(B) provides that the district courts of the United States shall have exclusive jurisdiction to approve such levy. Accordingly, judicial approval is required prior to levy of a taxpayer's principal residence (hereinafter referred to as the section 6334(e)(1) proceeding).

The Conference Report for RRA 98 states that no seizure of a dwelling that is the principal residence of the taxpayer or the taxpayer's spouse, former spouse, or minor child will be allowed without prior judicial approval. The Conference Report further provides that notice of the judicial hearing must be provided to the taxpayer and family members residing in the property. The Conference Report also states that at the judicial hearing, the Secretary will be required to demonstrate (1) that the requirements of any applicable law or administrative procedures relevant to the levy have been met, (2) that the liability is owed, and (3) that no reasonable alternative for the collection of the taxpayer's debt exists. IRS Restructuring and Reform Act of 1998, Conference Report to Accompany H.R. 2676, H.R. Conf. Rep. No. 105–599, 105th Cong., 2d Sess., at 267.

With respect to whether a liability is owed, these proposed regulations interpret the legislative history to require the IRS

to demonstrate only that an assessed liability has not been satisfied. The proposed regulations specifically do not require the IRS to demonstrate the merits of the underlying liability. Treasury and the IRS have concluded that the purpose of a section 6334(e)(1) proceeding is to determine whether the proposed seizure is appropriate rather than to afford the taxpayer with an additional opportunity to contest the merits of the underlying tax liability. As discussed below, a section 6334(e)(1) proceeding, therefore, looks to whether the IRS has followed applicable law and procedural rules relating to the levy and the existence of reasonable collection alternatives, in addition to whether an unsatisfied liability exists. Other provisions of the Code, such as the deficiency procedures for income taxes, provide taxpayers with the opportunity to challenge the merits of an asserted liability. In the levy context, section 6330 gives taxpayers the right to request a hearing prior to levy, including levies that also are the subject of a section 6334(e)(1) proceeding. Section 6330(c)(2)(B) specifically gives the taxpayer the right to challenge the merits of the underlying liability if the taxpayer did not receive the statutory notice of deficiency or did not otherwise have an opportunity to dispute the tax liability. In contrast, nothing in section 6334(e)(1) indicates that Congress intended to provide a taxpayer with a further opportunity to contest the merits of the underlying tax liability.

Consistent with the language of section 6334(e)(1) and the legislative history, the proposed regulations provide that judicial approval is required prior to levy of the principal residence of the taxpayer, taxpayer's spouse, taxpayer's former spouse, or taxpayer's minor child. Also in accordance with this legislative history, the proposed regulations provide that the Government will request that the taxpayer be given notice and an opportunity to participate in the section 6334(e)(1) proceeding.

The Government will initiate the section 6334(e)(1) proceeding by filing with a district court of the United States a petition seeking judicial approval of a principal residence levy. In its petition, the Government will set forth its *prima facie* case by demonstrating that 1) the underlying tax liability has not been satisfied, 2) the requirements of any applicable law or administrative procedure relevant to the levy have been met, and 3) no reasonable alternative for collection of the taxpayer's debt exists. The petition will ask the court to issue to the taxpayer an order to show cause why the principal residence property should not be levied and a notice of hearing.

The taxpayer will be granted a hearing to rebut the Government's *prima facie* case if the taxpayer files an objection within the time period required by the court raising a genuine issue of material fact demonstrating that 1) the assessed tax liability has been satisfied, 2) the taxpayer has other assets from which the liability can be satisfied, or 3) the IRS did not follow the applicable laws or procedures pertaining to the levy. The taxpayer is not permitted to challenge the merits underlying the tax liability in the proceeding. Unless the taxpayer makes a timely and appropriate showing, the court would be expected to enter an order approving the levy of the principal residence property.

If the property to be levied is the principal residence of the taxpayer's spouse, former spouse, or minor child, the Government will send each such person a letter providing notice of the commencement of the proceeding. The letter will be addressed in the name of the taxpayer's spouse or ex-spouse, individually or on behalf of any minor children. If it is unclear who is living in the principal residence and/or what such person's relationship is to the taxpayer, a letter will be addressed to "Occupant". The purpose of the letter is to make the family members aware that their living arrangements may be placed in jeopardy if the court approves levy of the principal residence property.

The proposed regulations provide that family members who receive notice of the commencement of a section 6334(e)(1) proceeding may not be joined as parties to the proceeding. As noted above, Treasury and the IRS believe that the purpose of such notification is to ensure that family members living at the residence that is the subject of the proposed levy understand that their living arrangements may be placed in jeopardy. A levy by the IRS, however, can reach only the taxpayer's interest in property. The property rights (if any) of family members living at the residence are outside of the scope of that levy and are not at issue when an order approving the levy is sought from the court. Accordingly, because only the taxpayer's property rights are at issue in a section 6334(e)(1) proceeding, the proposed regulations do not permit other family members to contest a request for judicial approval of a principal residence levy. This rule is similar to those for actions by the IRS to foreclose on tax liens on property under section 7403. In those actions, the Government names as defendants all individuals who may claim an interest in the property; residents who do not otherwise have a legal interest in property, such as by co-tenancy, are not named as defendants.

The proposed regulations incorporate the procedures for obtaining judicial approval of a principal residence levy.

Prior Approval of Levies of Certain Business Assets

In enacting RRA 98, Congress created new approval requirements for levies of certain business assets. Specifically, Congress enacted new section 6334(a)(13)(B)(ii), which provides that, except to the extent provided in section 6334(e), tangible personal property or real property (other than real property that is rented) used in the trade or business of an individual taxpayer shall be exempt from levy. Section 6334(e) was amended to provide that such property shall not be exempt from levy if a district director or assistant district director of the IRS personally approves (in writing) the levy of such property, or the Secretary finds that the collection of tax is in jeopardy. Section 6334(e)(2) of the Internal Revenue Code (Code). Section 6334(e) was further amended to provide that an official may not approve such levy unless the official determines that the taxpayer's other assets subject to collection are insufficient to pay the amount due, together with expenses of the proceedings.

RRA 98 section 3445(c)(1) clarifies that, with respect to permits issued by a state and required under state law for the harvest of fish or wildlife in the trade or business of an individual taxpayer, the term other assets as used in section 6334(e)(2) includes future income that may be derived by such taxpayer from the commercial sale of fish or wildlife under such permit. RRA 98 section 3445(c)(2)

provides that section 3445(c)(1) shall not be construed to invalidate or in any way prejudice any assertion that the privilege embodied in such permits is not property or a right to property under the Code.

The proposed regulations provide guidance on the current requirements of section 6334(e) relating to the procedures for approval of the levy of certain business assets.

Exemption Amounts and Conforming Amendments

In RRA 98, Congress amended sections 6334(a)(2) and (a)(3) to increase the applicable exemption dollar amounts (which are indexed for inflation). Congress also enacted a conforming amendment to section 6334(g)(1) to revise the dates to be used in calculating the inflation adjustment to the section 6334(a)(2) and (a)(3) exemptions. The proposed regulations provide guidance on these provisions.

IRS Reorganization

Pursuant to the reorganization of the IRS after RRA 98, the titles of district director and assistant district director cited in section 6334(e)(2)(A) no longer exist. The proposed regulations replace these titles with the current title, which is Area Director.

Levy on Certain Payments

In TRA 97, Congress amended section 6334 by adding new section 6334(f) and redesignating former section 6334(f) as section 6334(g). Section 6334(f) provides that any payment described in section 6331(h)(2)(B) or (h)(2)(C) (certain payments upon which continuous levy may be authorized) shall not be exempt from levy if the Secretary approves the levy thereon under section 6331(h). The proposed regulations provide guidance on this provision.

Proposed Effective Dates

The proposed regulations will apply on the date corresponding final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. 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 Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of the proposed regulations is Robin Ferguson of the Office of Associate Chief Counsel, Procedure and Administration (Collection, Bankruptcy and Summonses Division).

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.6334–1 is amended as follows:

1. Paragraphs (a)(2), (a)(3), (a)(8), (a)(13), (d), (e), and (f) are revised.

2. Paragraphs (g) and (h) are added.

The revisions and additions read as follows:

§301.6334–1 Property exempt from levy.

(a) * * *

(2) *Fuel, provisions, furniture, and personal effects*. So much of the fuel, provisions, furniture, and personal effects in the taxpayer's household, and of the arms for personal use, livestock, and poultry of the taxpayer, that does not exceed $6,250 in value.

(3) *Books and tools of a trade, business or profession*. So many of the books and tools necessary for the trade, business, or profession of an individual taxpayer as do not exceed in the aggregate $3,125 in value.

* * * * *

(8) *Judgments for support of minor children*. If the taxpayer is required under any type of order or decree (including an interlocutory decree or a decree of support pendente lite) of a court of competent jurisdiction, entered prior to the date of levy, to contribute to the support of that taxpayer's minor children, so much of that taxpayer's salary, wages, or other income as is necessary to comply with such order or decree. The taxpayer must establish the amount necessary to comply with the order or decree. The Service is not required to release a levy until such time as it is established that the amount to be released from levy actually will be applied in satisfaction of the support obligation. The Service may make arrangements with a delinquent taxpayer to establish a specific amount of such taxpayer's salary, wage, or other income for each pay period that shall be exempt from levy, for purposes of complying with a support obligation. If the taxpayer has more than one source of income sufficient to satisfy the support obligation imposed by the order or decree, the amount exempt from levy, at the discretion of the Service, may be allocated entirely to one salary, wage or source of other income or be apportioned between the several salaries, wages, or other sources of income.

* * * * *

(13) *Residences exempt in small deficiency cases and principal residences and*

certain business assets exempt in absence of certain approval or jeopardy—(i) Residences in small deficiency cases. If the amount of the levy does not exceed $5,000, any real property used as a residence of the taxpayer or any real property of the taxpayer (other than real property which is rented) used by any other individual as a residence.

(ii) *Principal residences and certain business assets*. Except to the extent provided in section 6334(e), the principal residence (within the meaning of section 121) of the taxpayer and tangible personal property or real property (other than real property which is rented) used in the trade or business of an individual taxpayer.

* * * * *

(d) *Levy allowed on principal residence*. The Service will seek approval, in writing, by a judge or magistrate of a district court of the United States prior to levy of property that is owned by the taxpayer and used as the principal residence of the taxpayer, the taxpayer's spouse, the taxpayer's former spouse, or the taxpayer's minor child.

(1) *Nature of judicial proceeding*. The Government will initiate a proceeding for judicial approval of levy on a principal residence by filing a petition with the appropriate United States District Court demonstrating that the underlying liability has not been satisfied, the requirements of any applicable law or administrative procedure relevant to the levy have been met, and no reasonable alternative for collection of the taxpayer's debt exists. The petition will ask the court to issue to the taxpayer an order to show cause why the principal residence property should not be levied and will also ask the court to issue a notice of hearing.

(2) The taxpayer will be granted a hearing to rebut the Government's *prima facie* case if the taxpayer files an objection within the time period required by the court raising a genuine issue of material fact demonstrating that the underlying tax liability has been satisfied, that the taxpayer has other assets from which the liability can be satisfied, or that the Service did not follow the applicable laws or procedures pertaining to the levy. The taxpayer is not permitted to challenge the merits underlying the tax liability in the proceeding. Unless the taxpayer files a timely and appropriate objection, the court would be expected to enter an order approving the levy of the principal residence property.

(3) *Notice letter to be issued to certain family members*. If the property to be levied is owned by the taxpayer but is used as the principal residence of the taxpayer's spouse, the taxpayer's former spouse, or the taxpayer's minor child, the Government will send a letter to each such person providing notice of the commencement of the proceeding. The letter will be addressed in the name of the taxpayer's spouse or ex-spouse, individually or on behalf of any minor children. If it is unclear who is living in the principal residence property and/or what such person's relationship is to the taxpayer, a letter will be addressed to "Occupant". The purpose of the letter is to provide notice to the family members that the property may be levied. The family members may not be joined as parties to the judicial proceeding because the levy attaches only to the taxpayer's legal interest in the subject property and the family members have no legal standing to contest the proposed levy.

(e) *Levy allowed on certain business assets*. The property described in section 6334(a)(13)(B)(ii) shall not be exempt from levy if—

(1) An Area Director of the Service personally approves (in writing) the levy of such property; or

(2) The Secretary finds that the collection of tax is in jeopardy. An Area Director may not approve a levy under paragraph (e)(1) unless the Area Director determines that the taxpayer's other assets subject to collection are insufficient to pay the amount due, together with expenses of the proceeding. When other assets of an individual taxpayer include permits issued by a state and required under state law for the harvest of fish or wildlife in the taxpayer's trade or business, the taxpayer's other assets also include future income that may be derived by such taxpayer from the commercial sale of fish or wildlife under such permit.

(f) *Levy allowed on certain specified payments*. Any payment described in section 6331(h)(2)(B) or (C) shall not be exempt from levy if the Secretary approves the levy thereon under section 6331(h).

(g) *Inflation adjustment*. For any calendar year beginning after 1999, each dollar amount referred to in paragraphs (a)(2) and (3) of this section will be increased by an amount equal to the dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for the calendar year (using the language "calendar year 1998" instead of "calendar year 1992" in section 1(f)(3)(B)). If any dollar amount as adjusted is not a multiple of $10, the dollar amount will be rounded to the nearest multiple of $10 (rounding up if the amount is a multiple of $5).

(h) *Effective date*. This section will apply as of the date final regulations are published in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 18, 2003, 8:45 a.m., and published in the issue of the Federal Register for August 19, 2003, 68 F.R. 49729)

Notice of Proposed Rulemaking

Partnership Transactions Involving Long-Term Contracts

REG–128203–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to partnership transactions involving contracts accounted for under a long-term contract method of accounting. The regulations are necessary to resolve issues that were reserved in final regulations under section 460 that were published in the **Federal Register** on May 15, 2002, addressing other mid-contract changes in taxpayer engaged in completing such contracts. The effect of the regulations is to explain the tax consequences of these partnership transactions.

DATES: Written and electronic comments and requests for a public hearing must be received by November 4, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–128203–02), 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–128203–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet directly to the IRS internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Richard Probst, (202) 622–3060; concerning submissions, Guy Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Background

Section 460 of the Internal Revenue Code generally requires that taxpayers determine taxable income from a long-term contract using the percentage-of-completion method (PCM). Under regulations finalized in 2001 (T.D. 8929, 2001–1 C.B. 756), a taxpayer using the PCM generally includes a portion of the total contract price in income for each taxable year that the taxpayer incurs contract costs allocable to the long-term contract. More specifically, to determine the income from a long-term contract, the taxpayer first computes the completion factor for the contract, which is the percentage of the estimated total allocable contract costs that the taxpayer has incurred (based on the all events test of section 461, including economic performance, regardless of the taxpayer's method of accounting) through the end of the taxable year. Second, the taxpayer computes the amount of cumulative gross receipts from the contract by multiplying the completion factor by the total contract price, which is the amount that the taxpayer reasonably expects to receive under the contract. Third, the taxpayer computes the amount of current-year gross receipts, which is the difference between the cumulative gross receipts for the current taxable year and the cumulative gross receipts for the immediately preceding taxable year. This difference may be a loss (a negative number) based on revisions to estimates of total allocable contract costs or total contract price. Fourth, the taxpayer takes into account both the current-year gross receipts and the amount of allocable contract costs actually incurred during the taxable year. To the extent any portion of the total contract price has not been included in taxable income by the completion year, section 460(b)(1) and the regulations require the taxpayer to include that portion in income for the taxable year following the completion year.

A long-term contract or a portion of a long-term contract that is exempt from the PCM may be accounted for under any permissible method, including the completed contract method (CCM). Under the CCM, a taxpayer does not take into account the gross contract price and allocable contract costs until the contract is complete, even though progress payments are received in years prior to completion.

A taxpayer generally must allocate costs to a contract subject to section 460(a) in the same manner as direct and indirect costs are capitalized to property produced by a taxpayer under section 263A. The regulations provide exceptions, however, that reflect the differences in the cost allocation rules of sections 263A and 460.

Section 460(h) directs the Secretary to prescribe regulations to the extent necessary or appropriate to carry out the purpose of section 460, including regulations to prevent a taxpayer from avoiding section 460 by using related parties, pass-through entities, intermediaries, options, and other similar arrangements.

On May 15, 2002, final regulations under section 460 were issued to address a mid-contract change in taxpayer engaged in completing a contract accounted for under a long-term contract method of accounting (T.D. 8995; 2002–1 C.B. 1070). The regulations divide the rules regarding a mid-contract change in taxpayer into two categories—constructive completion transactions and step-in-the-shoes transactions.

In a constructive completion transaction, the taxpayer that originally accounted for the long-term contract (old taxpayer) must recognize income from the contract as of the time of the transaction. The contract price used to determine the amount of income recognized by the taxpayer is the amount realized from the transaction, reduced by any amounts paid by the old taxpayer to the taxpayer subsequently accounting for the long-term contract (new taxpayer) that are allocable to the contract. Similarly, the new taxpayer in a constructive completion transaction is treated as though it entered into a new contract as of the date of the transaction. The new taxpayer's contract price is the amount that the new taxpayer reasonably expects to receive under the contract, reduced by the price paid by the new taxpayer for the contract, and increased by any amounts paid by the old taxpayer to the new taxpayer that are allocable to the contract. In contrast, in a step-in-the-shoes transaction, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. The new taxpayer must assume the old taxpayer's methods of accounting for the contract, with both the contract price and allocable contract costs based on amounts taken into account by both parties.

The final section 460 regulations provide that a contribution to a partnership in a transaction described in section 721(a), a transfer of a partnership interest, and a distribution by a partnership to which section 731 applies (other than a distribution of a contract accounted for under a long-term contract method of accounting) are step-in-the-shoes transactions. In a notice issued concurrently with the final regulations, Notice 2002–37, 2002–1 C.B. 1095, Treasury and the IRS announced their intention to publish regulations setting forth the special rules that apply to these partnership transactions and described many of these rules. The notice further provided that these regulations would apply to contributions, transfers, and distributions occurring on or after May 15, 2002. The IRS requested comments as to the appropriate scope and substance of the regulations. No comments were received.

Explanation and Summary of Contents

1. *Contribution of a Contract to a Partnership*

The final section 460 regulations provide that a contribution of a contract accounted for under a long-term contract method of accounting in a transaction described in section 721(a) is a step-in-the-shoes transaction. Under

section 722, the partner's basis in the partnership interest is increased by the adjusted basis of the contributed contract (including the uncompleted property, if applicable). Under section 723, the partnership's basis in the contributed contract (including the uncompleted property, if applicable) equals the partner's basis in the contributed contract (including the uncompleted property, if applicable).

Under the final section 460 regulations, the basis of a long-term contract (including the uncompleted property, if applicable) is determined by reference to the allocable contract costs incurred by the taxpayer but not taken into account in computing taxable income. Thus, if the contract is accounted for under the PCM, then the taxpayer's basis in the contract is $0, even though the taxpayer has incurred costs and recognized income under the contract. If, on the other hand, the contract is accounted for under the CCM, then the taxpayer's basis in the contract is equal to the costs incurred by the taxpayer, unreduced by any progress payments that the taxpayer has received but not taken into income with respect to the contract. Under these rules, a partner accounting for a long-term contract under the CCM that incurs $400 of allocable contract costs, receives $500 of progress payments with respect to the contract, and the contributes the contract, but not the progress payments, to a partnership would be able to claim a $400 basis in the partnership interest received. Without any adjustments, such an analysis would give rise to erroneous results.

For this reason, these proposed regulations, like the rules in the final section 460 regulations applicable to corporate step-in-the-shoes transactions, such as transactions described in section 351(a), require a partner that contributes a contract accounted for under a long-term contract method of accounting to a partnership to adjust the basis of the partnership interest received. Specifically, the proposed regulations require the partner to increase the basis of the partnership interest by the amount of gross receipts that the partner has recognized under the contract, and reduce the basis of the partnership interest by the amount of gross receipts the partner has received or reasonably expects to receive under the contract. If the decrease exceeds the partner's basis in the partnership interest, then the partner must recognize income equal to the excess. To ensure that the partnership is not taxed again on any income taken into account by the partner under this rule, the proposed regulations require the partnership to reduce its total contract price (or gross contract price) by the amount of income recognized by the contributing partner.

2. *Built-in Income and Loss*

Section 704(c) generally provides that income, gain, loss, or deduction attributable to property that is contributed to a partnership must be allocated to the contributing partner. The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. These proposed regulations provide that the principles of section 704(c) and §1.704–3 apply to allocations of income or loss with respect to a contract accounted for under a long-term contract method of accounting that is contributed to a partnership (or that is revalued by a partnership under §1.704–1(b)(2)(iv)(*f*)). The proposed regulations provide that the partnership must apply section 704(c) to such income or loss in a manner that reasonably accounts for the section 704(c) income or loss over the remaining term of the contract.

Under the proposed regulations, the amount of built-in income or built-in loss attributable to a contributed contract that is subject to section 704(c) is determined as follows. First, the contributing partner must take into account any income or loss required under the step-in-the-shoes rules for the period ending on the date of the contribution. Second, the partnership determines the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied the step-in-the-shoes rules, but before the contribution to the partnership. Finally, this amount is reduced by the amount of income, if any, that the contributing partner is required to recognize as a result of the contribution.

3. *Transfer of a Partnership Interest*

The transfer of an interest in a partnership engaged in a contract accounted for under a long-term contract method of accounting is a step-in-the-shoes transaction. Section 741 provides that gain or loss recognized on the sale or exchange of an interest in a partnership is considered as gain or loss from a capital asset, except as provided in section 751. Section 751(a) provides that the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or any part of the partner's interest in the partnership attributable to unrealized receivables (as defined in section 751(c)) or inventory items (as defined in section 751(d)) of the partnership shall be considered as an amount realized from the sale or exchange of property other than a capital asset. In Rev. Rul. 79–51, 1979–1 C.B. 225, the IRS addressed a transaction in which a partner sold the partner's entire interest in a partnership holding partially completed contracts, the income from which was being accounted for under the CCM. The IRS ruled that the value of the contracts at the time of sale are unrealized receivables for purposes of section 751(c).

Consistent with Rev. Rul. 79–51, the proposed regulations provide that contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of section 751(c). The amount of ordinary income or loss attributable to a contract is the amount of income or loss that the partnership would take into account under the constructive completion rules if, at the time of a transfer of a partnership interest, the partnership disposed of the contract for its fair market value in a constructive completion transaction.

4. *Adjustments to the Basis of Partnership Property*

Section 743(b) allows a partnership to adjust the basis of partnership property in the case of a transfer of an interest in the partnership by sale or exchange or on the death of a partner. If all or part of a basis adjustment under section 743(b) is allocated to a contract accounted for under a long-term contract method of accounting, the proposed regulations provide that the adjustment shall reduce or increase, as the case may be, the transferee partner's distributive share of income or loss from

the contract. In the case of a contract accounted for under the CCM, the basis adjustment is taken into account in the year in which the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, the portion of the basis adjustment that is recovered in each taxable year of the partnership must be determined by the partnership in a manner that reasonably accounts for the adjustment over the remaining term of the contract. Similar rules apply if all or part of an adjustment to the basis of partnership property under section 734(b) is allocated to a contract accounted for under a long-term contract method of accounting.

5. *Closing of the Books*

Generally, under the step-in-the-shoes rules, an old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. As a result, an old taxpayer using the PCM is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. This rule differs from §1.706–1(c)(2)(ii), which provides that, if a partner's interest in the partnership terminates during the taxable year, the partnership may determine the partner's distributive share of partnership items either by closing the partnership's books as of the termination date or by prorating the partnership's income for the entire year between the pre- and post-termination periods.

Consistent with §1.706–1(c)(2)(ii), these regulations generally provide that upon the transfer or liquidation of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting, the step-in-the-shoes rules apply to a contract accounted for under a long-term contract method of accounting only if the partnership's books are properly closed with respect to that contract under section 706. If the partnership's books are not closed with respect to the contract, the partnership shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transfer or liquidation as though no change in taxpayer had occurred with respect to that contract, and may pro rate income from the contract under a reasonable method complying with section 706. Similar rules are provided for distributions of property (other than a contract accounted for under a long-term contract method of accounting) from a partnership holding a long-term contract, and for contributions of property (other than a contract accounted for under a long-term contract method of accounting) to a partnership holding a contract accounted for under a long-term contract method of accounting.

Comments are requested regarding whether similar rules should be provided with respect to transfers of stock in an S corporation holding a contract accounted for under a long-term contract method of accounting. See section 1377(a)(1) and §1.1377–1(a) (providing that each shareholder's *pro rata* share of any S corporation item for any taxable year is generally the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion *pro rata* among the shares outstanding on that day); and section 1377(a)(2) and §1.1377–1(b) (providing that an S corporation may elect to close its books if a shareholder's entire interest in an S corporation is terminated during the S corporation's taxable year, and the corporation and all affected shareholders agree).

6. *Look-Back Method*

The final section 460 regulations generally require any old taxpayer that accounted for income from a long-term contract under the PCM, and that transfers the contract to a new taxpayer in a step-in-the-shoes transaction, to provide the information described in §1.460–6(g)(3)(ii)(D) to the new taxpayer. The proposed regulations provide that, if the step-in-the-shoes transaction is a contribution of property (other than a contract accounted for under a long-term contract method of accounting) to a partnership, the distribution of property (other than a contract accounted for under a long-term contract method of accounting) by a partnership, or a transfer of a partnership interest, the old taxpayer is not required to provide this information, because information necessary for the new taxpayer to apply the look-back method is provided by the partnership. A similar exception is provided if the step-in-the-shoes transaction is a transfer of stock in an S corporation, or a conversion to or from an S corporation.

7. *Distribution of a Contract by a Partnership*

The distribution of a contract accounted for under a long-term contract method of accounting by a partnership to a partner is a constructive completion transaction. The proposed regulations provide that, in determining the partnership's income on the constructive completion transaction, the fair market value of the contract is treated as the amount realized from the transaction. The proposed regulations also clarify that, for purposes of determining each partner's distributive share of partnership items, any income or loss resulting from the constructive completion must be allocated among the partners of the partnership as though the partnership closed its books on the date of the distribution.

Section 732 determines the basis of property (other than money) distributed by a partnership to a partner. Section 734(b) provides for an adjustment to the basis of partnership property as a result of certain distributions from partnerships that have a section 754 election in effect. The proposed regulations provide that, if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, for purposes of determining the partner's basis in the contract (including the uncompleted property, if applicable) under section 732 and the amount of any basis adjustment under section 734(b), the partnership's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is the partnership's allocable contract costs (including transaction costs), increased (or decreased) by the amount of cumulative taxable income (or loss) recognized by the partnership on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), and decreased by the amounts that the partnership has received or reasonably expects to receive under the contract.

The proposed regulations provide that, if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, in computing the total contract price (or gross contract price) for the new contract, the partner's basis in the contract (including the uncompleted property, if applicable) after the distribution (as determined under section 732) is treated as consideration paid by the partner that is allocable to the contract. Thus, the total contract price (or gross contract price) of the new contract is reduced by the partner's basis in the contract (including the uncompleted property, if applicable) immediately after the distribution.

Section 751(b)(1) provides that, to the extent a partner receives in a distribution partnership property which is unrealized receivables or inventory items which have appreciated substantially in value, in exchange for all or a part of the partner's interest in other partnership property (including money), the transaction is considered a sale or exchange of the property between the distributee partner and the partnership. The same treatment applies if a partner receives in a distribution partnership property (including money) other than unrealized receivables and substantially appreciated inventory in exchange for the partner's interest in the partnership's unrealized receivables or substantially appreciated inventory. Because the distribution of a contract accounted for under a long-term contract method of accounting is the distribution of an unrealized receivable, section 751(b) may apply to the distribution. Therefore, the proposed regulations provide an ordering rule under which a partnership that distributes a contract accounted for under a long-term contract method of accounting to apply the constructive completion rules before applying the rules of section 751(b) to the distribution.

6. *Treatment of progress payments under section 752*

In Rev. Rul. 73–301, 1973–2 C.B. 215, the IRS addressed whether unrestricted progress payments received by a partnership reporting its income under the CCM constitute a partnership liability under section 752. In that revenue ruling, the partnership performed all of the services required to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. The IRS ruled that the progress payments described in the ruling did not constitute a liability within the meaning of section 752. See also Rev. Rul. 81–241, 1981–2 C.B. 146, (citing and following Rev. Rul. 73–301). Treasury and the IRS request comments regarding whether there are circumstances under which the receipt of progress payments under a contract accounted for under a long-term contract method of accounting could give rise to a liability under section 752, and, if so, how the regulations would need to be revised to account for such liabilities.

Proposed Effective Date

As indicated in Notice 2002–37, the regulations are proposed to apply to contributions, transfers, and distributions that occur on or after May 15, 2002.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. Treasury and the IRS request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Matthew Lay and Richard Probst of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of Treasury and the IRS participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.460–0 is amended as follows:

1. Revising the entry for paragraph 1.460–4(k)(2)(iv).

2. Adding entries for §1.460–4(k)(2)(iv)(A) through (E).

3. Revising the entry for §1.460–4(k)(3)(iv).

4. Revising the entry for §1.460–4(k)(3)(iv)(A)(*2*) and adding an entry for § 1.460–4(k)(3)(iv)(C).

5. Revising the entry for §1.460–4(k)(3)(v).

6. Adding entries for §1.460–4(k)(3)(v)(A) through (D).

7. Adding entries for §1.460–6(g)(3)(ii)(D)(*1*) and (*2*).

The revisions and additions read as follows:

§1.460–0 Outline of regulations under section 460.

* * * * *

§1.460–4 Methods of accounting for long-term contracts.

* * * * *

(k) * * *

(2) * * *

(iv) Special rules relating to distributions of certain contracts by a partnership.

(A) In general.

(B) Old taxpayer.

(C) New taxpayer.

(D) Basis rules.

(E) Section 751.

(*1*) In general.

(*2*) Ordering rules.

(3) * * *

(iv) Special rules related to certain corporate and partnership transactions.

(A) * * *

(*2*) Basis adjustment in excess of stock or partnership interest basis.

* * * * *

(C) Definition of old taxpayer and new taxpayer for certain partnership transactions.

(v) Special rules relating to certain partnership transactions.

(A) Section 704(c).

(*1*) Contributions of contracts.

(*2*) Revaluations of partnership property.

(*3*) Allocation methods.

(B) Basis adjustments under sections 743(b) and 734(b).

(C) Cross reference.

(D) Exceptions to step-in-the-shoes rules.

* * * * *

§1.460–6 Look-back method.

* * * * *

(g) * * *

(3) * * *

(ii)* * *

(D) * * *

(*1*) In general.

(*2*) Special rules for certain pass-through entity transactions.

* * * * *

Par. 3. Section 1.460–4 is amended as follows:

1. Revising the sixth sentence in paragraph (k)(1).

2. Revising paragraph (k)(2)(iv).

3. Removing the first word "The" in paragraph (k)(3)(i), adding in its place "Except as otherwise provided in paragraph (k)(3)(v)(D) of this section, the".

4. Revising paragraph (k)(3)(i)(I).

5. Redesignating paragraphs (k)(3)(i)(J), (K) and (L) as paragraphs (k)(3)(i)(K), (L) and (M), respectively.

6. Adding a new paragraph (k)(3)(i)(J).

7. Revising paragraph (k)(3)(iv).

8. Adding text to paragraph (k)(3)(v).

9. Adding to paragraph (k)(5) *Example 9* through *Example 13*.

The additions and revisions read as follows.

§1.460–4 Methods of accounting for long-term contracts.

* * * * *

(k) * * *

(1) * * * Special rules relating to the treatment of certain partnership transactions are provided in paragraphs (k)(2)(iv) and (k)(3)(v) of this section. * * *

(2) * * *

(iv) *Special rules relating to distributions of certain contracts by a partnership* — (A) *In general*. The constructive completion rules of paragraph (k)(2) of this section apply to the distribution of a contract accounted for under a long-term contract method of accounting by a partnership to a partner. The constructive completion rules of paragraph (k)(2) of this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership, under §1.708–1(b)(4) (relating to terminations under section 708(b)(1)(B)) or §1.708–1(c)(3)(i) (relating to certain partnership mergers).

(B) *Old taxpayer*. The partnership that distributes the contract is treated as the old taxpayer for purposes of paragraph (k)(2)(ii) of this section. For purposes of determining the total contract price (or gross contract price) under paragraph (k)(2)(ii) of this section, the fair market value of the contract is treated as the amount realized from the transaction. For purposes of determining each partner's distributive share of partnership items, any income or loss resulting from the constructive completion must be allocated among the partners of the old taxpayer as though the partnership closed its books on the date of the distribution.

(C) *New taxpayer*. The partner receiving the distributed contract is treated as the new taxpayer for purposes of paragraph (k)(2)(iii) of this section. For purposes of determining the total contract price (or gross contract price) under paragraph (k)(2)(iii) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) after the distribution (as determined under section 732) is treated as consideration paid by the new taxpayer that is allocable to the contract. Thus, the total contract price (or gross contract price) of the new contract is reduced by the partner's basis in the contract (including the uncompleted property, if applicable) immediately after the distribution.

(D) *Basis rules*. For purposes of determining the new taxpayer's basis in the contract (including the uncompleted property, if applicable) under section 732, and the amount of any basis adjustment under section 734(b), the partnership's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to—

(*1*) The partnership's allocable contract costs (including transaction costs);

(*2*) Increased (or decreased) by the amount of cumulative taxable income (or loss) recognized by the partnership on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion); and

(*3*) Decreased by the amounts that the partnership has received or reasonably expects to receive under the contract.

(E) *Section 751 — (1) In general*. Contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of section 751(c). For purposes of section 751, the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting is the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if the contract were disposed of for its fair market value in a constructive completion transaction, adjusted to account for any income or loss from the contract that is allocated under section 706 to that portion of the taxable year of the partnership ending on the date of the distribution, sale, or exchange.

(*2*) *Ordering rules*. Because the distribution of a contract accounted for under a long-term contract method of accounting is the distribution of an unrealized receivable, section 751(b) may apply to the distribution. A partnership that distributes a contract accounted for under a long-term contract method of accounting must apply paragraph (k)(2)(ii) of this section before applying the rules of section 751(b) to the distribution.

* * * * *

(3) * * *

(i) * * *

(I) Contributions of contracts accounted for under a long-term contract method of accounting to which section 721(a) applies;

(J) Contributions of property (other than contracts accounted for under a long-term contract method of accounting) to a partnership that holds a contract accounted for under a long-term contract method of accounting;

* * * * *

(iv) *Special rules related to certain corporate and partnership transactions* — (A) *Old taxpayer — basis adjustment* — (*1*) *In general*. Except as provided in paragraph (k)(3)(iv)(A)(*2*) of this section, in the case of a transaction described in paragraph (k)(3)(i)(D), (E), or (I) of this section, the old taxpayer must adjust its basis in the stock or partnership interest of the new taxpayer by —

(*i*) Increasing such basis by the amount of gross receipts the old taxpayer has recognized under the contract; and

(*ii*) Reducing such basis by the amount of gross receipts the old taxpayer has received or reasonably expects to receive under the contract.

(*2*) *Basis adjustment in excess of stock or partnership interest basis*. If the old and new taxpayer do not join in the filing of a consolidated federal income tax return, the old taxpayer may not adjust its basis in the stock or partnership interest of the new taxpayer under paragraph (k)(3)(iv)(A)(*1*) of this section below zero and the old taxpayer must recognize ordinary income to the extent the basis in the stock or partnership interest of the new taxpayer otherwise would be adjusted below zero. If the old and new taxpayer join in the filing of a consolidated federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero under paragraph (k)(3)(iv)(A)(*1*) of this section. See §§1.1502–19 and 1.1502–32(a)(3)(ii).

(*3*) *Subsequent dispositions of certain contracts*. If the old taxpayer disposes of a contract in a transaction described in paragraph (k)(3)(i)(D), (E), or (I) of this section that the old taxpayer acquired in a transaction described in paragraph (k)(3)(i)(D), (E), or (I) of this section, the basis adjustment rule of this paragraph (k)(3)(iv)(A) is applied by treating the old taxpayer as having recognized the amount of gross receipts recognized by the previous old taxpayer under the contract and any amount recognized by the previous old taxpayer with respect to the contract in connection with the transaction in which the old taxpayer acquired the contract. In addition, the old taxpayer is treated as having received or as reasonably expecting to receive under the contract any amount the previous old taxpayer received or reasonably expects to receive under the contract. Similar principles will apply in the case of multiple successive transfers described in paragraph (k)(3)(i)(D), (E), or (I) of this section involving the contract.

(B) *New Taxpayer* — (*1*) *Contract price adjustment*. Generally, payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction do not affect the contract price. Notwithstanding the preceding sentence and paragraph (k)(3)(iii)(B) of this section, however, in the case of transactions described in paragraph (k)(3)(i)(B), (D), (E), or (I) of this section, the total contract price (or gross contract price) must be reduced to the extent of any amount recognized by the old taxpayer with respect to the contract in connection with the transaction (*e.g.*, any amount recognized under section 351(b) or section 357 that is attributable to the contract and any income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A) of this section).

(*2*) *Basis in contract*. The new taxpayer's basis in a contract (including the uncompleted property, if applicable) acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) or paragraph (k)(3)(i)(I) of this section will be computed under section 362, section 334, or section 723, as applicable. Upon a new taxpayer's completion (actual or constructive) of a CCM or a PCM contract acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) or paragraph (k)(3)(i)(I) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) is reduced to zero. The new taxpayer is not entitled to a deduction or loss in connection with any basis reduction pursuant to this paragraph (k)(3)(iv)(B)(*2*).

(C) *Definition of old taxpayer and new taxpayer for certain partnership transactions*. For purposes of paragraphs (k)(3)(ii), (iii) and (iv) of this section, in the case of a transaction described in paragraph (k)(3)(i)(I) of this section, the partner contributing the contract to the partnership is treated as the old taxpayer, and the partnership receiving the contract from the partner is treated as the new taxpayer.

(v) *Special rules relating to certain partnership transactions* — (A) *Section 704(c)* — (*1*) *Contributions of contracts*. The principles of section 704(c) and §1.704–3 apply to income or loss with respect to a contract accounted for under a long-term contract method of accounting that is contributed to a partnership. The amount of built-in income or built-in loss attributable to a contributed contract that is subject to section 704(c) is determined as follows. First, the contributing partner must take into account any income or loss required under paragraph (k)(3)(ii)(A) of this section for the period ending on the date of the contribution. Second, the partnership must determine the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. Finally, this amount is reduced by the amount of income, if any, that the contributing partner is required to recognize as a result of the contribution.

(*2*) *Revaluations of partnership property*. The principles of sections 704(c) and 1.704–3 apply to allocations of income or loss with respect to a long-term contract that is revalued by a partnership under §1.704–1(b)(2)(iv)(*f*). The amount of built-in income or built-in loss attributable

to such a contract is equal to the amount of income or loss that would be taken into account if, immediately before the revaluation, the contract were disposed of for its fair market value in a constructive completion transaction.

(*3*) *Allocation methods*. In the case of a contract accounted for under the CCM, any built-in income or loss under section 704(c) is taken into account in the year the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, any built-in income or loss under section 704(c) must be taken into account in a manner that reasonably accounts for the section 704(c) income or loss over the remaining term of the contract.

(B) *Basis adjustments under sections 743(b) and 734(b)*. For purposes of §§1.743–1(d), 1.755–1(b), and 1.755–1(c), the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting is the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if, at the time of the sale of a partnership interest or the distribution to a partner, the partnership disposed of the contract for its fair market value in a constructive completion transaction. If all or part of the transferee's basis adjustment under section 743(b) or the partnership's basis adjustment under section 734(b) is allocated to a contract accounted for under a long-term contract method of accounting, the basis adjustment shall reduce or increase, as the case may be, the affected party's income or loss from the contract. In the case of a contract accounted for under the CCM, the basis adjustment is taken into account in the year in which the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, the portion of that basis adjustment that is recovered in each taxable year of the partnership must be determined by the partnership in a manner that reasonably accounts for the adjustment over the remaining term of the contract.

(C) *Cross reference*. See paragraph (k)(2)(iv)(E) of this section for rules relating to the application of section 751 to the transfer of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting.

(D) *Exceptions to step-in-the-shoes rules*. Upon a contribution described in paragraph (k)(3)(i)(J) of this section, a transfer described in paragraph (k)(3)(i)(K) of this section, or a distribution described in paragraph (k)(3)(i)(L) of this section, paragraphs (k)(3)(ii) and (iii) of this section apply to a contract accounted for under a long-term contract method of accounting only if the partnership's books are properly closed with respect to that contract under section 706. In these cases, the partnership is treated as both the old taxpayer and the new taxpayer for purposes of paragraphs (k)(3)(ii) and (iii) of this section. In all other cases involving these transactions, the partnership shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transaction as though no change in taxpayer had occurred with respect to the contract, and must allocate the income or loss from the contract for that period under a reasonable method complying with section 706.

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(5) * * *

Example 9. Constructive completion — PCM — distribution of contract by partnership — (i) *Facts*. In Year 1, W, X, Y, and Z each contribute $100,000 to form equal partnership PRS. In Year 1, PRS enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, PRS incurs costs of $600,000 and receives $650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, PRS distributes the contract to X in liquidation of X's interest. PRS incurs no costs and receives no progress payments in Year 2 prior to the distribution. At the time of the distribution, PRS's only asset other than the long-term contract and the partially constructed property is $450,000 cash ($400,000 initially contributed and $50,000 in excess progress payments). The fair market value of the contract is $150,000. Pursuant to the distribution, X assumes PRS's contract obligations and rights. In Year 2, X incurs additional allocable contract costs of $50,000. X correctly estimates at the end of Year 2 that X will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract (rather than $150,000 as originally estimated by PRS). Assume that X properly accounts for the contract under the PCM, that PRS has no income or loss other than income or loss from the contract, and that PRS has an election under section 754 in effect in Year 2.

(ii) *Tax consequences to PRS*. For Year 1, PRS reports receipts of $750,000 (the completion factor multiplied by total contract price ($600,000/$800,000 x $1,000,000)) and costs of $600,000, for a profit of $150,000, which is allocated equally among W, X, Y, and Z ($37,500 each). Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract ($150,000) is treated as the amount realized from the transaction. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount treated as realized from the transaction ($650,000 + $150,000)) and the total allocable contract costs are $600,000. Thus, in Year 2 PRS reports receipts of $50,000 (total contract price minus receipts already reported ($800,000 - $750,000)), and costs incurred in year 2 of $0, for a profit of $50,000. Under paragraph (k)(2)(iv)(B) of this section, this profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is $12,500.

(iii) *Tax consequences to X*. X's basis in its interest in PRS immediately prior to the distribution is $150,000 (X's $100,000 initial contribution, increased by $37,500, X's distributive share of Year 1 income, and $12,500, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to $150,000 (the partnership's allocable contract costs, $600,000, increased by the amount of income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), $200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, $650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is $150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract (including the uncompleted property) is treated as consideration paid by X that is allocable to the contract. X's total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract ($350,000 - $150,000)). For Year 2, X reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) x $200,000]) and costs of $50,000 (the costs incurred after the distribution of the contract), for a profit of $30,000. For Year 3, X reports receipts of $120,000 (the total contract price minus receipts already reported ($200,000 - $80,000)) and costs of $75,000, for a profit of $45,000.

(iv) *Section 734(b)*. Because X's basis in the contract (including the uncompleted property) immediately after the distribution, $150,000, is equal to PRS's basis in the contract (including the uncompleted property) immediately prior to the distribution, a basis adjustment under section 734(b) is not required.

Example 10. Constructive completion — CCM — distribution of contract by partnership — (i) *Facts*. The facts are the same as in *Example 9*, except that

PRS and X properly account for the contract under the CCM.

(ii) *Tax consequences to PRS*. PRS reports no income or costs from the contract in Year 1. Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract ($150,000) is treated as the amount realized from the transaction. For purposes of applying the CCM in Year 2, the gross contract price is $800,000 (the sum of the amounts received under the contract and the amount treated as realized from the transaction ($650,000 + $150,000)) and the total allocable contract costs are $600,000. Thus, in Year 2 PRS reports profits of $200,000 ($800,000 - $600,000). This profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is $50,000.

(iii) *Tax consequences to X*. X's basis in its interest in PRS immediately prior to the distribution is $150,000 ($100,000 initial contribution, increased by $50,000, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to $150,000 (the partnership's allocable contract costs, $600,000, increased by the amount of cumulative taxable income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), $200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, $650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is $150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract is treated as consideration paid by X that is allocable to the contract. Under the CCM, X reports no gross receipts or costs in Year 2. For Year 3, the completion year, X reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract ($350,000 - $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that X incurred to complete the contract ($50,000 + $75,000)), for a profit of $75,000.

(iv) *Section 734(b)*. The results under section 734(b) are the same as in *Example 9*.

Example 11. Step-in-the-shoes — PCM — contribution of contract to partnership — (i) *Facts*. In Year 1, X enters into a contract that X properly accounts for under the PCM. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $600,000 and receives $650,000 in progress payments under the contract. Under the contract, X performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. In Year 2, X contributes the contract (including the uncompleted property) with a basis of $0 and $125,000 of cash to partnership PRS in exchange for a one-fourth partnership interest. X incurs costs of $10,000, and receives no progress payments in Year 2 prior to the contribution of the contract. X and the other three partners of PRS share equally in its capital, profits, and losses. The parties determine that, at the time of the contribution, the fair market value of the contract is $160,000. Following the contribution in Year 2, PRS incurs additional allocable contract costs of $40,000. PRS correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract (rather than $150,000 as originally estimated by PRS).

(ii) *Tax consequences to X*. For Year 1, X reports receipts of $750,000 (the completion factor multiplied by the total contract price ($600,000/$800,000 x $1,000,000)) and costs of $600,000, for a profit of $150,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i)(I) of this section, X is not treated as completing the contract in Year 2. Under paragraph (k)(3)(ii)(A) of this section, for Year 2, X reports receipts of $12,500 (the completion factor multiplied by the total contract price ($610,000/$800,000 x $1,000,000), $762,500, decreased by receipts already reported, $750,000) and costs of $10,000, for a profit of $2,500. Under section 722, X's initial basis in its interest in PRS is $125,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in its interest in PRS by the amount of gross receipts X recognized under the contract, $762,500, and reduce its basis by the amount of gross receipts X received under the contract, the $650,000 in progress payments. Accordingly, X's basis in its interest in PRS is $237,500.

(iii) *Tax consequences to PRS*. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, PRS must account for the contract using the same methods of accounting used by X prior to the transaction. The total contract price is the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and PRS. For Year 2, PRS reports receipts of $134,052 (the completion factor multiplied by the total contract price [($650,000/$725,000) x $1,000,000], $896,552, decreased by receipts reported by X, $762,500) and costs of $40,000, for a profit of $94,052. For Year 3, PRS reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 - $896,552)) and costs of $75,000, for a profit of $28,448.

(iv) *Section 704(c)*. The principles of section 704(c) and §1.704–3 apply to allocations of income or loss with respect to the contract contributed by X. In this case, the amount of built-in income that is subject to section 704(c) is the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. In a constructive completion transaction, the total contract price would be $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)). X would report receipts of $47,500 (total contract price minus receipts already reported ($810,000 - $762,500)) and costs of $0, for a profit of $47,500. Thus, the amount of built-in income that is subject to section 704(c) is $47,500. The partnership must apply section 704(c) to this income in a manner that reasonably accounts for the income over the remaining term of the contract. For example, in Year 2, PRS could allocate $26,810 to X under section 704(c) (the amount of built-in income, $47,500, multiplied by a fraction, the numerator of which is the completion factor for the year, $650,000/725,000, less the completion factor for the prior year, $610,000/$800,000, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the event creating the section 704(c) income or loss, $610,000/$800,000). The remaining $67,242 would be allocated equally among all of the partners. In Year 3, the completion year, PRS could allocate $20,690 to X under section 704(c) ($47,500 x [($725,000/$725,000 - $650,000/$725,000) / (100 percent - $610,000/$800,000)]). The remaining $7,758 would be allocated equally among all the partners.

Example 12. Step-in-the-shoes — CCM — contribution of contract to partnership — (i) *Facts*. The facts are the same as in *Example 11*, except that X and PRS properly account for the contract under the CCM, and X has a basis of $610,000 in the contract (including the uncompleted property).

(ii) *Tax consequences to X*. X reports no income or costs from the contract in Years 1 or 2. X is not treated as completing the contract in Year 2. Under section 722, X's initial basis in its interest in PRS is $735,000 (the sum of $125,000 cash and X's basis of $610,000 in the contract (including the uncompleted property)). Pursuant to paragraph (k)(3)(iv)(A)(*1*)(*ii*) of this section, X must reduce its basis in its interest in PRS by the amount of gross receipts X received under the contract, or $650,000. Accordingly, X's basis in its interest in PRS is $85,000.

(iii) *Tax consequences to PRS*. PRS must account for the contract using the same methods of accounting used by X prior to the transaction. Under the CCM, PRS reports no gross receipts or costs in Year 2. For Year 3, the completion year, PRS reports its gross contract price of $1,000,000 (the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract), and total allocable contract costs of $725,000 (the allocable contract costs of X and PRS), for a profit of $275,000.

(iv) *Section 704(c)*. In this case, the amount of built-in income that is subject to section 704(c) is the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. In a constructive completion transaction, X would report its gross contract price of $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)) and its total allocable contract costs of $610,000, for a profit of $200,000. Thus, the amount of built-in income that is subject to section 704(c) is $200,000. Out of PRS's income of $275,000, in Year 3, $200,000 must be allocated to X under section 704(c), and the remaining $75,000 is allocated equally among all of the partners.

Example 13. Step-in-the-shoes — PCM — transfer of a partnership interest — (i) *Facts*. In Year 1, W, X, Y, and Z each contribute $100,000 to form equal

partnership PRS. In Year 1, PRS enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, PRS incurs costs of $600,000 and receives $650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payment or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, W transfers W's interest in PRS to T for $150,000. Assume that $10,000 of PRS's Year 2 costs are incurred prior to the transfer, $40,000 are incurred after the transfer; and that PRS receives no progress payments in Year 2. Also assume that the fair market value of the contract on the date of the transfer is $160,000, that PRS closes its books with respect to the contract under section 706 on the date of the transfer, and that PRS correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract (rather than $150,000 as originally estimated by PRS).

(ii) *Income reporting for period ending on date of transfer*. For Year 1, PRS reports receipts of $750,000 (the completion factor multiplied by total contract price ($600,000/$800,000 x $1,000,000)) and costs of $600,000, for a profit of $150,000. This profit is allocated equally among W, X, Y, and Z ($37,500 each). Under paragraph (k)(3)(ii)(A) of this section, for the part of Year 2 ending on the date of the transfer of W's interest, PRS reports receipts of $12,500 (the completion factor multiplied by the total contract price ($610,000/$800,000 x $1,000,000) minus receipts already reported ($750,000)) and costs of $10,000 for a profit of $2,500. This profit is allocated equally among W, X, Y, and Z ($625 each).

(iii) *Income reporting for period after transfer*. PRS must continue to use the PCM. For the part of Year 2 beginning on the day after the transfer, PRS reports receipts of $134,052 (the completion factor multiplied by the total contract price decreased by receipts reported by PRS for the period ending on the date of the transfer [($650,000/$725,000 x $1,000,000) - $762,500]) and costs of $40,000, for a profit of $94,052. This profit is shared equally among T, X, Y, and Z ($23,513 each). For Year 3, PRS reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 - $896,552)) and costs of $75,000, for a profit of $28,448. The profit for Year 3 is shared equally among T, X, Y, and Z ($7,112 each).

(iv) *Tax Consequences to W*. W's amount realized is $150,000. W's adjusted basis in its interest in PRS is $138,125 ($100,000 originally contributed, plus $37,500, W's distributive share of PRS's Year 1 income, and $625, W's distributive share of PRS's Year 2 income prior to the transfer). Accordingly, W's income from the sale of W's interest in PRS is $11,875. Under paragraph (k)(2)(iv)(E) of this section, for purposes of section 751(a), the amount of ordinary income attributable to the contract is determined as follows. First, the partnership must determine the amount of income or loss from the contract that is allocated under section 706 to the period ending on the date of the sale ($625). Second, the partnership must determine the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if the contract were disposed of for its fair market value in a constructive completion transaction. Because PRS closed its books under section 706 with respect to the contract on the date of the sale, this calculation is treated as occurring immediately after the partnership has applied paragraph (k)(3)(ii)(A) of this section on the date of the sale. In a constructive completion transaction, the total contract price would be $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)). PRS would report receipts of $47,500 (total contract price minus receipts already reported ($810,000 - $762,500)) and costs of $0, for a profit of $47,500. Thus, the amount of ordinary income attributable to the contract is $47,500, and W's share of that income is $11,875. Thus, under §1.751–1(a), all of W's $11,875 of income from the sale of W's interest in PRS is ordinary income.

(v) *Tax Consequences to T*. T's adjusted basis for its interest in PRS is $150,000. Under §1.743–1(d)(2), the amount of income that would be allocated to T if the contract were disposed of for its fair market value (adjusted to account for income from the contract for the portion of PRS's taxable year that ends on the date of the transfer) is $11,875. Under §1.743–1(b), the amount of T's basis adjustment under section 743(b) is $11,875. Under paragraph (k)(3)(v)(B) of this section, the portion of T's basis adjustment that is recovered in Year 2 and Year 3 must be determined by PRS in a manner that reasonably accounts for the adjustment over the remaining term of the contract. For example, PRS could recover $6,703 of the adjustment in Year 2 (the amount of the basis adjustment, $11,875, multiplied by a fraction, the numerator of which is the excess of the completion factor for the year, $650,000/$725,000, less the completion factor for the prior year, $610,000/$800,000, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the transfer, $610,000/$800,000). T's distributive share of income in Year 2 from the contract would be adjusted from $23,513 to $16,810 as a result of the basis adjustment. In Year 3, the completion year, PRS could recover $5,172 of the adjustment ($11,875 x [($725,000/$725,000 - $650,000/$725,000) / (100 percent - $610,000/$800,000)]). T's distributive share of income in Year 3, the completion year, from the contract would be adjusted from $7,112 to $1,940 as a result of the basis adjustment.

* * * * *

Par. 4. Section 1.460–6 is amended as follows:

1. Paragraph (g)(3)(ii)(D) is revised.

2. Paragraph (g)(4) is revised.

The revisions read as follows:

§1.460–6 Look-back method.

* * * * *

(g) * * *

(3) * * *

(ii) * * *

(D) *Information old taxpayer must provide* — (1) *In general*. Except as provided in paragraph (g)(3)(ii)(D)(*2*) of this section, in order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that accounted for income from a long-term contract under the PCM or PCCM for either regular or alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the first taxable year ending on or after a step-in-the-shoes transaction described in §1.460–4(k)(3)(i). The required information is as follows -

(*i*) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (*i.e.*, whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

(*ii*) Any submethods used in the application of PCM (*e.g.*, the simplified cost-to-cost method or the 10-percent method);

(*iii*) The amount of total contract price reported by year;

(*iv*) The numerator and the denominator of the completion factor by year;

(*v*) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

(*vi*) Whether the old taxpayer was a corporate or a noncorporate taxpayer by year; and

(*vii*) Any other information required by the Commissioner by administrative pronouncement.

(*2*) *Special rules for certain pass-through entity transactions*. For purposes of paragraph (g)(3)(ii)(D)(*1*) of this section, in the case of a transaction described in §1.460–4(k)(3)(i)(I), the contributing partner is treated as the old taxpayer, and the partnership is treated as the new taxpayer. In the case of transactions described in §§1.460–4(k)(3)(i)(F), (G), (J), (K), or (L), the old taxpayer is not required to provide the information described in paragraph (g)(3)(ii)(D)(*1*) of this section, because information necessary for the new taxpayer to apply the look-back method is provided by the pass-through entity. This paragraph (g)(3)(ii)(D) is applicable for transactions on or after August 6, 2003.

* * * * *

(4) *Effective date*. Except as provided in paragraph (g)(3)(ii)(D) of this section, this paragraph (g) is applicable for transactions on or after May 15, 2002.

* * * * *

Par. 5. In §1.704–3, a sentence is added at the end of paragraph (a)(3)(ii) to read as follows:

§1.704–3 Contributed property.

(a) * * *

(3) * * *

(ii) * * * See §1.460–4(k)(3)(v)(A) for a rule relating to the amount of built-in income or built-in loss attributable to a contract accounted for under a long-term contract method of accounting.

* * * * *

Par. 6. Section 1.722–1 is amended by adding a new sentence between the sixth and seventh sentences to read as follows:

§1.722–1 Basis of contributing partner's interest.

* * *See §1.460–4(k)(3)(iv)(A) for rules relating to basis adjustments required where a contract accounted for under a long-term contract method of accounting is transferred in a contribution to which section 721(a) applies.

* * * * *

Par. 7. A sentence is added at the end of §1.723–1 to read as follows:

§1.723–1 Basis of property contributed to partnership.

* * * See §1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of contracts accounted for using a long-term contract method of accounting that are acquired in certain contributions to which section 721(a) applies.

Par. 8. In §1.732–1, a sentence is added at the end of paragraph (c)(1)(i) to read as follows:

§1.732–1 Basis of distributed property other than money.

* * * * *

(c) * * *

(1) * * *

(i) * * * See §1.460–4(k)(2)(iv)(D) for a rule determining the partnership's basis in a long-term contract accounted for under a long-term contract method of accounting.

* * * * *

Par. 9. In §1.734–1, the undesignated paragraph immediately following paragraph (b)(1)(ii) is revised to read as follows:

§1.734–1 Optional adjustment to basis of undistributed partnership property.

* * * * *

(b) * * *

(1) * * *

(ii) * * *

See §1.460–4(k)(2)(iv)(D) for a rule determining the partnership's basis in a long-term contract accounted for under a long-term contract method of accounting. The provisions of this paragraph (b)(1) are illustrated by the following examples:

* * * * *

Par. 10. Section 1.743–1 is amended as follows:

1. A sentence is added at the end of paragraph (d)(2).

2. A sentence is added at the end of paragraph (j)(2).

The additions read as follows:

§1.743–1 Optional adjustment to basis of partnership property.

* * * * *

(d) * * *

(2) * * * See §1.460–4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

* * * * *

(j) * * *

(2) * * * See §1.460–4(k)(3)(v)(B) for rules relating to the effect of a basis adjustment under section 743(b) that is allocated to a contract accounted for under a long-term contract method of accounting in determining the transferee's distributive share of income or loss from the contract.

* * * * *

Par. 11. In §1.751–1, a sentence is added at the end of paragraph (a)(2) to read as follows:

§1.751–1 Unrealized receivables and inventory items.

(a) * * *

(2) * * * See §1.460–4(k)(2)(iv)(E) for rules relating to the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting.

* * * * *

Par. 12. Section 1.755–1 is amended as follows.

1. Adding a sentence at the end of paragraph (b)(1)(ii).

2. Paragraph (c)(5) is redesignated as paragraph (c)(6).

3. New paragraph (c)(5) is added.

The additions read as follows:

§1.755–1 Rules for allocation of basis.

* * * * *

(b) * * *

(1) * * *

(ii) * * * See §1.460–4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

* * *

(c) * * *

(5) *Cross reference*. See §1.460–4(k)(3)(v)(B) for a rule relating to the computation of unrealized appreciation or depreciation in a contract accounted for under a long-term contract method of accounting.

* * * * *

Dale F. Hart,
Acting Deputy Commissioner for Services and Enforcement.

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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 laws 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 a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—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.—Statement 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.
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79-410
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79-424
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80-78
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

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80-79
Obsoleted by
Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

80-101
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

80-167
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

80-170
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

80-358
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

81-190
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

81-225
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Rev. Rul. 2003-92, 2003-33 I.R.B. *350*

81-247
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

82-164
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

82-226
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

83-101
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

83-119
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

84-28
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

84-30
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

85-55
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

85-136
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

86-52
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Rev. Rul. 2003-99, 2003-34 I.R.B. *388*

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87-1
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88-7
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89-72
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2003-58
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