

## **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.

### **SPECIAL ANNOUNCEMENT**

#### **Announcement 2003-61, page 890.**

This announcement clarifies certain changes to the September 2003 revision of Publication 1220, *Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically or Magnetically*.

### **INCOME TAX**

#### **Rev. Rul. 2003-109, page 839.**

**Disallowance of convention expenses; North American geographical area.** All geographical areas included in the North American area for purposes of section 274 of the Code are listed. Rev. Ruls. 87-95 and 94-56 superseded.

#### **T.D. 9088, page 841.**

Final regulations under section 482 of the Code clarify that stock-based compensation is taken into account in determining the intangible development costs of a controlled participant in a qualified cost sharing arrangement. The regulations also provide rules for measuring the cost associated with stock-based compensation; clarify that stock-based compensation is appropriately taken into account as a comparability factor for purposes of the comparable profits method; and provide rules that coordinate the cost sharing rules with the arm's length standard.

#### **REG-106486-98, page 853.**

Proposed regulations under section 1275 of the Code provide for the treatment of contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a currency other than the taxpayer's

functional currency. The regulations generally provide that taxpayers should apply the existing rules to nonfunctional currency contingent payment debt instruments in the currency in which the debt instrument is denominated, and should then translate those amounts into the taxpayers' functional currency using the rules provided. In addition, a rule is provided to determine the currency in which the calculations should be made in the case of a multi-currency debt instrument. A public hearing is scheduled for December 3, 2003.

#### **REG-108524-00, page 869.**

Proposed regulations under section 1446 of the Code provide guidance with respect to the withholding tax liability of a partnership with income that is effectively connected with its United States trade or business, all or a portion of which is allocable under section 704 to foreign partners. Rev. Procs. 89-31 and 92-66 obsolete.

#### **Notice 2003-69, page 851.**

Section 1(h) of the Code was amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003 to provide that certain dividends paid to an individual shareholder from either a domestic corporation or a "qualified foreign corporation" are subject to tax at the reduced rates applicable to certain capital gains. The term "qualified foreign corporation" is defined to include certain foreign corporations that are eligible for benefits of a comprehensive income tax treaty with the United States, which the Secretary determines is satisfactory for purposes of this provision and which includes an exchange of information program. This notice provides a current list of U.S. income tax treaties that meet the requirements of section 1(h)(11)(C)(i)(II).

(Continued on the next page)

Actions Relating to Court Decisions is on the page following the Introduction.  
Finding Lists begin on page ii.



## EMPLOYEE PLANS

**Notice 2003-61, page 851.**

**Weighted average interest rate update.** The weighted average interest rate for October 2003 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

# 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.

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

## Actions Relating to Decisions of the Tax Court

It is the policy of the Internal Revenue Service to announce at an early date whether it will follow the holdings in certain cases. An Action on Decision is the document making such an announcement. An Action on Decision will be issued at the discretion of the Service only on unappealed issues decided adverse to the government. Generally, an Action on Decision is issued where its guidance would be helpful to Service personnel working with the same or similar issues. Unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent.

Actions on Decisions shall be relied upon within the Service only as conclusions applying the law to the facts in the particular case at the time the Action on Decision was issued. Caution should be exercised in extending the recommendation of the Action on Decision to similar cases where the facts are different. Moreover, the recommendation in the Action on Decision may be superseded by new legislation, regulations, rulings, cases, or Actions on Decisions.

Prior to 1991, the Service published acquiescence or nonacquiescence only in certain regular Tax Court opinions. The

Service has expanded its acquiescence program to include other civil tax cases where guidance is determined to be helpful. Accordingly, the Service now may acquiesce or nonacquiesce in the holdings of memorandum Tax Court opinions, as well as those of the United States District Courts, Claims Court, and Circuit Courts of Appeal. Regardless of the court deciding the case, the recommendation of any Action on Decision will be published in the Internal Revenue Bulletin.

The recommendation in every Action on Decision will be summarized as acquiescence, acquiescence in result only, or nonacquiescence. Both “acquiescence” and “acquiescence in result only” mean that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. However, “acquiescence” indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions; whereas, “acquiescence in result only” indicates disagreement or concern with some or all of those reasons. “Nonacquiescence” signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In

reference to an opinion of a circuit court of appeals, a “nonacquiescence” indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.

The Actions on Decisions published in the weekly Internal Revenue Bulletin are consolidated semiannually and appear in the first Bulletin for July and the Cumulative Bulletin for the first half of the year. A semiannual consolidation also appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

The Commissioner does NOT ACQUIESCE in the following decision:

**Michael and Nancy B. McNamara v. Commissioner<sup>1</sup>**

236 F.3d 410 (8th Cir. 2000), rem’g  
McNamara v. Commissioner,  
T.C. Memo 1999-333;  
Hennen v. Commissioner,  
T.C. Memo 1999-306;  
Bot v. Commissioner,  
T.C. Memo 1999-256  
T.C. Dkt. Nos. 7537-98 (McNamara);  
7535-98 (Hennen), 7970-98 (Bot)

<sup>1</sup> Nonacquiescence relating to whether farm rental income is includible in self-employment income if the lessor materially participates in farm production, but the lease agreement itself does not require the lessor to materially participate.

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

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

26 CFR 1.274-1: *Disallowance of Certain Entertainment, etc., Expenses.*

**Disallowance of convention expenses; North American geographical area.** All geographical areas included in the North American area for purposes of section 274 of the Code are listed. Rev. Ruls. 87-95 and 94-56 superseded.

### Rev. Rul. 2003-109

#### ISSUE

Section 274(h) of the Internal Revenue Code limits deductions for expenses incurred in connection with a convention, seminar, or similar meeting held outside the “North American area.” This revenue ruling contains an updated list of all geographical areas currently included in the North American area for purposes of this section.

#### LAW AND ANALYSIS

Section 274(h) disallows deductions under section 162 for expenses allocable to attendance of an individual at a convention, seminar, or similar meeting (a “convention”) held outside the “North American area.” However, the disallowance does not apply if the taxpayer can demonstrate that the convention’s location satisfies specified standards of reasonableness.

Geographical areas are included in the “North American area” for purposes of section 274(h) under one of four provisions.

#### *Section 274(h)(3)(A)*

Section 274(h)(3)(A) defines the term “North American area” as the United States, its possessions, the Trust Territory of the Pacific Islands, Canada, and Mexico. The United States consists of the fifty states of the United States and the District of Columbia. The possessions of the United States, for this purpose, are American Samoa, Baker Island, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana

Islands, Guam, Howland Island, Jarvis Island, Johnston Island, Kingman Reef, the Midway Islands, Palmyra, the United States Virgin Islands, Wake Island, and other United States islands, cays, and reefs not part of the fifty states or the District of Columbia. The jurisdictions that formerly constituted the Trust Territory of the Pacific Islands — the Republic of the Marshall Islands, the Federated States of Micronesia, and the Republic of Palau — are now covered by the compacts with the United States described below.

#### *The Compact of Free Association Act of 1985*

The Compact of Free Association Act of 1985, Pub. L. No. 99-239, 99 Stat. 1770 (1986) went into effect on October 21, 1986, with respect to the Republic of the Marshall Islands, and on November 3, 1986, with respect to the Federated States of Micronesia. Section 405 of Title IV of the Compact provides that, for purposes of section 274(h)(3)(A) of the Code, the Republic of the Marshall Islands and the Federated States of Micronesia are included in the North American area.

#### *The Compact of Free Association Between the United States and the Republic of Palau*

The Compact of Free Association between the United States and the Republic of Palau, Pub. L. 99-658, 100 Stat. 3672 (1986) went into effect on October 1, 1994. Section 255(d) of Title II of the Compact with Palau provides that, for purposes of section 274(h)(3)(A) of the Code, Palau is included in the North American area.

#### *Section 274(h)(6)*

Section 274(h)(6) provides that the term “North American area” also includes any “beneficiary country” if, as of the time a convention begins, (1) there is in effect an agreement described in section 274(h)(6)(C) providing for the exchange of tax information between the United States and the beneficiary country, and (2) there is not in effect a finding by the Secretary of the Treasury that the tax laws of the beneficiary country discriminate

against conventions held in the United States.

Section 274(h)(6)(B) defines the term, “beneficiary country” as meaning a beneficiary country as defined in section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act, Pub. L. No. 98-67, 97 Stat. 384 (1983), and Bermuda. An agreement described in section 274(h)(6)(C) providing for the exchange of information between the United States and a beneficiary country generally must provide:

for the exchange of such information (not limited to information concerning nationals or residents of the United States or the beneficiary country) as may be necessary or appropriate to carry out and enforce the tax laws of the United States and the beneficiary country (whether criminal or civil proceedings), including information which may otherwise be subject to nondisclosure provisions of the local law of the beneficiary country such as provisions respecting bank secrecy and bearer shares. Section 274(h)(6)(C)(i).

Rul. 94-56, 1994-2 C.B. 37, modifying Rev. Rul. 87-95, 1987-2 C.B. 79, identifies each of the following jurisdictions as a beneficiary country for which there is in effect an agreement with the United States described in section 274(h)(6)(C) and for which there is not in effect a finding by the Secretary of the Treasury that the tax laws of the beneficiary country discriminate against conventions held in the United States: Barbados, Bermuda, Costa Rica, Dominica, Dominican Republic, Grenada, Guyana, Honduras, Jamaica, Saint Lucia, and Trinidad and Tobago. Each of these jurisdictions continues to be considered as part of the North American area under section 274(h)(6) for purposes of claiming deductions for expenses incurred in connection with a convention beginning on or after the date on which the tax information exchange agreement between the jurisdiction and the United States came into effect.

Since the publication of Rev. Rul. 94-56, the “Agreement Between the Government of the United States of America and the Government of Antigua and Barbuda for the Exchange of Information

with Respect to Taxes” has come into effect. This agreement entered into force on February 10, 2003, and came into effect as of that date. *See* Treas. News Release JS-165 (April 8, 2003). Antigua and Barbuda is included within the North American area under section 274(h)(6) as of February 10, 2003.

#### HOLDING

For purposes of claiming deductions for expenses incurred in connection with a convention, seminar, or similar meeting, the following areas are included in the “North American area” as of the effective

date of section 274(h) except as otherwise indicated:

1. The fifty states of the United States and the District of Columbia;
2. The possessions of the United States, which for this purpose are American Samoa, Baker Island, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, Guam, Howland Island, Jarvis Island, Johnston Island, Kingman Reef, the Midway Islands, Palmyra, the United States Virgin Islands, Wake Island, and other United States islands, cays, and reefs not part of the fifty states or the District of Columbia;
3. Canada;
4. Mexico;
5. The Republic of the Marshall Islands;
6. The Federated States of Micronesia;
7. The Republic of Palau;

*For expenses incurred in attending a convention that began after:*

- |                         |                   |
|-------------------------|-------------------|
| 8. Antigua and Barbuda  | February 9, 2003  |
| 9. Barbados             | November 2, 1984  |
| 10. Bermuda             | December 1, 1988  |
| 11. Costa Rica          | February 11, 1991 |
| 12. Dominica            | May 7, 1988       |
| 13. Dominican Republic  | October 11, 1989  |
| 14. Grenada             | July 12, 1987     |
| 15. Guyana              | August 26, 1992   |
| 16. Honduras            | October 10, 1991  |
| 17. Jamaica             | December 17, 1986 |
| 18. Saint Lucia         | April 21, 1991    |
| 19. Trinidad and Tobago | February 8, 1990  |

This revenue ruling will be updated as future developments result in the inclusion of other areas in, or the exclusion of areas from, the North American area.

#### EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 94-56 and Rev. Rul. 87-95 are superseded.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Mae J. Lew of the Office of Associate Chief Counsel (International), Branch 1. For further information regarding this revenue ruling, contact Mae J. Lew at (202) 435-5262 (not a toll-free call).

## Section 482.—Allocation of Income and Deductions Among Taxpayers

26 CFR 1.482-1: Allocation of income and deductions among taxpayers.

T.D. 9088

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

#### Compensatory Stock Options Under Section 482

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance regarding the application of the rules of section 482 governing qualified cost sharing arrangements. These regulations provide guidance regarding the treatment of stock-based compensation for purposes of the rules governing qualified cost sharing arrangements and for purposes of the comparability factors to be considered under the comparable profits method.

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

*Applicability Dates:* For dates of applicability of these regulations, see §§1.482-1(j)(5) and 1.482-7(k).

FOR FURTHER INFORMATION CONTACT: Douglas Giblen, (202) 435-5265 (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 of 1995 (44 U.S.C. 3507) under control number 1545-1794. Responses to these collections of information are required by the

IRS to monitor compliance with the federal tax rules for determining stock-based compensation costs to be shared among controlled participants in qualified cost sharing arrangements.

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 or recordkeeper varies from 2 hours to 7 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 **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224.

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

#### Background

On July 29, 2002, Treasury and the IRS published in the **Federal Register** proposed amendments to the regulations (REG-106359-02, 2002-2 C.B. 405 [67 FR 48997]) under section 482 of the Internal Revenue Code (Code). These proposed regulations provide guidance regarding treatment of stock-based compensation for purposes of qualified cost sharing arrangements (QCSAs) and the comparable profits method and clarify the coordination of the rules regarding QCSAs with the arm's length standard. Written comments responding to these proposed regulations were received, and a public hearing was held on November 20, 2002. After consideration of all the comments, the proposed regulations under section 482 of the Code are adopted as revised by this Treasury decision.

#### Explanation of Revisions and Summary of Comments

These final regulations are the first in a series of regulatory guidance under section 482 through which Treasury and the IRS intend to update, clarify and improve current regulatory guidance in the transfer pricing area. A broader regulatory project on the treatment of QCSAs and a regulatory project on the transfer pricing of services are in progress, and Treasury and the IRS intend to issue proposed regulations with respect to each project in the near term.

These final regulations set forth explicit provisions clarifying that stock-based compensation is taken into account in determining the operating expenses treated as intangible development costs of a controlled participant in a QCSA under §1.482-7. These final regulations provide rules for measuring the cost associated with stock-based compensation; clarify that the utilization and treatment of stock-based compensation is appropriately taken into account as a comparability factor for purposes of the comparable profits method under §1.482-5; and provide rules that coordinate the rules of §1.482-7 regarding QCSAs with the arm's length standard as set forth in §1.482-1.

Treasury and the IRS received comments with respect to the proposed regulations. Most commentators objected to the proposed regulations in their entirety or suggested postponement of their finalization. Some commentators suggested modifications to be adopted in the event that the proposed regulations were finalized in some form.

After fully considering these comments, Treasury and the IRS continue to believe that the proposed regulations reflect a sound application of established principles under section 482. At the same time, Treasury and the IRS have concluded that certain suggested modifications to the administrative provisions of the proposed regulations are appropriate. These modifications are incorporated into the final regulations.

#### A. Stock-Based Compensation as a Cost to Be Shared and the Arm's Length Standard as Applied to QCSAs

— §§1.482-7(d)(2)(i) and (a)(3), and 1.482-1(a)(1), (b)(2)(i) and (c)

A QCSA subject to the rules of §1.482-7 is an arrangement to develop intangibles which meets certain administrative and other requirements and in which the participants to the arrangement share intangible development costs in proportion to their shares of reasonably anticipated benefits attributable to the intangibles developed under the arrangement. In the case of a QCSA, §1.482-7(a)(2) limits the ability of the Commissioner to make allocations, except to the extent necessary to make each controlled participant's share of the costs equal its share of reasonably anticipated benefits. An arrangement in which significant intangible development costs are not shared in proportion to reasonably anticipated benefits (or are not shared at all) would not in substance constitute an arrangement to which the rules of §1.482-7 are applicable.

The proposed regulations address the treatment of stock-based compensation under a QCSA, and the interaction between the rules applicable to QCSAs and the arm's length standard. The proposed regulations provide that stock-based compensation related to the covered intangible development area must be taken into account in determining the costs to be shared by participants in a QCSA. The proposed regulations further provide that a QCSA produces results consistent with an arm's length result if, and only if, all costs related to the intangible development, as determined in accordance with the specific guidance in §1.482-7(d), are shared in proportion to reasonably anticipated benefits.

Commentators objected to this rule on the basis of interpretations of the arm's length standard and on other grounds.

#### *1. Comments relating to arm's length standard*

Commentators asserted that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard unless there is evidence that parties at arm's length take stock-based compensation into account in similar circumstances. Commentators asserted that third-party evidence, such as

the government's own procurement contracting practices and agreements between unrelated parties with some characteristics similar to QCSAs, would show that parties at arm's length do not take stock-based compensation into account in determining costs to be reimbursed.

Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines). The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income "reasonably reflect the actual economic activity undertaken by each." See H.R. Conf. Rep. No. 99-481, at II-638 (1986). The regulations relating to QCSAs implement that legislative intent by using costs incurred by each controlled participant with respect to the intangible development as a proxy for actual economic activity undertaken by each, and by requiring each controlled participant to share these costs in proportion to its anticipated economic benefit from intangibles developed pursuant to the arrangement. In order for the costs incurred by a participant to reasonably reflect its actual economic activity, the costs must be determined on a comprehensive basis. Therefore, in order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must reflect all relevant costs, including such critical elements of cost as the cost of compensating employees for providing services related to the development of the intangibles pursuant to the QCSA. Treasury and the IRS do not believe that there is any basis for distinguishing between stock-based compensation and other forms of compensation in this context.

Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into

account in similar circumstances. Section 1.482-1(b)(1) provides that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that *would have been realized* if uncontrolled taxpayers *had engaged* in the same transaction under the same circumstances." (Emphasis added). While the results actually realized in similar transactions under similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs such data may not be available. As recognized in the legislative history of the Tax Reform Act of 1986, there is little, if any, public data regarding transactions involving high-profit intangibles. H.R. Rep. No. 99-426, at 423-25 (1985). The uncontrolled transactions cited by commentators do not share enough characteristics of QCSAs involving the development of high-profit intangibles to establish that parties at arm's length would not take stock options into account in the context of an arrangement similar to a QCSA. Government contractors that are entitled to reimbursement for services on a cost-plus basis under government procurement law assume substantially less entrepreneurial risk than that assumed by service providers that participate in QCSAs, and therefore the economic relationship between the parties to such an arrangement is very different from the economic relationship between participants in a QCSA. The other agreements highlighted by commentators establish arrangements that differ significantly from QCSAs in that they provide for the payment of markups on cost or of non-cost-based service fees to service providers within the arrangement or for the payment of royalties among participants in the arrangement. Such terms, which may have the effect of mitigating the impact of using a cost base to be shared or reimbursed that is less than comprehensive, would not be permitted by the QCSA regulations. Further, the QCSA regulations would not allow the Commissioner to impose such terms in the context of a QCSA.

The regulations relating to QCSAs have as their focus reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of



high-profit intangibles. These final regulations reflect that at arm's length the parties to an arrangement that is based on the sharing of costs to develop intangibles in order to obtain the benefit of an independent right to exploit such intangibles would ensure through bargaining that the arrangement reflected all relevant costs, including all costs of compensating employees for providing services related to the arrangement. Parties dealing at arm's length in such an arrangement based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation.

For example, assume that two parties are negotiating an arrangement similar to a QCSA in order to attempt to develop patentable pharmaceutical products, and that they anticipate that they will benefit equally from their exploitation of such patents in their respective geographic markets. Assume further that one party is considering the commitment of several employees to perform research with respect to the arrangement. That party would not agree to commit employees to an arrangement that is based on the sharing of costs in order to obtain the benefit of independent exploitation rights unless the other party agrees to reimburse its share of the compensation costs of the employees. Treasury and the IRS believe that if a significant element of that compensation consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation.

An arrangement between controlled taxpayers for the development of intangible assets in which one taxpayer's share of significant costs exceeds its share of reasonably anticipated benefits from the exploitation of the developed intangibles would not in substance be a QCSA and therefore would be subject to analysis under the other section 482 regulations. For example, as in the transactions cited by commentators, a controlled taxpayer might agree at the outset of an arrangement to bear a disproportionate share of costs in an arrangement in which it receives a service fee or a contingent royalty from the exploitation of the developed intangibles. More generally, controlled taxpayers might agree at the outset of an

arrangement to determine the compensation of one party based on a subset of that taxpayer's costs or on a basis that does not take that taxpayer's costs into account at all (e.g., based on an amount determined with reference to a comparable uncontrolled price or transaction). In either case, such an arrangement between controlled taxpayers would not in substance constitute an arrangement to which the rules of §1.482-7 would apply. Indeed, the limitations contained in §1.482-7(a)(2) could produce results inconsistent with an arm's length result if applied to such an arrangement because the Commissioner would be precluded from making allocations that could be necessary to ensure that each controlled taxpayer is compensated appropriately. Rather, such an arrangement should be analyzed under the other section 482 regulations (in particular, sections 1.482-1, 1.482-2(b), and 1.482-4) to determine whether it reaches results consistent with the arm's length standard, and any allocations by the Commissioner should be consistent with such other section 482 regulations.

## 2. Other comments

Commentators offered various other reasons for not taking stock-based compensation into account in the context of QCSAs. Commentators expressed the view that stock-based compensation should not be taken into account because it does not constitute an economic cost or require a cash outlay, or, to the extent such compensation does constitute a cost, because the cost is borne by shareholders whose share value is diluted when additional shares are issued on exercise. Commentators also noted that the treatment of stock-based compensation for financial reporting purposes should not mandate that stock-based compensation be taken into account in the context of QCSAs.

In response to such views, and as discussed above, Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account in the context of QCSAs is appropriate. The final regulations provide that stock-based compensation must be taken into account in the context of QCSAs because such a result is consistent with the arm's length standard. Treasury and the IRS agree that

the disposition of financial reporting issues does not mandate a particular result under these regulations.

One commentator suggested that even if stock-based compensation generates a cost to a participant, there is precedent within the regulations relating to QCSAs for excluding certain costs, notably interest and taxes. Treasury and the IRS believe that the technical treatment under the regulations relating to QCSAs of interest, taxes and other expenses not related to the intangible development area does not warrant failing to take into account an element of employee compensation that is clearly related to the intangible development area. Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity consistent with the legislative intent in this area, those costs must be determined on a comprehensive basis and so must take into account all relevant costs, in particular critical elements such as employee compensation. As noted above, Treasury and the IRS do not believe that there is a basis for distinguishing between stock-based compensation and other forms of compensation in this context.

One commentator also claimed that the historical administrative practice of the IRS has been not to challenge the failure to take stock-based compensation into account in other transfer pricing contexts in which the determination of cost is relevant. Treasury and the IRS believe that such perceived practices of the IRS with respect to other section 482 contexts are not relevant to determining the appropriate regulatory rule applicable to QCSAs.

As an alternate approach, one commentator suggested that rather than requiring stock-based compensation to be taken into account in the QCSA context, Treasury and the IRS should promulgate a "stock-based compensation safe harbor" applicable to QCSAs. This suggested "safe harbor" has not been adopted in the final regulations. As noted above, Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity, those costs must be determined on a comprehensive basis and so must take into account all relevant costs, in particular critical elements such as employee compensation.

The final regulations therefore require employee compensation to be taken into account, rather than provide for a safe harbor under which such compensation could be ignored.

*B. Grant-Date Identification Rule — §1.482-7(d)(2)(ii)*

The proposed regulations identify the stock-based compensation to be included in the cost pool based on whether the compensation is related to the intangible development area on the date the option is granted.

One commentator noted that this identification rule is inconsistent with the IRS treatment of stock-based compensation in other tax areas such as sourcing, where IRS rulings trace the compensation to the entire period over which the employee performed the services compensated by the option.

The grant-date identification rule has been retained in the final regulations. As noted in the preamble of the proposed regulations, it is desirable in the QCSA context to select a single date for identification of covered stock-based compensation. The grant of compensation generally is the single economic event most closely associated with the services being compensated.

*C. Provision of Specific Methods of Measurement and Timing*

The proposed regulations prescribe two alternative methods for determining the operating expenses attributable to stock-based compensation. The default rule under §1.482-7(d)(2)(iii)(A) provides that the costs attributable to stock-based compensation generally are included as intangible development costs upon the exercise of the option and measured by the spread between the option strike price and the price of the underlying stock. An elective rule under §1.482-7(d)(2)(iii)(B) provides that the costs attributable to stock options are taken into account in certain cases in accordance with the “fair value” of the option, as reported for financial accounting purposes either as a charge against income or in footnoted disclosures.

Commentators claimed that parties at arm’s length would not use either of the alternatives prescribed in the proposed regulations because they would produce

results that are too speculative or not sufficiently related to the employee services that are compensated. One commentator suggested that the final regulations should not limit taxpayers to the two prescribed measurement methods but rather should codify the current IRS administrative practice of permitting any reasonable method. In the commentator’s view, a standard based on any reasonable method should permit the intrinsic-value method, which measures the difference between strike price and underlying stock value at date of grant, exclusive of time value. However, the commentator suggested that if Treasury and the IRS consider an element of time value indispensable, an alternative would be to require the use of the “minimum value” method, which accounts for the time value of stock options by assuming the underlying stock will grow at the risk-free interest rate.

These suggestions were not adopted. Treasury and the IRS believe that it is appropriate for regulations to prescribe guidance in this context that is consistent with the arm’s length standard and that also is objective and administrable. As long as the measurement method is determined at or before grant date, either of the prescribed measurement methods can be expected to result in an appropriate allocation of costs among QCSA participants and therefore would be consistent with the arm’s length standard. The results under the default measurement rule are consistent with what would occur under an arm’s length agreement at or before the grant date to take stock-based compensation into account at the date of exercise when more facts are known and therefore to share the risks associated with such compensation between the date of grant and the date of exercise. The results under the elective measurement rule are consistent with what would occur under an alternative arm’s length agreement at or before the grant date to determine the value of the compensation up front and take such compensation into account at that time. With respect to the specific methods proposed by commentators, Treasury and the IRS believe that “intrinsic value” ignores significant elements of the economic value of stock-based compensation and “minimum value” ignores the important variable of volatility that enters into the economic pricing models used for financial reporting purposes.

The prescribed measurement methods are objective and administrable because they rely on valuations or measurements of stock-based compensation prepared for other purposes. The prescribed measurement methods do not require or permit valuations of stock-based compensation specifically for QCSA purposes. A standard under which the validity of the taxpayer’s method would have to be analyzed on a case-by-case basis would be unduly difficult to administer and potentially could lead to significant disputes.

*D. General Rule of Measurement — §1.482-7(d)(2)(iii)(A)*

Under the default measurement rule, the amount taken into account for QCSA purposes generally is the amount allowable as a federal income tax deduction on exercise of the stock-based compensation. This amount generally is the “spread” between the option price and the fair market value of the underlying stock at the date of exercise.

One commentator suggested that this method would be improved if the amount taken into account for QCSA purposes were limited to the portion of the spread that accrued between date of grant and full vesting, as further prorated to reflect only the time during which the employee was engaged in cost-shared activities.

This suggestion has not been adopted in the final regulations. Treasury and the IRS believe that the grant-date identification rule already limits in an appropriate way the stock-based compensation taken into account. The purpose of the default measurement rule is to measure the amount attributable to stock-based compensation that must be taken into account under the grant-date identification rule. Accordingly, the default measurement rule does not require further refinement through proration. Further, additional recordkeeping and analysis necessary to identify relevant time periods and employee activities involving the covered intangibles and to perform proration calculations are not warranted.

The proposed regulations set forth special rules for the application of the general rule of measurement in the event of modification of a stock option and expiration or

termination of a QCSA. The final regulations retain these rules with technical modifications.

*E. Treatment of Statutory Stock Options — §1.482-7(d)(2)(iii)(A)(1)*

Under the default measurement rule in the proposed regulations, a special rule applies to statutory stock options (also referred to as incentive and employee stock purchase plan stock options). Under this special rule, the spread on statutory stock options generally is taken into account for QCSA purposes on exercise, even though section 421 denies a deduction with respect to statutory stock options unless and until there is a disqualifying disposition of the underlying stock by the employee.

One commentator suggested that the special rule for statutory stock options should be removed because it imposes an unnecessary administrative burden on taxpayers to apply different rules for different purposes. This suggestion was not adopted in the final regulations. Treasury and the IRS believe that the more important concern is consistent treatment of statutory and nonstatutory stock options for this purpose. This consistency is achieved only if the spread on both statutory and nonstatutory options is included in the cost pool on exercise.

*F. Elective Method of Measurement — §1.482-7(d)(2)(iii)(B)*

The proposed regulations permit an elective method of measurement and timing with respect to options on publicly traded stock of companies subject to financial reporting under U.S. generally accepted accounting principles (U.S. GAAP), provided that the stock is traded on a U.S. securities market. Under the election, the amount taken into account for QCSA purposes associated with compensatory stock options is their “fair value,” generally measured by reference to economic pricing models as of the date of grant, as reflected either as a charge against income or as a footnote disclosure in the company’s audited financial statements, in compliance with current U.S. GAAP.

One commentator proposed that the elective measurement method be made available to all taxpayers. The commentator further suggested that controlled

participants should be permitted to use any reasonable method to measure stock-based compensation in the form of options on stock of foreign corporations as long as that method is consistent with international accounting standards or with accounting principles that are prevalent in the home country of the controlled participant. In the commentator’s view, the limitations in the proposed regulations are not justified by difficulty of valuation and may be vulnerable to challenges under anti-discrimination clauses in U.S. income tax treaties.

Treasury and the IRS agree that the elective method should be more broadly available and have modified these rules in the final regulations. Specifically, the final regulations extend the availability of the elective method to options on the stock of certain companies that prepare their financial statements in accordance with accounting principles other than U.S. GAAP, while continuing to limit the availability of the elective method to options on stock that is publicly traded on a U.S. securities market. Thus, the availability of the elective method is not extended to options on stock of privately held companies or companies whose stock is traded only on foreign securities markets.

Treasury and the IRS believe that objectivity and ease of administration are important features of any method of measuring costs attributable to stock-based compensation for purposes of QCSAs. The elective method should be available only for options on stock whose value is readily determinable and for companies that are required to determine the fair value of stock options for a non-tax purpose. Treasury and the IRS recognize that foreign-based companies whose stock is traded on a U.S. securities market (directly or through the use of American Depositary Receipts) are required to determine the fair value of options on their stock even though they do not necessarily prepare financial statements in accordance with U.S. GAAP. Companies satisfy that requirement by preparing financial statements in accordance with a comprehensive body of generally accepted accounting principles (GAAP) that is consistent with the U.S. GAAP requirement of determining the fair value of stock options, or by preparing reconciliations of their financial statements with U.S. GAAP in a

manner that reflects the fair value of stock options.

Accordingly, the final regulations provide that in determining eligibility for the elective method, financial statements prepared in accordance with GAAP other than U.S. GAAP are considered as prepared in accordance with U.S. GAAP in two circumstances. First, financial statements are considered as prepared in accordance with U.S. GAAP where the fair value of stock options is reflected in a legally required reconciliation between the applicable GAAP and U.S. GAAP. In such a case, the fair value of stock options for purposes of the elective method of measurement will be the fair value reflected in such reconciliation. Second, financial statements are considered as prepared in accordance with U.S. GAAP where, under the applicable GAAP, the fair value of stock options is reflected as a charge against income in audited financial statements or is disclosed in footnotes to such statements. In such a case, the fair value of stock options for purposes of the elective method of measurement will be the fair value reflected in such audited financial statements.

Treasury and the IRS continue to believe that the elective method should be available only for options on stock whose value is readily determinable and for companies that are required to determine the fair value of stock options for a non-tax purpose. Accordingly, the final regulations do not extend the availability of the elective method to options on stock of privately held companies or companies whose stock is traded only on foreign securities markets.

One commentator suggested that the election to use the elective method should be made on the taxpayer’s return rather than evidenced in the written cost sharing agreement. In the view of the commentator, such a procedure would be more practical from an enforcement perspective.

This suggestion was not adopted. Treasury and the IRS continue to believe that the most effective way to ensure that all participants are bound by the election is to incorporate it within the written cost sharing agreement.

*G. Modification of Comparable Profits Method — §1.482-5(c)(2)(iv)*

The proposed regulations provide that in applying the comparable profits method, if there are material differences among the tested party and uncontrolled comparables with respect to the utilization or treatment of stock-based compensation, such material differences are an appropriate basis for comparability adjustments. One commentator expressed the view that this provision contradicts the arm's length coordination rules for QCSAs because the treatment of stock-based compensation by unrelated parties is considered relevant for purposes of the comparable profits method but not relevant for purposes of QCSAs.

No revision was made in response to this comment. Treasury and the IRS believe that the rule provided in the proposed regulations with respect to the application of the comparable profits method is appropriate because the financial data with respect to similar business activities that generally is used as a reference point for that method is subject to adjustment to ensure comparability.

*H. Effective Date and Transition Rules — §1.482-7(k) and (d)(2)(iii)(B)(2)*

The provisions of the proposed regulations applicable to QCSAs would apply to stock-based compensation granted in taxable years beginning on or after publication of final regulations. Participants in a QCSA in existence on the effective date may, on a one-time basis, amend their agreement to elect the grant-date method of measurement without the Commissioner's consent. The election with respect to existing QCSAs must be made not later than the latest due date, without regard to extensions, for an income tax return of a controlled participant for the first taxable year beginning after the effective date of final regulations.

One commentator stated that the prospective effective date does not afford taxpayers a reasonable time to amend their cost sharing agreements or restructure complex international operations. A transition period of two years after the publication of final regulations was suggested.

This suggestion was not adopted. Treasury and the IRS consider the period stated

in the proposed regulations adequate for the initial planning and recordkeeping that may be occasioned by the final regulations.

With respect to the special transition rule permitting taxpayers to elect the grant-date method of measurement by amendment of an existing written cost sharing agreement no later than the latest due date of an income tax return of a controlled participant, one commentator suggested that the due date should not disregard filing extensions. The commentator maintained that fairness dictates affording taxpayers this extra time for the analysis needed to make this significant decision.

In response to this comment, the final regulations provide that the due date for amendments to existing cost sharing agreements is determined with regard to filing extensions.

Some commentators urged Treasury and the IRS to postpone finalization of the proposed regulations until the OECD completes its ongoing consideration of the treatment of stock options for transfer pricing purposes and an international consensus begins to form so that the potential for international disputes and resulting negative effects on U.S. business can be minimized. Similarly, a commentator suggested that the effects of applying the principles of the proposed regulations to other areas of transfer pricing should be thoroughly studied and harmonized before finalizing the regulations to avoid creating traps for the unwary or other unforeseen consequences.

These suggestions were not implemented. Treasury and the IRS do not believe that international discussion of issues compels the suspension of the regulatory process. Also, Treasury and the IRS believe that it is important to provide timely guidance on issues such as those addressed by the proposed and final regulations.

Finally, the preamble to the proposed regulations states that the proposed regulations clarify that stock-based compensation must be taken into account in the QCSA context. Several commentators interpreted this language as in effect requiring the new rules to be applied retroactively. These commentators urged that the final regulations contain further assurances of prospective intent and explicitly recognize that these regulations represent a

fundamental change to the traditional approach to section 482.

No revisions were made in light of these comments. As noted earlier, Treasury and the IRS believe that requiring stock-based compensation to be taken into account in the QCSA context is consistent with the arm's length standard and long-standing policies underlying section 482. The final regulations, like the proposed regulations, clearly specify that the specific rules provided therein are prospective in application. Moreover, as stated in the proposed regulations, while taxpayers may rely on the proposed regulations until the effective date of the final regulations, no inference is intended with respect to the treatment of stock-based compensation granted in taxable years beginning before the effective date of these final regulations.

*I. Paperwork Reduction Act and Regulatory Flexibility Act*

One commentator expressed the view that the compliance burden imposed by the proposed regulations on each taxpayer will significantly exceed the two to seven hours estimated under the Paperwork Reduction Act. The commentator also asserted that the estimated number of taxpayers affected by the rules was too low.

The burden estimates as stated in the final regulations reflect no change. Treasury and the IRS reviewed the estimates made in the proposed regulations and concluded that they are reasonable.

Similarly, with respect to the Regulatory Flexibility Act, the commentator challenged the statement in the preamble of the proposed regulations that the new regulatory requirements will not have a significant economic impact on a substantial number of small entities. Upon review of available information, Treasury and the IRS found no basis for a change in the statement or in the operative finding that the economic impact of the collections of information in the proposed regulations is not significant with respect to small entities.

*J. Documentation Requirements and Other Provisions on Which No Comments Received*

Section 1.482-7(j)(2)(i)(F) of the proposed regulations requires that controlled

participants maintain specific documentation to establish the amount attributable to stock-based compensation that is taken into account in determining the costs to be shared, including the method of measurement and timing used with respect to that amount. No comments were received on this particular provision, and it is retained in the final regulations.

Treasury and the IRS intend that this provision will require controlled participants that use the elective method of measurement to maintain documentation establishing compliance with the requirements of §1.482-7(d)(2)(iii)(B). For example, documentation should establish that applicable financial statements reflecting the value of stock options with respect to which the elective method is used, as well as applicable accounting principles under which such financial statements are prepared, are in conformity with the fair-value and reconciliation requirements adopted in the final regulations with respect to GAAP other than U.S. GAAP.

Several other provisions of the proposed regulations similarly were not commented upon and have been adopted without modification in the final regulations. These provisions include §1.482-7(d)(2)(iii)(A)(2), relating to deductions of foreign controlled participants; the last sentence of §1.482-7(d)(2)(ii), relating to repricing and other modifications of stock options; and §1.482-7(d)(2)(iii)(C), providing consistency rules for measurement and timing of stock-based compensation.

### 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. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few small entities are expected to enter into QCSAs involving stock-based compensation, and that for those who do, the burdens

imposed under §1.482-7(d)(2)(iii)(B) and (j)(2)(i)(F) will be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), 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 Douglas Giblen of the Office of Associate Chief Counsel (International). However, other personnel from Treasury and the IRS 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 continues to read in part as follows:

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

Sections 1.482-1, 1.482-5 and 1.482-7 also issued under 26 U.S.C. 482. \* \* \*

Par. 2. Section 1.482-0 is amended by:

1. Redesignating the entry for §1.482-7(a)(3) as the entry for §1.482-7(a)(4).

2. Adding a new entry for §1.482-7(a)(3).

3. Redesignating the entry for §1.482-7(d)(2) as the entry for §1.482-7(d)(3).

4. Adding new entries for §1.482-7(d)(2).

The additions and redesignation read as follows:

#### *§1.482-0 Outline of regulations under section 482.*

\* \* \* \* \*

#### *§1.482-7 Sharing of costs.*

(a) In general.

\* \* \* \* \*

(3) Coordination with §1.482-1.

(4) Cross references.

\* \* \* \* \*

(d) Costs.

\* \* \* \* \*

(2) Stock-based compensation.

(i) In general.

(ii) Identification of stock-based compensation related to intangible development.

(iii) Measurement and timing of stock-based compensation expense.

(A) In general.

(1) Transfers to which section 421 applies.

(2) Deductions of foreign controlled participants.

(3) Modification of stock option.

(4) Expiration or termination of qualified cost sharing arrangement.

(B) Election with respect to options on publicly traded stock.

(1) In general.

(2) Publicly traded stock.

(3) Generally accepted accounting principles.

(4) Time and manner of making the election.

(C) Consistency.

(3) Examples.

\* \* \* \* \*

Par. 3. Section 1.482-1 is amended by:

1. Removing the sixth sentence of paragraph (a)(1) and adding two sentences in its place.

2. Adding a sentence at the end of paragraph (b)(2)(i).

3. Adding a sentence at the end of paragraph (c)(1).

4. Adding paragraph (j)(5).

The additions read as follows:

#### *§1.482-1 Allocation of income and deductions among taxpayers.*

(a) \* \* \*

(1) \* \* \* Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482-7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996. \* \* \*

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(i) \* \* \* Section 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \* See §1.482-7 for the applicable method in the case of a qualified cost sharing arrangement.

\* \* \* \* \*

(j) \* \* \*

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of §1.482-5 apply for taxable years beginning on or after August 26, 2003.

Par. 4. Section 1.482-5 is amended by adding a sentence at the end of paragraph (c)(2)(iv) to read as follows:

*§1.482-5 Comparable profits method.*

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(iv) \* \* \* As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by §1.482-7(d)(2)(i)) among the tested party and comparable parties.

\* \* \* \* \*

Par. 5. Section 1.482-7 is amended by:

1. Redesignating paragraph (a)(3) as paragraph (a)(4).
2. Adding a new paragraph (a)(3).
3. Redesignating paragraph (d)(2) as paragraph (d)(3).
4. Adding a new paragraph (d)(2).
5. Removing the word “and” at the end of paragraph (j)(2)(i)(D).
6. Removing the period at the end of paragraph (j)(2)(i)(E) and adding “; and” in its place.
7. Adding paragraph (j)(2)(i)(F).
8. Revising paragraph (k).

The additions and revision read as follows:

*§1.482-7 Sharing of costs.*

(a) \* \* \*

(3) *Coordination with §1.482-1.* A qualified cost sharing arrangement produces results that are consistent with an arm’s length result within the meaning of §1.482-1(b)(1) if, and only if, each controlled participant’s share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement

equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

\* \* \* \* \*

(d) \* \* \*

(2) *Stock-based compensation*—(i) *In general.* For purposes of this section, a controlled participant’s operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation related to intangible development.* The determination of whether stock-based compensation is related to the intangible development area within the meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation expense*—(A) *In general.* Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation

(for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(1) *Transfers to which section 421 applies.* Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(2) *Deductions of foreign controlled participants.* Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as an allowable deduction of a controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(3) *Modification of stock option.* Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(4) *Expiration or termination of qualified cost sharing arrangement.* Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant

upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) *Election with respect to options on publicly traded stock—(1) In general.* With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(2) *Publicly traded stock.* As used in this paragraph (d)(2)(iii)(B), the term *publicly traded stock* means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(3) *Generally accepted accounting principles.* For purposes of this paragraph (d)(2)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either—

(i) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(ii) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair

value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(4) *Time and manner of making the election.* The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a qualified cost sharing arrangement in existence on August 26, 2003, the election must be made by written amendment to the cost sharing agreement not later than the latest due date (with regard to extensions) of a federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003, and the consent of the Commissioner is not required.

(C) *Consistency.* Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)(2) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

\* \* \* \* \*  
(j) \* \* \*  
(2) \* \* \*  
(i) \* \* \*

(F) The amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used with respect to that amount as well as the data, as of date of grant, used to identify stock-based compensation related to the development of covered intangibles.

\* \* \* \* \*  
(k) *Effective date.* This section applies for taxable years beginning on or after January 1, 1996. However, paragraphs (a)(3), (d)(2) and (j)(2)(i)(F) of this section apply for stock-based compensation granted in taxable years beginning on or after August 26, 2003.

\* \* \* \* \*

#### PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 10. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read in part as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*  
(b) \* \* \*

\* \* \* \* \*

1.482-7 ..... 1545-1794

\* \* \* \* \*

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

Approved August 11, 2003.

Pamela F. Olson,  
*Assistant Secretary of the Treasury.*

(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. 51171)

### Section 871.—Tax on Nonresident Alien Individuals

If a nonresident alien individual or foreign corporation that is a partner in a partnership makes an election to treat certain income as effectively connected, such partner must notify the partnership. See REG-108524-00, page 869.

### Section 1443.—Foreign Tax-Exempt Organizations

A foreign organization described in section 501(c) whose allocable share of partnership income is effectively connected may be subject to withholding under section 1446. See REG-108524-00, page 869.

### Section 1461.—Liability for Withheld Tax

A partnership subject to withholding under section 1446, including a publicly traded partnership, is obligated to report such withholding. See REG-108524-00, page 869.

### Section 1462.—Withheld Tax as Credit to Recipient of Income

Withholding tax paid under section 1446 on behalf of a fiduciary, partnership, or intermediary is deemed to have been paid by beneficial owner of the income to the extent that the beneficial owner is required to include such income on its return. See REG-108524-00, page 869.

### Section 1463.—Tax Paid by Recipient of Income

A partnership is not relieved from liability for interest or any penalties or additions to tax otherwise applicable if it fails to withhold under section 1446 but a partner or beneficial owner pays the tax. See REG-108524-00, page 869.

### Section 6109.—Identifying Numbers

A foreign person that furnishes to a partnership documentation to establish its domestic or foreign status must provide the partnership its identifying number on such documentation. See REG-108524-00, page 869.

### Section 6721.—Failure to File Correct Information Returns

Forms required to be filed by a partnership to report withholding under section 1446 are considered information returns. See REG-108524-00, page 869.



## Part III. Administrative, Procedural, and Miscellaneous

### Weighted Average Interest Rate Update

#### Notice 2003-61

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88-73, 1988-2 C.B. 383, provides guidelines for determining the

weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)-1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner

for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for September 2003 is 5.14 percent. Pursuant to Notice 2002-26, 2002-1 C.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
October	2003	5.29	4.76 to 5.82	4.76 to 6.35

#### Drafting Information

The principal authors of this notice are Paul Stern and Tony Montanaro of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Stern may be reached at 1-202-283-9703. Mr. Montanaro may be reached at 1-202-283-9714. The telephone numbers in two preceding sentences are not toll-free.

### United States Income Tax Treaties That Meet the Requirements of Section 1(h)(11)(C)(i)(II)

#### Notice 2003-69

##### Summary

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27, 117 Stat. 752) (the "2003 Act"), was enacted on May 28, 2003. Subject to certain limitations, the 2003 Act generally provides that a dividend paid to an individual shareholder from either a domestic corporation or a "qualified foreign corporation" is subject to tax at the reduced rates applicable to certain capital gains. A qualified foreign corporation includes certain foreign corporations that are eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and which includes an exchange of information program. This notice contains the current list of the U.S. tax treaties that meet these requirements.

Treasury and the IRS are working on additional guidance concerning other aspects of this provision.

##### Analysis

Section 1(h)(1) of the Code generally provides that a taxpayer's "net capital gain" for any taxable year will be subject to a maximum tax rate of 15 percent (or 5 percent in the case of certain taxpayers). The 2003 Act added section 1(h)(11), which provides that net capital gain for purposes of section 1(h) means net capital gain (determined without regard to section 1(h)(11)) increased by "qualified dividend income." Qualified dividend income means dividends received during the taxable year from domestic corporations and "qualified foreign corporations." Section 1(h)(11)(B)(i). Subject to certain exceptions, a qualified foreign corporation is any foreign corporation that is either (i) incorporated in a possession of the United States, or (ii) eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and which includes an

exchange of information program (the “treaty test”). Section 1(h)(11)(C)(i).<sup>1</sup> A qualified foreign corporation does not include any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a foreign personal holding company (as defined in section 552), a foreign investment company (as defined in section 1246(b)), or a passive foreign investment company (as defined in section 1297).<sup>2</sup> Section 1(h)(11)(C)(iii).

The appendix to this notice sets forth the current list of U.S. income tax treaties that meet the requirements of section 1(h)(11)(C)(i)(II). Four U.S. income tax treaties do not meet the requirements of section 1(h)(11)(C)(i)(II). The tax treaties with Bermuda and The Netherlands Antilles are not comprehensive income tax treaties within the meaning of section 1(h)(11). The U.S.-U.S.S.R. income tax treaty, which was signed on June 20,

1973, and currently applies to certain former Soviet Republics, does not include an information exchange program. The current income tax treaty with Barbados was determined not to be satisfactory for purposes of section 1(h)(11) because of concern that the treaty may operate to provide benefits which are intended to mitigate or eliminate double taxation in cases where there is no risk of double taxation.<sup>3</sup>

Treasury and the IRS intend to update this list, as appropriate. Situations that may result in changes to the list include the entry into force of new income tax treaties and the amendment or renegotiation of existing tax treaties. Further, Treasury and the IRS continue to study the operation of each of our income tax treaties, including the implications of any changes in the domestic laws of the treaty partner, to ensure that the treaty accomplishes its intended objectives and continues to be satisfactory

for purposes of this provision. It is anticipated that any changes to the list of income tax treaties that meet the requirements of section 1(h)(11)(C)(i)(II) will apply only to dividends paid after the date of publication of the revised list.

Finally, in order to be treated as a qualified foreign corporation under the treaty test, a foreign corporation must be eligible for benefits of one of the U.S. income tax treaties listed in the Appendix. Accordingly, the foreign corporation must be a resident within the meaning of such term under the relevant treaty and must satisfy any other requirements of that treaty, including the requirements under any applicable limitation on benefits provision. Treasury and the IRS are working on guidance concerning whether foreign corporations are qualified foreign corporations under the treaty test.

The notice is effective for taxable years beginning after December 31, 2002.

## APPENDIX

### U.S. INCOME TAX TREATIES SATISFYING THE REQUIREMENTS OF SECTION 1(h)(11)(C)(i)(II)

Australia	Greece	Lithuania	Slovak Republic
Austria	Hungary	Luxembourg	Slovenia
Belgium	Iceland	Mexico	South Africa
Canada	India	Morocco	Spain
China	Indonesia	Netherlands	Sweden
Cyprus	Ireland	New Zealand	Switzerland
Czech Republic	Israel	Norway	Thailand
Denmark	Italy	Pakistan	Trinidad and Tobago
Egypt	Jamaica	Philippines	Tunisia
Estonia	Japan	Poland	Turkey
Finland	Kazakhstan	Portugal	Ukraine
France	Korea	Romania	United Kingdom
Germany	Latvia	Russian Federation	Venezuela

<sup>1</sup> A foreign corporation that does not satisfy either of these two tests is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States. Section 1(h)(11)(C)(ii). Treasury and the IRS are working on guidance concerning the definition of “readily tradable on an established securities market in the United States.”

<sup>2</sup> A dividend from a qualified foreign corporation also is subject to the other limitations in section 1(h)(11). For example, a shareholder receiving a dividend from a qualified foreign corporation must satisfy the holding period requirements of section 1(h)(11)(B)(iii).

<sup>3</sup> The conference report provides that, for the period prior to this determination, foreign corporations will not be considered qualified foreign corporations by reason of eligibility for benefits of the U.S.-Barbados income tax treaty. H.R. Rep. 108-126, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. at 42 (2003).

## Part IV. Items of General Interest

### Notice of Proposed Rulemaking; Notice of Public Hearing; and Withdrawal of Previous Proposed Regulations Section

### Guidance Regarding the Treatment of Certain Contingent Payment Debt Instruments With One or More Payments That Are Denominated in, or Determined by Reference to, a Nonfunctional Currency

REG-106486-98;  
INTL-0015-91

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of public hearing; and withdrawal of previous proposed regulations section.

SUMMARY: This document contains proposed regulations regarding the treatment of contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a currency other than the taxpayer's functional currency. These regulations are necessary because current regulations do not provide guidance concerning the tax treatment of such instruments. The proposed regulations generally provide that taxpayers should apply the existing rules under section 1275 of the Internal Revenue Code, with certain modifications, to non-functional currency contingent payment debt instruments. This document also withdraws existing proposed regulations and provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for December 3, 2003, at 10 a.m. must be submitted by November 12, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-106486-98), room 5203, Internal Revenue Service, POB

7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to: REG-106486-98, 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](http://www.irs.gov/regs). The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Milton Cahn at (202) 622-3870; concerning submission and delivery of comments and the public hearing, Treena Garrett, (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

#### PAPERWORK REDUCTION ACT

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 28, 2003. Comments are specifically requested concerning:

Whether the proposed collections of information is necessary for the proper performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collections of information in this proposed regulation are in §1.988-6(a)(1) (cross reference to §1.1275-4) and §1.988-6(d)(3). This information is required to ensure consistency in the treatment of the debt instrument between the issuer and the holders. This information will be used for audit and examination purposes. The disclosure of information is mandatory as regards the issuers of non-functional currency contingent payment debt instruments. The reporting of information is mandatory as regards holders of debt instruments which determine their own projected payment schedule. The recordkeeping requirement is mandatory for any party that determines the comparable yield and projected payment schedule for a debt instrument. The likely respondents are business or other for-profit institutions.

Taxpayers provide the information on a statement attached to its timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

Estimated total annual reporting, and/or recordkeeping burden: 100 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: 1 hour.

Estimated number of respondents and/or recordkeepers: 100

Estimated annual frequency of responses: on occasion.

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

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return

information are confidential, as required by 26 U.S.C. 6103.

## Background

On March 17, 1992, Treasury and the IRS issued proposed regulations (INTL-0015-91), §§1.988-1(a)(3), (4) and (5), regarding contingent payment debt instruments, dual currency debt instruments and multi-currency debt instruments. The proposed regulations followed the general approach in the then-proposed §1.1275-4(g) contingent payment debt regulations (LR-189-84, 1986-1 C.B. 820 [51 FR 12022] (1986), amended at 56 FR 8308 (1991)) and bifurcated such debt instruments into contingent and noncontingent components. After an instrument was bifurcated, the proposed regulations applied the rules in §§1.988-1 through 1.988-5, as appropriate, to the resulting components.

On December 16, 1994, Treasury and the IRS withdrew the then proposed §1.1275-4(g) regulations and proposed a new set of §1.1275-4 regulations (FI-59-91, 1995-1 C.B. 895 [59 FR-64884]). These regulations were finalized on June 14, 1996.

Section 1.1275-4 of the final regulations adopted the “noncontingent bond method” for certain contingent payment debt instruments. Under the noncontingent bond method, interest accrues on a contingent payment debt instrument at a rate equal to the instrument’s comparable yield, which is the yield at which an issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. In addition, the noncontingent bond method treats all interest on a debt instrument as original issue discount, which must be taken into account as it accrues, regardless of the taxpayer’s normal method of accounting.

Under the noncontingent bond method, the comparable yield is used to construct a projected payment schedule for the debt instrument, which includes a projected amount for each contingent payment. If the actual amount of a contingent payment is greater than the projected amount, the difference is treated as additional interest. If the actual amount of a contingent payment is less than the projected amount,

the difference generally offsets current interest accruals. In some cases, the difference may result in a loss to the holder and income to the issuer.

On August 2, 1999, as a result of the withdrawal of the 1994 proposed §1.1275-4(g) regulations and the promulgation of the final §1.1275-4 regulations, the IRS issued Announcement 99-76, 1999-2 C.B. 223, which provided a description of a regulatory approach that Treasury and the IRS were considering as a replacement to the proposed regulations in §§1.988-1(a)(3), (4) and (5) for contingent payment debt instruments with one or more payments denominated in, or determined by reference to, a nonfunctional currency. Announcement 99-76 stated that Treasury and the IRS were considering issuing regulations that would apply the noncontingent bond method in the taxpayer’s nonfunctional currency and would translate payments received on the instrument into functional currency under the rules of §§1.988-1 through 1.988-5. Announcement 99-76 requested comments on this approach. No comments were received.

Treasury and the IRS believe that proposed regulations §1.988-1(a)(3), (4) and (5) should be withdrawn because they incorporate the bifurcation approach rather than the noncontingent bond method ultimately adopted under §1.1275-4. Treasury and the IRS believe, as reflected in Announcement 99-76, that nonfunctional currency contingent payment debt instruments should be accounted for under rules similar to those that govern the treatment of functional currency contingent payment debt instruments. Treasury and the IRS believe that providing a consistent set of rules in this area is in the best interests of sound tax administration.

## Explanation of Provisions

### *In General*

These proposed regulations provide guidance for four different types of debt instruments: (1) debt instruments issued for money or publicly-traded property for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which have one or more

non-currency contingencies, (2) debt instruments issued for money or publicly-traded property for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which have no non-currency contingencies, (3) debt instruments issued for money or publicly-traded property for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which also have one or more non-currency contingencies, and (4) debt instruments which otherwise would fall into one of the three foregoing categories but for the fact that the instruments are not issued for money or publicly-traded property. These proposed regulations do not discuss the treatment of tax-exempt obligations described in §1.1275-4(d) which are denominated in one or more nonfunctional currencies. Comments are requested as to the proper treatment of such instruments.

Consistent with the approach described in Announcement 99-76, these proposed regulations generally apply the rules of §1.1275-4(b) (*i.e.*, the noncontingent bond method) to nonfunctional currency contingent payment debt instruments issued for money or publicly traded property. The proposed regulations generally provide that the noncontingent bond method is applied in the currency in which the instrument is denominated (the denomination currency).

Application of the §1.1275-4(b) rules to nonfunctional currency contingent instruments generally requires taxpayers (i) to accrue interest in the denomination currency at a yield at which the issuer would issue a fixed rate debt instrument denominated in the denomination currency with terms and conditions similar to those of the contingent payment debt instrument, (ii) to translate the interest accrued from the denomination currency into the functional currency (and account for foreign currency gain or loss on payments of interest and principal) under the principles of §1.988-2(b), and (iii) to account for gain or loss arising from contingencies in a manner consistent with the rules of §1.1275-4(b).

## *Applying the Noncontingent Bond Method in the Denomination Currency*

As noted, the proposed regulations require taxpayers to apply the noncontingent bond method in the instrument's denomination currency. For example, in the case of an instrument whose denomination currency is the British pound, an issuer whose functional currency is the U.S. dollar would first determine the comparable yield of the instrument, that is, the yield at which the issuer would issue a fixed rate instrument in British pounds with terms and conditions similar to those of the instrument actually being issued. Second, the issuer would construct a projected payment schedule applying that yield. Third, the amount of interest accrued in each taxable year would be determined in British pounds based on the comparable yield and translated into dollars under the principles of section 988. Fourth, the issuer and holder would account for differences between the projected amount of payments and the actual amount of payments (so-called positive adjustments and negative adjustments) under rules similar to those in §1.1275-4(b). Consistent with the rules of §1.1275-4(b), the proposed regulations provide that net positive adjustments are treated as additional interest on the instrument. Net negative adjustments generally offset current interest accruals, and in some cases may result in a loss to the holder and income to the issuer. Finally, the issuer and holders would determine foreign currency gain or loss with respect to interest and principal payments on the instrument.

### *Determination of the comparable yield and projected payment schedule*

Consistent with §1.1275-4(b)(4)(iv), the holder uses the yield and projected payment schedule determined by the issuer to determine the holder's interest accruals and adjustments for a debt instrument. If the issuer does not determine a comparable yield and projected payment schedule for the debt instrument, or if the issuer's comparable yield or projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and the projected payment schedule for the debt instrument under the rules of the proposed regulations. A

holder that determines its own comparable yield and projected payment schedule must explicitly disclose, in the manner set forth in §1.1275-4(b)(4)(iv), both this fact and the reason why the holder made its own determination.

### *Determination of Basis*

In general, the proposed regulations provide that a holder maintains its adjusted basis in functional currency by computing basis adjustments in the denomination currency under the rules of §1.1275-4(b)(7)(iii) and then translating such adjustments into functional currency. Thus, the proposed regulations provide that a holder's basis is increased by the holder's accrued but unpaid interest inclusions on the debt instrument, generally without regard to any positive or negative adjustments, and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. These amounts are translated into functional currency under the principles of §1.988-2(b).

### *Determination of Amount Realized*

The proposed regulations generally follow §1.1275-4(b)(7)(iv) in determining the amount realized, but do so in the denomination currency. Thus, for purposes of determining the amount realized by a holder on the scheduled retirement of a debt instrument, the holder generally is treated as receiving the projected amount of any contingent payment due at maturity. In the case of a sale, exchange or unscheduled retirement of a debt instrument, general recognition principles of tax law generally apply (e.g., section 1001(b)). However, the amount realized by a holder on either the scheduled retirement, or the sale, exchange, or unscheduled retirement of a debt instrument, is reduced by any negative adjustment carryforward existing in the taxable year of the sale, exchange or retirement.

To calculate gain or loss other than foreign currency gain or loss, the proposed regulations require the translation of the amount realized into functional currency. Foreign currency gain or loss is computed separately, as described below. The proposed regulations generally translate the

amount realized by reference to the rates used to translate the components of interest and principal that make up adjusted basis. The amount realized is translated using the adjusted basis rates in order to separate from the foreign currency gain or loss the amount of gain or loss on the sale, exchange or retirement of the debt instrument which does not result from changes in foreign exchange rates. Thus, where the amount realized in the denomination currency equals the adjusted basis of the instrument in the denomination currency prior to translation, the amount realized is translated in its entirety by reference to the rates used to translate adjusted basis. Where the amount realized differs from the adjusted basis prior to translation, additional attribution and translation rules are required.

Where the amount realized in the denomination currency is less than the adjusted basis in the denomination currency, that is, where the holder realizes a loss (not taking into account foreign currency gain or loss), the following rules apply as to which parts of adjusted basis are not recovered. In the case of a scheduled retirement at maturity, the loss is attributable to principal (the amount in denomination currency which the holder paid to purchase the debt instrument). The loss is attributable to principal because the holder will not entirely recover the holder's original investment in the debt instrument. In the case of a sale or exchange, the loss is first attributable to accrued interest. Attributing the loss first to interest results in symmetrical treatment between a loss resulting from a negative adjustment and a loss resulting from a sale.

When the holder's amount realized in the denomination currency exceeds the amount of its basis in the denomination currency prior to translation, that is, where the holder realizes a gain (not taking into account foreign currency gain or loss), the excess of amount realized over adjusted basis is translated at the spot rate on the date of receipt. This rule ensures symmetrical treatment between a positive adjustment and a gain on the instrument.

### *Determination of Foreign Currency Gain or Loss*

The proposed regulations provide that foreign currency gain or loss is determined

on an instrument with respect to principal and interest based on the comparable yield and projected payment schedule under the principles of §1.988-2(b). In general, no foreign currency gain or loss is recognized until payment is made or received pursuant to the instrument, and no foreign currency gain or loss is computed with respect to positive or negative adjustments. However, foreign currency gain or loss is determined with respect to positive adjustments described in §1.1275-4(b)(9)(ii) (relating to certain fixed but deferred contingent payments), based upon the difference between the spot rate on the date the positive adjustment becomes fixed and the spot rate on the date the positive adjustment is paid or received.

#### *Source Rules*

Consistent with the rules of §1.1275-4(b)(6)(ii), the proposed regulations provide that all gain (other than foreign currency gain) on an instrument is characterized as interest for all tax purposes, including source and character rules. Losses of a holder from a contingent payment debt instrument are generally sourced by reference to the rules of §1.1275-4(b)(9)(iv). Under §1.1275-4(b)(9)(iv), a holder's deductions or loss related to a contingent payment debt instrument that are treated as ordinary losses are treated as deductions that are definitely related to the class of gross income to which income from such debt instrument belongs. Deductions or losses that the holder treats as capital losses are allocated, consistently with the general principles of §1.865-1(b)(2), to the class of gross income with respect to which interest income from the instrument would give rise.

#### *Treatment of Subsequent Holders*

The proposed regulations provide that the rules of §1.1275-4(b)(9) generally apply to subsequent holders of an instrument who purchase the instrument for an amount greater or less than the instrument's adjusted issue price (determined in the denomination currency). Accordingly, to the extent that the purchase price for an instrument exceeds the adjusted issue price of the instrument, the holder is required to allocate such excess to interest accrued on the instrument or to

projected payments on the instrument in a reasonable manner. Each such allocation is treated as a negative adjustment on the instrument, and the holder's basis on the instrument is decreased as these negative adjustments are taken into account.

To the extent that the adjusted issue price of the instrument exceeds its purchase price, the holder is required to allocate such excess to interest accrued on the instrument or to projected payments on the instrument in a reasonable manner. As the difference is taken into account, the holder is treated as receiving a positive adjustment on the instrument, and the holder's basis is increased as these positive adjustments are taken into account.

The proposed regulations generally translate the difference between the purchase price and adjusted issue price into functional currency at the rate used to translate the interest or projected payment subject to the adjustment. Thus, for example, a positive adjustment attributable to interest is translated at the same rate used to translate interest in the period in which it accrues (*e.g.*, the average rate for the accrual period). The basis adjustment corresponding to such a positive or negative adjustment is translated at the same rate applicable to the positive or negative adjustment itself.

#### *Netting*

The proposed regulations do not provide for the netting of market gain or loss with currency gain or loss on nonfunctional currency contingent payment debt instruments. On the one hand, different character and source rules generally apply to market gain or loss and currency gain or loss, and netting such items may produce results inconsistent with the tax treatment of other types of instruments. On the other hand, where market gain or loss and currency gain or loss counteract each other with respect to a taxpayer, requiring separate recognition of such gain and loss may not accurately reflect the economic benefits and burdens associated with the instrument. Accordingly, Treasury and the IRS request comments regarding the extent to which netting should be permitted or required. *Examples 2 and 4* of the proposed regulations demonstrate cases in

which netting potentially could be permitted or required because both illustrate instances in which market loss could be netted against currency gain.

#### *Debt Instruments Denominated in Multiple Currencies*

In the case of an instrument for which payments are denominated in, or determined by reference to, more than one currency, the proposed regulations provide that the issuer must first determine the instrument's predominant currency, which will be used as the instrument's denomination currency for purposes of applying the rules of the proposed regulations. The predominant currency of the instrument is determined on the issue date by comparing the present value in functional currency of the noncontingent and projected payments denominated in, or determined by reference to, each currency. For this purpose, the applicable discount rate must be a nonfunctional currency discount rate, but the rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance.

After the denomination currency has been determined, all payments on the instrument that are denominated in, or determined by reference to, a currency other than the denomination currency are treated as non-currency related contingent payments for purposes of applying the rules of the proposed regulations. Treasury and the IRS request comments regarding whether all gain or loss with respect to a debt instrument for which payments are denominated in, or determined by reference to, more than one currency and which has no non-currency contingencies should be treated as foreign currency gain or loss.

#### *Debt Instruments Issued for Non-publicly Traded Property*

In the case of a nonfunctional currency contingent debt instrument issued for non-publicly traded property, the instrument is not accounted for using the noncontingent bond method. Rather, the debt instrument is separated into its components based on

the currency in which the payments are denominated and whether the payments are contingent or noncontingent. The noncontingent components in each currency are treated as a separate debt instrument denominated in the currency in which the payment (or payments) is denominated. A component consisting of a contingent payment is generally treated in the manner provided in §1.1275-4(c)(4). For purposes of the contingent payment, the test rate (the interest rate which is used to discount the contingent payment so as to determine the amount of the payment which is treated as principal, and the amount which is treated as interest) is determined by reference to the dollar unless the dollar does not reasonably reflect the economic substance of the contingent component.

### Proposed Effective Dates

Section 1.988-6 is proposed to apply to nonfunctional currency contingent payment debt instruments issued 60 days or more after the date §1.988-6 is published as a final regulation in the **Federal Register**.

### Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required.

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few, if any, small entities issue or hold foreign currency denominated contingent payment debt instruments. Generally, it is expected that the only domestic holders of these instruments will likely be financial institutions, investment banking firms, investment funds, and other sophisticated investors, due to the foreign currency risk and other contingencies inherent in these instruments. 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, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 3, 2003, at 10 a.m. in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 12, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

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

\* \* \* \* \*

Section 1.988-1(a)(3), (4) and (5) as proposed on March 17, 1992 at 57 FR 9218 income tax regulations are withdrawn, and

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 1.988-2 is amended by:

1. Adding the text of paragraph (b)(2)(i)(B)(1).

2. Removing the last sentence of paragraph (b)(2)(i)(B)(2).

The addition reads as follows:

*§1.988-2 Recognition and computation of exchange gain or loss.*

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(i) \* \* \*

(B) \* \* \* (1) *Operative rules.* See §1.988-6 for rules applicable to contingent debt instruments for which one or more payments are denominated in, or determined by reference to, a nonfunctional currency.

\* \* \* \* \*

Par. 3. Section 1.988-6 is added to read as follows:

*§1.988-6 Nonfunctional currency contingent payment debt instruments.*

(a) *In general—(1) Scope.* This section determines the accrual of interest and the amount, timing, source, and character of any gain or loss on nonfunctional currency contingent payment debt instruments described in this paragraph (a)(1). Except as set forth by the rule in this section, the rules in §1.1275-4 (relating to contingent payment debt instruments) apply to the following instruments—

(i) A debt instrument described in §1.1275-4(b)(1) for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which has one or more non-currency related contingencies;

(ii) A debt instrument described in §1.1275-4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has no non-currency related contingencies;

(iii) A debt instrument described in §1.1275-4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has one or more non-currency related contingencies; and

(iv) A debt instrument otherwise described in paragraph (a)(1)(i), (ii) or (iii) of this section, except that the debt instrument is described in §1.1275-4(c)(1) rather than §1.1275-4(b)(1) (e.g., the instrument is issued for non-publicly traded property).

(2) *Exception for hyperinflationary currencies*—(i) *In general.* Except as provided in paragraph (a)(2)(ii) of this section, this section shall not apply to an instrument described in paragraph (a)(1) of this section if any payment made under such instrument is determined by reference to a hyperinflationary currency, as defined in §1.985-1(b)(2)(ii)(D). In such case, the amount, timing, source and character of interest, principal, foreign currency gain or loss, and gain or loss relating to a non-currency contingency shall be determined under the method that reflects the instrument's economic substance.

(ii) *Discretion as to method.* If a taxpayer does not account for an instrument described in paragraph (a)(2)(i) of this section in a manner that reflects the instrument's economic substance, the Commissioner may apply the rules of this section to such an instrument or apply the principles of §1.988-2(b)(15), reasonably taking into account the contingent feature or features of the instrument.

(b) *Instruments described in paragraph (a)(1)(i) of this section*—(1) *In general.* Paragraph (b)(2) of this section provides rules for applying the noncontingent bond method (as set forth in §1.1275-4(b)) in the nonfunctional currency in which a debt instrument described in paragraph (a)(1)(i) of this section is denominated, or by reference to which its payments are determined (the denomination currency). Paragraph (b)(3) of this section describes how amounts determined in paragraph (b)(2) of this section shall be translated from the denomination currency of the instrument into the taxpayer's functional currency. Paragraph (b)(4) of this section describes how gain or loss (other than foreign currency gain or loss) shall be determined and characterized with respect to the instrument. Paragraph (b)(5) of this section describes how foreign currency gain or loss shall be

determined with respect to accrued interest and principal on the instrument. Paragraph (b)(6) of this section provides rules for determining the source and character of any gain or loss with respect to the instrument. Paragraph (b)(7) of this section provides rules for subsequent holders of an instrument who purchase the instrument for an amount other than the adjusted issue price of the instrument. Paragraph (c) of this section provides examples of the application of paragraph (b) of this section. See paragraph (d) of this section for the determination of the denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section. See paragraph (e) of this section for the treatment of an instrument described in paragraph (a)(1)(iv) of this section.

(2) *Application of noncontingent bond method*—(i) *Accrued interest.* Interest accruals on an instrument described in paragraph (a)(1)(i) of this section are initially determined in the denomination currency of the instrument by applying the noncontingent bond method, set forth in §1.1275-4(b), to the instrument in its denomination currency. Accordingly, the comparable yield, projected payment schedule, and comparable fixed rate debt instrument, described in §1.1275-4(b)(4), are determined in the denomination currency. For purposes of applying the noncontingent bond method to instruments described in this paragraph, the applicable Federal rate described in §1.1275-4(b)(4)(i) shall be the rate described in §1.1274-4(d) with respect to the denomination currency.

(ii) *Net positive and negative adjustments.* Positive and negative adjustments, and net positive and net negative adjustments, with respect to an instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275-4(b)(6) (and §1.1275-4(b)(9)(i) and (ii), if applicable) in the denomination currency. Accordingly, a net positive adjustment is treated as additional interest (in the denomination currency) on the instrument. A net negative adjustment first reduces interest that otherwise would be accrued by the taxpayer during the current tax year in the denomination currency. If a net negative adjustment exceeds the interest that would otherwise be accrued by the taxpayer during the current tax year in

the denomination currency, the excess is treated as ordinary loss (if the taxpayer is a holder of the instrument) or ordinary income (if the taxpayer is the issuer of the instrument). The amount treated as ordinary loss by a holder with respect to a net negative adjustment is limited, however, to the amount by which the holder's total interest inclusions on the debt instrument (determined in the denomination currency) exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years (determined in the denomination currency). Similarly, the amount treated as ordinary income by an issuer with respect to a net negative adjustment is limited to the amount by which the issuer's total interest deductions on the debt instrument (determined in the denomination currency) exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years (determined in the denomination currency). To the extent a net negative adjustment exceeds the current year's interest accrual and the amount treated as ordinary loss to a holder (or ordinary income to the issuer), the excess is treated as a negative adjustment carryforward, within the meaning of §1.1275-4(b)(6)(iii)(C), in the denomination currency.

(iii) *Adjusted issue price.* The adjusted issue price of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275-4(b)(7) in the denomination currency. Accordingly, the adjusted issue price is equal to the debt instrument's issue price in the denomination currency, increased by the interest previously accrued on the debt instrument (determined without regard to any net positive or net negative adjustments on the instrument) and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument. All adjustments to the adjusted issue price are calculated in the denomination currency.

(iv) *Adjusted basis.* The adjusted basis of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275-4(b)(7) in the taxpayer's functional currency. In accordance with those rules, a holder's basis in the debt instrument is increased



by the interest previously accrued on the debt instrument (translated into functional currency), without regard to any net positive or net negative adjustments on the instrument (except as provided in paragraph (b)(7) or (8) of this section, if applicable), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument to the holder (translated into functional currency). See paragraph (b)(3)(iii) of this section for translation rules.

(v) *Amount realized.* The amount realized by a holder and the repurchase price paid by the issuer on the scheduled or unscheduled retirement of a debt instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275-4(b)(7) in the denomination currency. For example, with regard to a scheduled retirement at maturity, the holder is treated as receiving the projected amount of any contingent payment due at maturity, reduced by the amount of any negative adjustment carryforward. For purposes of translating the amount realized by the holder into functional currency, the rules of paragraph (b)(3)(iv) of this section shall apply.

(3) *Treatment and translation of amounts determined under noncontingent bond method*—(i) *Accrued interest.* The amount of accrued interest, determined under paragraph (b)(2)(i) of this section, is translated into the taxpayer's functional currency at the average exchange rate, as described in §1.988-2(b)(2)(iii)(A), or, at the taxpayer's election, at the appropriate spot rate, as described in §1.988-2(b)(2)(iii)(B).

(ii) *Net positive and negative adjustments*—(A) *Net positive adjustments.* A net positive adjustment, as referenced in paragraph (b)(2)(ii) of this section, is translated into the taxpayer's functional currency at the spot rate on the last day of the taxable year in which the adjustment is taken into account under §1.1275-4(b)(6), or, if earlier, the date the instrument is disposed of or otherwise terminated.

(B) *Net negative adjustments.* A net negative adjustment is treated and, where necessary, is translated from the denomination currency into the taxpayer's functional currency under the following rules:

(1) The amount of a net negative adjustment determined in the denomination currency that reduces the current year's interest in that currency shall first reduce the current year's accrued but unpaid interest, and then shall reduce the current year's interest which was accrued and paid. No translation is required.

(2) The amount of a net negative adjustment treated as ordinary income or loss under §1.1275-4(b)(6)(iii)(B) first is attributable to accrued but unpaid interest accrued in prior taxable years. For this purpose, the net negative adjustment shall be treated as attributable to any unpaid interest accrued in the immediately preceding taxable year, and thereafter to unpaid interest accrued in each preceding taxable year. The amount of the net negative adjustment applied to accrued but unpaid interest is translated into functional currency at the same rate used, in each of the respective prior taxable years, to translate the accrued interest.

(3) Any amount of the net negative adjustment remaining after the application of paragraphs (b)(3)(ii)(B)(1) and (2) of this section is attributable to interest accrued and paid in prior taxable years. The amount of the net negative adjustment applied to such amounts is translated into functional currency at the spot rate on the date the debt instrument was issued or, if later, acquired.

(4) Any amount of the net negative adjustment remaining after application of paragraphs (b)(3)(ii)(B)(1), (2) and (3) of this section is a negative adjustment carryforward, within the meaning of §1.1275-4(b)(6)(iii)(C). A negative adjustment carryforward is carried forward in the denomination currency and is applied to reduce interest accruals in subsequent years. In the year in which the instrument is sold, exchanged or retired, any negative adjustment carryforward not applied to interest reduces the holder's amount realized on the instrument (in the denomination currency). An issuer of a debt instrument described in paragraph (a)(1)(i) of this section who takes into income a negative adjustment carryforward (that is not applied to interest) in the year the instrument is retired, as described in §1.1275-4(b)(6)(iii)(C), translates such income into functional currency at the spot rate on the date the instrument was issued.

(iii) *Adjusted basis*—(A) *In general.* Except as otherwise provided in this paragraph and paragraphs (b)(7) or (8) of this section, a holder determines and maintains adjusted basis by translating the denomination currency amounts determined under §1.1275-4(b)(7)(iii) into functional currency as follows:

(1) The holder's initial basis in the instrument is determined by translating the amount paid by the holder to acquire the instrument (in the denomination currency) into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(2) An increase in basis attributable to interest accrued on the instrument is translated at the rate applicable to such interest under paragraph (b)(3)(i) of this section.

(3) Any noncontingent payment and the projected amount of any contingent payments determined in the denomination currency that decrease the holder's basis in the instrument under §1.1275-4(b)(7)(iii) are translated as follows:

(i) The payment first is attributable to the most recently accrued interest to which prior amounts have not already been attributed. The payment is translated into functional currency at the rate at which the interest was accrued.

(ii) Any amount remaining after the application of paragraph (b)(3)(iii)(A)(3)(i) of this section is attributable to principal. Such amounts are translated into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(B) *Exception for interest reduced by a negative adjustment carryforward.* Solely for purposes of this §1.988-6, any amounts of accrued interest income that are reduced as a result of a negative adjustment carryforward shall be treated as principal and translated at the spot rate on the date the instrument was issued or, if later, acquired.

(iv) *Amount realized*—(A) *Instrument held to maturity*—(1) *In general.* With respect to an instrument held to maturity, a holder translates the amount realized by separating such amount in the denomination currency into the component parts of interest and principal that make up adjusted basis prior to translation under paragraph (b)(3)(iii) of this section, and translating each of those component parts of the amount realized at the same rate used to translate the respective component parts

of basis under paragraph (b)(3)(iii) of this section. The amount realized first shall be translated by reference to the component parts of basis consisting of accrued interest during the taxpayer's holding period as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a last in first out basis. Any remaining portion of the amount realized shall be translated by reference to the rate used to translate the component of basis consisting of principal as determined under paragraph (b)(3)(iii) of this section.

(2) *Subsequent purchases at discount and fixed but deferred contingent payments.* For purposes of this paragraph (b)(3)(iv) of this section, any amount which is required to be added to adjusted basis under paragraph (b)(7) or (8) of this section shall be treated as additional interest which was accrued on the date the amount was added to adjusted basis. To the extent included in amount realized, such amounts shall be translated into functional currency at the same rates at which they were translated for purposes of determining adjusted basis. See paragraphs (b)(7)(iv) and (b)(8) of this section for rules governing the rates at which the amounts are translated for purposes of determining adjusted basis.

(B) *Sale, exchange, or unscheduled retirement—(1) Holder.* In the case of a sale, exchange, or unscheduled retirement, application of the rule stated in paragraph (b)(3)(iv)(A) of this section shall be as follows. The holder's amount realized first shall be translated by reference to the principal component of basis as determined under paragraph (b)(3)(iii) of this section, and then to the component of basis consisting of accrued interest as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a first in first out basis. Any gain recognized by the holder (*i.e.*, any excess of the sale price over the holder's basis, both expressed in the denomination currency) is translated into functional currency at the spot rate on the payment date.

(2) *Issuer.* In the case of an unscheduled retirement of the debt instrument, any excess of the adjusted issue price of the debt instrument over the amount paid by the issuer (expressed in denomination currency) shall first be attributable to accrued unpaid interest, to the extent the

accrued unpaid interest had not been previously offset by a negative adjustment, on a last-in-first-out basis, and then to principal. The accrued unpaid interest shall be translated into functional currency at the rate at which the interest was accrued. The principal shall be translated at the spot rate on the date the debt instrument was issued.

(C) *Effect of negative adjustment carryforward with respect to the issuer.* Any amount of negative adjustment carryforward treated as ordinary income under §1.1275-4(b)(6)(iii)(C) shall be translated at the exchange rate on the day the debt instrument was issued.

(4) *Determination of gain or loss not attributable to foreign currency.* A holder of a debt instrument described in paragraph (a)(1)(i) of this section shall recognize gain or loss upon sale, exchange, or retirement of the instrument equal to the difference between the amount realized with respect to the instrument, translated into functional currency as described in paragraph (b)(3)(iv) of this section, and the adjusted basis in the instrument, determined and maintained in functional currency as described in paragraph (b)(3)(iii) of this section. The amount of any gain or loss so determined is characterized as provided in §1.1275-4(b)(8), and sourced as provided in paragraph (b)(6) of this section.

(5) *Determination of foreign currency gain or loss—(i) In general.* Other than in a taxable disposition of the debt instrument, foreign currency gain or loss is recognized with respect to a debt instrument described in paragraph (a)(1)(i) of this section only when payments are made or received. No foreign currency gain or loss is recognized with respect to a net positive or negative adjustment, as determined under paragraph (b)(2)(ii) of this section (except with respect to a positive adjustment described in paragraph (b)(8) of this section). As described in this paragraph (b)(5), foreign currency gain or loss is determined in accordance with the rules of §1.988-2(b).

(ii) *Foreign currency gain or loss attributable to accrued interest.* The amount of foreign currency gain or loss recognized with respect to payments of interest previously accrued on the instrument is determined by translating the amount of interest paid or received into functional currency at the spot rate on the date of payment and subtracting from such amount

the amount determined by translating the interest paid or received into functional currency at the rate at which such interest was accrued under the rules of paragraph (b)(3)(i) of this section. For purposes of this paragraph, the amount of any payment that is treated as accrued interest shall be reduced by the amount of any net negative adjustment treated as ordinary loss (to the holder) or ordinary income (to the issuer), as provided in paragraph (b)(2)(ii) of this section. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iii) *Principal.* The amount of foreign currency gain or loss recognized with respect to payment or receipt of principal is determined by translating the amount paid or received into functional currency at the spot rate on the date of payment or receipt and subtracting from such amount the amount determined by translating the principal into functional currency at the spot rate on the date the instrument was issued or, in case of the holder, if later, acquired. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iv) *Payment ordering rules—(A) In general.* Except as provided in paragraph (b)(5)(iv)(B) of this section, payments with respect to an instrument described in paragraph (a)(1)(i) of this section shall be treated as follows:

(1) A payment shall first be attributable to any net positive adjustment on the instrument that has not previously been taken into account.

(2) Any amount remaining after applying paragraph (b)(5)(iv)(A)(1) of this section shall be attributable to accrued but unpaid interest, remaining after reduction by any net negative adjustment, and shall be attributable to the most recent accrual period to the extent prior amounts have not already been attributed to such period.

(3) Any amount remaining after applying paragraphs (b)(5)(iv)(A)(1) and (2) of this section shall be attributable to principal. Any interest paid in the current year that is reduced by a net negative adjustment shall be considered a payment of principal for purposes of determining foreign currency gain or loss.

(B) *Special rule for sale or exchange or unscheduled retirement.* Payments made

or received upon a sale or exchange or unscheduled retirement shall first be applied against the principal of the debt instrument (or in the case of a subsequent purchaser, the purchase price of the instrument in denomination currency) and then against accrued unpaid interest (in the case of a holder, accrued while the holder held the instrument).

(C) *Subsequent purchaser that has a positive adjustment allocated to a daily portion of interest.* A positive adjustment that is allocated to a daily portion of interest pursuant to paragraph (b)(7)(iv) of this section shall be treated as interest for purposes of applying the payment ordering rule of this paragraph (b)(5)(iv).

(6) *Source of gain or loss.* The source of foreign currency gain or loss recognized with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.988-4. Consistent with the rules of §1.1275-4(b)(8), all gain (other than foreign currency gain) on an instrument described in paragraph (a)(1)(i) of this section is treated as interest income for all purposes. The source of an ordinary loss (other than foreign currency loss) with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.1275-4(b)(9)(iv). The source of a capital loss with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.865-1(b)(2).

(7) *Basis different from adjusted issue price—(i) In general.* The rules of §1.1275-4(b)(9)(i), except as set forth in this paragraph (b)(7), shall apply to an instrument described in paragraph (a)(1)(i) of this section purchased by a subsequent holder for more or less than the instrument's adjusted issue price.

(ii) *Determination of basis.* If an instrument described in paragraph (a)(1)(i) of this section is purchased by a subsequent holder, the subsequent holder's initial basis in the instrument shall equal the amount paid by the holder to acquire the instrument, translated into functional currency at the spot rate on the date of acquisition.

(iii) *Purchase price greater than adjusted issue price.* If the purchase price of the instrument (determined in the denomination currency) exceeds the adjusted issue price of the instrument, the

holder shall, consistent with the rules of §1.1275-4(b)(9)(i)(B), reasonably allocate such excess to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the excess shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a negative adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the rate used to translate the interest which is offset by the negative adjustment. To the extent related to a projected payment, such excess shall be treated as a negative adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the spot rate on the date the instrument was acquired.

(iv) *Purchase price less than adjusted issue price.* If the purchase price of the instrument (determined in the denomination currency) is less than the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275-4(b)(9)(i)(C), reasonably allocate the difference to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the difference shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a positive adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the rate used to translate the interest to which it relates. For purposes of determining adjusted basis under paragraph (b)(3)(iii) of this section, such increase in adjusted basis shall be treated as an additional accrual of interest during the period to which the positive adjustment relates. To the extent related to a projected payment, such difference shall be treated as a positive adjustment on the date the payment is made. On the date

of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the spot rate on the date the adjustment is taken into account. For purposes of determining the amount realized on the instrument in functional currency under paragraph (b)(3)(iv) of this section, amounts attributable to the excess of the adjusted issue price of the instrument over the purchase price of the instrument shall be translated into functional currency at the same rate at which the corresponding adjustments are taken into account under this paragraph (b)(7)(iv) for purposes of determining the adjusted basis of the instrument.

(8) *Fixed but deferred contingent payments.* In the case of an instrument with a contingent payment that becomes fixed as to amount before the payment is due, the rules of §1.1275-4(b)(9)(ii) shall be applied in the denomination currency of the instrument. For this purpose, foreign currency gain or loss shall be recognized on the date payment is made or received with respect to the instrument under the principles of paragraph (b)(5) of this section. Any increase or decrease in basis required under §1.1275-4(b)(9)(ii)(D) shall be taken into account at the same exchange rate as the corresponding net positive or negative adjustment is taken into account.

(c) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. The examples are as follows:

*Example 1. Treatment of net positive adjustment—(i) Facts.* On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a zero-coupon debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275-4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under paragraph (b)(2)(i) of this section and §1.1275-4(b), is 10 percent, compounded annually, and the projected payment schedule, as constructed under the rules of §1.1275-4(b), provides for a single payment of

£1210 on December 31, 2006 (consisting of a non-contingent payment of £975 and a projected payment of £235). The debt instrument is a capital asset in

the hands of Z. Z does not elect to use the spot-rate convention described in §1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is

£1300. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00=\$1.00
Dec. 31, 2005	£1.00=\$1.10
Dec. 31, 2006	£1.00=\$1.20

Accrual Period	Average rate (pounds to dollars)
2005	£1.00=\$1.05
2006	£1.00=\$1.15

(ii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2005 (issue price of £1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ( $\$1.05 \times \pounds 100 = \$105$ ). Accordingly, Z has interest income in 2005 of \$105.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the \$1000 basis ( $\$1.00 \times \pounds 1000$  original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2005. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2006, is \$1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £110 of interest on the debt instrument for 2006 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £110 at the average exchange rate for the accrual period ( $\$1.15 \times \pounds 110 = \$126.50$ ). Accordingly, Z has interest income in 2006 of \$126.50.

(B) *Effect of net positive adjustment.* The payment actually made on December 31, 2006, is £1300, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net positive adjustment of £90 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(3)(ii)(A) of this section, the £90 net positive adjustment is treated as additional interest income and is translated into dollars at the spot rate on

the last day of the year ( $\$1.20 \times \pounds 90 = \$108$ ). Accordingly, Z has a net positive adjustment of \$108 resulting in a total interest inclusion for 2006 of \$234.50 ( $\$126.50 + \$108 = \$234.50$ ).

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payment and the projected amount of the contingent payment to be received, is \$1231.50 ( $\$1105$  plus  $\$126.50$  of accrued interest for 2006).

(D) *Amount realized.* Even though Z receives £1300 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1210 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1210 (representing the interest accrued in 2005) is translated at the rate at which it was accrued ( $\pounds 1 = \$1.05$ ), resulting in an amount realized of \$105; £110 of the £1210 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued ( $\pounds 1 = \$1.15$ ), resulting in an amount realized of \$126.50; and £1000 of the £1210 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased ( $\pounds 1 = \$1$ ), resulting in an amount realized of \$1000. Z's total amount realized is \$1231.50, the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss.* Under paragraph (b)(5) of this section Z recognizes foreign currency gain under section 988 on the instrument with respect to the consideration actually received at maturity (except for the net positive adjustment), £1210.

The amount of recognized foreign currency gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in 2005, the foreign currency gain is \$15 [ $\pounds 100 \times (\$1.20 - \$1.05)$ ]. With respect to interest accrued in 2006, the foreign currency gain equals \$5.50 [ $\pounds 110 \times (\$1.20 - \$1.15)$ ]. With respect to principal, the foreign currency gain is \$200 [ $\pounds 1000 \times (\$1.20 - \$1.00)$ ]. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of \$220.50.

(F) *Source.* Z has interest income of \$105 in 2005, interest income of \$234.50 in 2006 (attributable to £110 of accrued interest and the £90 net positive adjustment), and a foreign currency gain of \$220.50 in 2006. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of \$220.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 2. Treatment of net negative adjustment*—(i) *Facts.* Assume the same facts as in *Example 1*, except that Z receives £975 at maturity instead of £1300.

(ii) *Treatment in 2005.* The treatment of the debt instrument in 2005 is the same as in *Example 1*. Thus, Z has interest income in 2005 of \$105. On January 1, 2006, the adjusted issue price of the debt instrument is £1100, and Z's adjusted basis in the instrument is \$1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section and based on the comparable yield, Z's accrued interest for 2006 is £110 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ( $\$1.15 \times \pounds 110 = \$126.50$ ).

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is £975, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £235 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2006 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(1) of this section the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £125 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2005. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year (£1 = \$1.05). Accordingly, Z has an ordinary loss of \$105 in 2006. The remaining £25 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is \$1231.50 (\$1105 plus \$126.50 of accrued interest for 2006).

(D) *Amount realized.* Even though Z receives £975 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £25. Therefore, Z is treated

as receiving £1185 (£1210 - £25) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1185 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = \$1.05), resulting in an amount realized of \$105; £110 of the £1185 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = \$1.15), resulting in an amount realized of \$126.50; and £975 of the £1185 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = \$1), resulting in an amount realized of \$975. Z's amount realized is \$1206.50 (\$105 + \$126.50 + \$975 = \$1206.50), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of \$25 on retirement of the instrument (\$1206.50 - \$1231.50 = -\$25).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the consideration actually received at maturity, £975. Under paragraph (b)(5)(ii) of this section, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006. In addition, no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Accordingly, Z recognizes foreign currency gain with respect to principal only. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of \$195 [£975 x (\$1.20 - \$1.00)].

(F) *Source.* In 2006, Z has an ordinary loss of \$105, a capital loss of \$25, and a foreign currency gain of \$195. Under paragraph (b)(6) of this section and §1.1275-4(b)(9)(iv), the \$105 ordinary loss generally reduces Z's foreign source passive income

under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865-1(b)(2), the \$25 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the \$25 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of \$195 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 3. Negative adjustment and periodic interest payments—(i) Facts.* On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a two-year debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275-4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988-2(b)(2) and 1.1275-4(b), is 10 percent, compounded semiannually. The debt instrument provides for semiannual interest payments of £30 payable each June 30, and December 31, and a contingent payment at maturity on December 31, 2006, which is projected to equal £1086.20 (consisting of a noncontingent payment of £980 and a projected payment of £106.20) in addition to the interest payable at maturity. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £981.00. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00=\$1.00
June 30, 2005	£1.00=\$1.20
Dec. 31, 2005	£1.00=\$1.40
June 30, 2006	£1.00=\$1.60
Dec. 31, 2006	£1.00=\$1.80

Accrual Period	Average rate (pounds to dollars)
Jan.–June 2005	£1.00=\$1.10
July–Dec. 2005	£1.00=\$1.30
Jan.–June 2006	£1.00=\$1.50
July–Dec. 2006	£1.00=\$1.70

(ii) *Treatment in 2005—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues

£50 of interest on the debt instrument for the January-June accrual period (issue price of £1000 x 10 percent/2). Under paragraph (b)(3)(i) of this section,

Z translates the £50 at the average exchange rate for the accrual period (\$1.10 x £50 = \$55.00). Similarly,

Z accrues £51 of interest in the July-December accrual period  $[(£1000 + £50 - £30) \times 10 \text{ percent}/2]$ , which is translated at the average exchange rate for the accrual period  $(\$1.30 \times £51 = \$66.30)$ . Accordingly, Z accrues \$121.30 of interest income in 2005.

(B) *Adjusted issue price and basis—(1) January-June accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2005, the adjusted issue price of the debt instrument is  $£1020 (£1000 + £50 - £30 = £1020)$ . For purposes of determining Z's dollar basis in the debt instrument, the \$1000 basis is increased by the £50 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period  $(\$1.10 \times £50 = \$55)$ . The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988-2(b)(7), at the rate applicable to accrued interest  $(\$1.10 \times £30 = \$33)$ . Accordingly, Z's adjusted basis as of July 1, 2005, is  $\$1022 (\$1000 + \$55 - \$33)$ .

(2) *July-December accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, on January 1, 2006, the adjusted issue price of the instrument is  $£1041 (£1020 + £51 - £30 = £1041)$ . For purposes of determining Z's dollar basis in the debt instrument, the \$1022 basis is increased by the £51 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period  $(\$1.30 \times £51 = \$66.30)$ . The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988-2(b)(7), at the rate applicable to accrued interest  $(\$1.30 \times £30 = \$39)$ . Accordingly, Z's adjusted basis as of January 1, 2006, is  $\$1049.30 (\$1022 + \$66.30 - \$39)$ .

(C) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of each £30 payment of interest actually received during 2005. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(ii) of this section, by reference to the difference between the spot rate on the date the £30 payment was made and the average exchange rate for the accrual period during which the interest accrued. Accordingly, Z recognizes \$3 of foreign currency gain on the January-June interest payment  $[£30 \times (\$1.20 - \$1.10)]$ , and \$3 of foreign currency gain on the July-December interest payment  $[£30 \times (\$1.40 - \$1.30)]$ . Z recognizes in 2005 a total of \$6 of foreign currency gain.

(D) *Source.* Z has interest income of \$121.30 and a foreign currency gain of \$6. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of \$6

is sourced by reference to Z's residence and is therefore from sources within the United States.

(iii) *Treatment in 2006—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for the January-June accrual period is  $£52.05$  (adjusted issue price of  $£1041 \times 10 \text{ percent}/2$ ). Under paragraph (b)(3)(i) of this section, Z translates the  $£52.05$  at the average exchange rate for the accrual period  $(\$1.50 \times £52.05 = \$78.08)$ . Similarly, Z accrues  $£53.15$  of interest in the July-December accrual period  $[(£1041 + £52.05 - £30) \times 10 \text{ percent}/2]$ , which is translated at the average exchange rate for the accrual period  $(\$1.70 \times £53.15 = \$90.35)$ . Accordingly, Z accrues  $\$105.20$ , or  $\$168.43$ , of interest income in 2006.

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is  $\$981.00$ , rather than the projected  $\$1086.20$ . Under paragraph (b)(2)(ii)(B) of this section, Z has a net negative adjustment of  $\$105.20$  on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of  $\$105.20$  in 2006 is reduced to zero by the net negative adjustment. Elimination of the 2006 accrued interest fully utilizes the net negative adjustment.

(C) *Adjusted issue price and basis—(1) January-June accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2006, the adjusted issue price of the debt instrument is  $£1063.05 (£1041 + £52.05 - £30 = £1063.05)$ . For purposes of determining Z's dollar basis in the debt instrument, the  $\$1049.30$  adjusted basis is increased by the  $£52.05$  of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period  $(\$1.50 \times £52.05 = \$78.08)$ . The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988-2(b)(7), at the rate applicable to accrued interest  $(\$1.50 \times £30 = \$45)$ . Accordingly, Z's adjusted basis as of July 1, 2006, is  $\$1082.38 (\$1049.30 + \$78.08 - \$45)$ .

(2) *July-December accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, immediately before maturity on December 31, 2006, the adjusted issue price of the instrument is  $£1086.20 (£1063.05 + £53.15 - £30 = £1086.20)$ . For purposes of determining Z's dollar basis in the debt instrument, the  $\$1082.38$  adjusted basis is increased by the  $£53.15$  of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period  $(\$1.70 \times £53.15 = \$90.36)$ . The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988-2(b)(7), at the rate applicable to accrued interest  $(\$1.70 \times £30 =$

$\$51)$ . Accordingly, Z's adjusted basis on December 31, 2006, immediately prior to maturity is  $\$1121.74 (\$1082.38 + \$90.36 - \$51)$ .

(D) *Amount realized.* Even though Z receives  $\$981.00$  at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving  $\$1086.20$  on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly,  $\$20$  of the  $\$1086.20$  (representing the interest accrued in the January-June 2005 accrual period, less  $\$30$  interest paid) is translated into dollars at the rate at which it was accrued ( $\$1 = \$1.10$ ), resulting in an amount realized of  $\$22$ ;  $\$21$  of the  $\$1086.20$  (representing the interest accrued in the July-December 2005 accrual period, less  $\$30$  interest paid) is translated into dollars at the rate at which it was accrued ( $\$1 = \$1.30$ ), resulting in an amount realized of  $\$27.30$ ;  $\$22.05$  of the  $\$1086.20$  (representing the interest accrued in the January-June 2006 accrual period, less  $\$30$  interest paid) is translated into dollars at the rate at which it was accrued ( $\$1 = \$1.50$ ), resulting in an amount realized of  $\$33.08$ ;  $\$23.15$  of the  $\$1086.20$  (representing the interest accrued in the July 1-December 31, 2006, accrual period, less the  $\$30$  interest payment) is translated into dollars at the rate at which it was accrued ( $\$1 = \$1.70$ ), resulting in an amount realized of  $\$39.36$ ; and  $\$1000$  (representing principal) is translated into dollars at the spot rate on the date the instrument was purchased ( $\$1 = \$1$ ), resulting in an amount realized of  $\$1000$ . Accordingly, Z's total amount realized is  $\$1121.74 (\$22 + \$27.30 + \$33.08 + \$39.36 + \$1000)$ , the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to each  $\$30$  payment actually received during 2006. These payments, however, are treated as payments of principal for this purpose because all 2006 accrued interest is reduced to zero by the net negative adjustment. See paragraph (b)(5)(iv)(A)(3) of this section. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the  $\$30$  payment is made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes  $\$18$  of foreign currency gain on the January-June 2006 interest payment  $[£30 \times (\$1.60 - \$1.00)]$ , and  $\$24$  of foreign currency gain on the July-December 2006 interest payment  $[£30 \times (\$1.80 - \$1.00)]$ . Z separately recognizes foreign currency gain with respect to the consideration actually received at maturity,  $\$981.00$ . The amount of such gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in January-June 2005 (other than the  $\$30$  payments), the foreign currency gain is  $\$14 [£20 \times (\$1.80 - \$1.10)]$ . With respect to the portion of the payment attributable to interest accrued in July-December 2005 (other than the

£30 payments), the foreign currency gain is \$10.50 [ $£21 \times (\$1.80 - \$1.30)$ ]. With respect to the portion of the payment attributable to interest accrued in 2006 (other than the £30 payments), no foreign currency gain or loss is recognized under paragraph (b)(5)(ii) of this section because such interest was reduced to zero by the net negative adjustment. With respect to the portion of the payment attributable to principal, the foreign currency gain is \$752 [ $£940 \times (\$1.80 - \$1.00)$ ]. Thus, Z recognizes a foreign currency gain of \$42 on receipt of the two £30 payments in 2006, and \$776.50 ( $\$14 + \$10.50 + \$752$ ) on receipt of the payment at maturity, for a total 2006 foreign currency gain of \$818.50.

(F) *Source.* Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of \$818.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 4. Purchase price greater than adjusted issue price—(i) Facts.* On July 1, 2005, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases a debt instrument with a non-currency contingency for £1405. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275-4(b) if it were denominated in dollars. The debt instrument was originally issued by a foreign corporation on December 31, 2003, for an issue price of £1000, and matures on December 31, 2006. The debt instrument's comparable yield, determined in British pounds under §§1.988-2(b)(2) and 1.1275-4(b), is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue

date under the rules of §1.1275-4(b)) provides for a single payment at maturity of £1349.70 (consisting of a noncontingent payment of £1000 and a projected payment of £349.70). At the time of the purchase, the adjusted issue price of the debt instrument is £1161.76, assuming semiannual accrual periods ending on June 30 and December 31 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1400. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
July 1, 2005	£1.00=\$1.00
Dec. 31, 2006	£1.00=\$2.00

  

Accrual period	Average rate (pounds to dollars)
July 1– December 31, 2005	£1.00=\$1.50
January 1–June 30, 2006	£1.00=\$1.50
July 1–December 31, 2006	£1.00=\$1.50

(ii) *Initial basis.* Under paragraph (b)(7)(ii) of this section, Z's initial basis in the debt instrument is \$1405, Z's purchase price of £1405, translated into functional currency at the spot rate on the date the debt instrument was purchased ( $£1 = \$1$ ).

(iii) *Allocation of purchase price differential.* Z purchased the debt instrument for £1405 when its adjusted issue price was £1161.76. Under paragraph (b)(7)(iii) of this section, Z allocates the £243.24 excess of purchase price over adjusted issue price to the contingent payment at maturity. This allocation is reasonable because the excess is due to an increase in the expected amount of the contingent payment and not, for example, to a decrease in prevailing interest rates.

(iv) *Treatment in 2005—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £59.54 of interest on the debt instrument for the July-December 2005 accrual period (issue price of £1161.76  $\times$  10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £59.54 of interest at the average exchange rate for the accrual period ( $\$1.50 \times £59.54 = \$89.31$ ). Accordingly, Z has interest income in 2005 of \$89.31.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in

July-December 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1221.30 ( $£1161.76 + £59.54$ ). For purposes of determining Z's dollar basis in the debt instrument on January 1, 2006, the \$1405 basis is increased by the £59.54 of accrued interest, translated at the rate at which interest was accrued for the July-December 2005 accrual period. Paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the instrument, as of January 1, 2006, is \$1494.31 [ $\$1405 + (\$59.54 \times \$1.50)$ ].

(v) *Treatment in 2006—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £62.59 of interest on the debt instrument for the January-June 2006 accrual period (issue price of £1221.30  $\times$  10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £62.59 of accrued interest at the average exchange rate for the accrual period ( $\$1.50 \times £62.59 = \$93.89$ ). Similarly, Z accrues £65.80 of interest in the July-December 2006 accrual period [ $(£1221.30 + £62.59) \times 10.25$  percent/2], which is translated at the average exchange rate for the accrual period ( $\$1.50 \times £65.80 = \$98.70$ ). Accordingly, Z accrues £128.39, or \$192.59, of interest income in 2006.

(B) *Effect of positive and negative adjustments—(1) Offset of positive adjustment.* The payment actually made on December 31, 2006, is £1400, rather than the projected £1349.70. Under

paragraph (b)(2)(ii) of this section, Z has a positive adjustment of £50.30 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(7)(iii) of this section, however, Z also has a negative adjustment of £243.24, attributable to the excess of Z's purchase price for the debt instrument over its adjusted issue price. Accordingly, Z will have a net negative adjustment of £192.94 ( $£50.30 - £243.24 = -£192.94$ ) for 2006.

(2) *Offset of accrued interest.* Z's accrued interest income of £128.39 in 2006 is reduced to zero by the net negative adjustment. The net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £64.55 net negative adjustment as an ordinary loss to the extent of the £59.54 previously accrued interest in 2005. This £59.54 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year ( $£1 = \$1.50$ ). Accordingly, Z has an ordinary loss of \$89.31 in 2006. The remaining £5 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis—(1) January-June accrual period.* Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument on July 1, 2006, is £1283.89

(£1221.30 + £62.59 = £1283.89). Under paragraphs (b)(2)(iv) and (b)(3)(iii) of this section, Z's adjusted basis as of July 1, 2006, is \$1588.20 (\$1494.31 + \$93.89).

(2) *July–December accrual period.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1349.70 (£1283.89 + £65.80 accrued interest for July–December). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is \$1686.90 (\$1588.20 plus \$98.70 of accrued interest for July–December).

(3) *Adjustment to basis upon contingent payment.* Under paragraph (b)(7)(iii) of this section, Z's adjusted basis in the debt instrument is reduced at maturity by £243.24, the excess of Z's purchase price for the debt instrument over its adjusted issue price. For this purpose, the adjustment is translated into functional currency at the spot rate on the date the instrument was acquired (£1 = \$1). Accordingly, Z's adjusted basis in the debt instrument at maturity is \$1443.66 (\$1686.90 - \$243.24).

(D) *Amount realized.* Even though Z receives £1400 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £5.01. Therefore, Z is treated as receiving £1344.69 (£1349.70 - £5.01) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £59.54 of the £1344.69 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = \$1.50), resulting in an amount realized of \$89.31; £62.59

of the £1344.69 (representing the interest accrued in January–June 2006) is translated into dollars at the rate at which it was accrued (£1 = \$1.50), resulting in an amount realized of \$93.89; £65.80 of the £1344.69 (representing the interest accrued in July–December 2006) is translated into dollars at the rate at which it was accrued (£1 = \$1.50), resulting in an amount realized of \$98.70; and £1156.76 of the £1344.69 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = \$1), resulting in an amount realized of \$1156.76. Z's amount realized is \$1438.66 (\$89.31 + \$93.89 + \$98.70 + \$1156.76), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of \$5 on retirement of the instrument (\$1438.66 - \$1443.66 = -\$5).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain under section 988 on the instrument with respect to the entire consideration actually received at maturity, £1400. While foreign currency gain or loss ordinarily would not have arisen with respect to £50.30 of the £1400, which was initially treated as a positive adjustment in 2006, the larger negative adjustment in 2006 reduced this positive adjustment to zero. Accordingly, foreign currency gain or loss is recognized with respect to the entire £1400. Under paragraph (b)(5)(ii) of this section, however, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006, and no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Therefore, the entire £1400 is treated as a return of principal for the purpose of determining foreign currency gain or loss, and Z recognizes a total foreign currency gain on December 31, 2001, of \$1400 [ $£1400 \times (\$2.00 - \$1.00)$ ].

(F) *Source.* Z has an ordinary loss of \$89.31, a capital loss of \$5, and a foreign currency gain of \$1400. Under paragraph (b)(6) of this section and

§1.1275-4(b)(9)(iv), the \$89.31 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865-1(b)(2), the \$5 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the \$5 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of \$1400 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 5. Sale of an instrument with a negative adjustment carryforward—(i) Facts.* On December 31, 2003, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases at original issue a debt instrument with non-currency contingencies for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275-4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988-2(b)(2) and 1.1275-4(b), is 10 percent, compounded annually, and the projected payment schedule for the debt instrument provides for payments of £310 on December 31, 2005 (consisting of a noncontingent payment of £50 and a projected amount of £260) and £990 on December 31, 2006 (consisting of a noncontingent payment of £940 and a projected amount of £50). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2005, is £50. On December 30, 2006, Z sells the debt instrument for £940. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2003	£1.00=\$1.00
Dec. 31, 2005	£1.00=\$2.00
Dec. 31, 2006	£1.00=\$2.00

Accrual period	Average rate (pounds to dollars)
January 1–December 31, 2004	£1.00=\$2.00
January 1–December 31, 2005	£1.00=\$2.00
January 1–December 31, 2006	£1.00=\$2.00

(ii) *Treatment in 2004—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2004 (issue price of £1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the

average exchange rate for the accrual period (\$2.00 x £100 = \$200). Accordingly, Z has interest income in 2004 of \$200.

(B) *Adjusted issue price and basis.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in

pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2004. Thus, on January 1, 2005, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the \$1000 basis (\$1.00 x £1000 original cost basis) is



increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2004. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2005, is \$1200 (\$1000 + \$200).

(iii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for 2005 is £110 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ( $\$2.00 \times £110 = \$220$ ).

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2005, is £50, rather than the projected £310. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £260 on December 31, 2005, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2005 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(I) of this section, the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £150 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2004. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year ( $£1 = \$2.00$ ). Accordingly, Z has an ordinary loss of \$200 in 2005. The remaining £50 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument on January 1, 2006, is £900, *i.e.*, the adjusted issue price of the debt instrument on January 1, 2005 (£1100), increased by the interest accrued in 2005 (£110), and decreased by the projected amount of the December 31, 2005, payment (£310). See paragraph (b)(2)(iii) of this section. Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is \$900 (determined as described below). Z's adjusted basis on January 1, 2006, is Z's adjusted basis on January 1, 2005 (\$1200), increased by the functional currency amount of interest accrued in 2005 (\$220), and decreased by the amount of the payments made in 2005, based solely on the projected payment schedule, (£310). The amount of the projected payment is first attributable to the interest accrued in 2005 (£110), and then to the interest accrued in 2004 (£100), and the remaining amount to principal (£100). The interest component of the projected payment is translated into functional currency at the rates at which it was accrued, and the principal component of the projected payment is translated into functional currency at the spot rate on the date the instrument was issued. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument, following the increase of adjusted basis for interest accrued in 2005 ( $\$1200 + \$220 = \$1420$ ), is decreased by \$520 ( $\$220 + \$200 + \$100 = \$520$ ). Z's adjusted basis on January 1, 2006, is therefore, \$900.

(D) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of the £50 payment actually received on December 31, 2005. Based on paragraph (b)(5)(iv) of this section, the £50 payment is attributable to principal since the accrued unpaid interest was completely eliminated by the net negative adjustment. The amount of foreign currency gain is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £50 payment was made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes \$50 of foreign currency gain on the £50 payment. [ $(\$2.00 - \$1.00) \times £50 = \$50$ ]. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of \$50 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iv) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £90 of interest on the debt instrument for 2004 (adjusted issue price of £900 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £90 at the average exchange rate for the accrual period ( $\$2.00 \times £90 = \$180$ ). Accordingly, prior to taking into account the 2005 negative adjustment carryforward, Z has interest income in 2006 of \$180.

(B) *Effect of net negative adjustment.* The £50 negative adjustment carryforward from 2005 is a negative adjustment for 2006. Since there are no other positive or negative adjustments, there is a £50 negative adjustment in 2006 which reduces Z's accrued interest income by £50. Accordingly, after giving effect to the £50 negative adjustment carryforward, Z will accrue \$80 of interest income. [ $(£90 - £50) \times \$2.00 = \$80$ ]

(C) *Adjusted issue price.* Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument determined in pounds is increased by the interest accrued in 2006 (prior to taking into account the negative adjustment carryforward). Thus, on December 30, 2006, the adjusted issue price of the debt instrument is £990.

(D) *Adjusted basis.* For purposes of determining Z's dollar basis in the debt instrument, Z's \$900 adjusted basis on January 1, 2006, is increased by the accrued interest, translated at the rate at which interest was accrued for 2006. See paragraph (b)(3)(iii)(A) of this section. Note, however, that under paragraph (b)(3)(iii)(B) the amount of accrued interest which is reduced as a result of the negative adjustment carryforward, *i.e.*, £50, is treated for purposes of this section as principal, and is translated at the spot rate on the date the instrument was issued, *i.e.*,  $£1.00 = \$1.00$ . Accordingly, Z's adjusted basis in the debt instrument as of December 30, 2006, is \$1030 ( $\$900 + \$50 + \$80$ ).

(E) *Amount realized.* Z's amount realized in denomination currency is £940, *i.e.*, the amount of pounds Z received on the sale of the debt instrument. Under paragraph (b)(3)(iv)(B)(I) of this section, Z's amount realized is first translated by reference to the principal component of basis (including the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section) and then the remaining amount realized, if any, is translated by reference to the accrued unpaid interest component of adjusted basis. Thus, £900 of Z's amount realized is translated by reference to the principal component of

adjusted basis. The remaining £40 of Z's amount realized is treated as principal under paragraph (b)(3)(iii)(B) of this section, and is also translated by reference to the principal component of adjusted basis. Accordingly, Z's amount realized in functional currency is \$940. (No part of Z's amount realized is attributable to the interest accrued on the debt instrument.) Z realizes a loss of \$90 on the sale of the debt instrument ( $\$1030 \text{ basis} - \$940 \text{ amount realized}$ ). Under paragraph (b)(4) of this section and §1.1275-4(b)(8), \$80 of the loss is characterized as ordinary loss, and the remaining \$10 of loss is characterized as capital loss. Under §§1.988-6(b)(6) and 1.1275-4(b)(9)(iv) the \$80 ordinary loss is treated as a deduction that is definitely related to the interest income accrued on the debt instrument. Similarly, under §§1.988-6(b)(6) and 1.865-1(b)(2) the \$10 capital loss is also allocated to the interest income from the debt instrument.

(F) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the £940 he received on the sale of the debt instrument. Under paragraph (b)(5)(iv) of this section, the £940 Z received is attributable to principal (and the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section). Thus, Z recognizes foreign currency gain on December 31, 2006, of \$940. [ $(\$2.00 - \$1.00) \times £940$ ]. Under paragraph (b)(6) of this section and §1.988-4, Z's foreign currency gain of \$940 is sourced by reference to Z's residence and is therefore from sources within the United States.

(d) *Multicurrency debt instruments*—(1) *In general.* Except as provided in this paragraph (d), a multicurrency debt instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be treated as an instrument described in paragraph (a)(1)(i) of this section and shall be accounted for under the rules of paragraph (b) of this section. Because payments on an instrument described in paragraph (a)(1)(ii) or (iii) of this section are denominated in, or determined by reference to, more than one currency, the issuer and holder or holders of the instrument are required to determine the denomination currency of the instrument under paragraph (d)(2) of this section before applying the rules of paragraph (b) of this section.

(2) *Determination of denomination currency.* The denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be the predominant currency of the instrument. The predominant currency of the instrument shall be determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary)

into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (e.g., changes in value of one or more currencies).

(3) *Issuer/holder consistency.* The issuer determines the denomination currency under the rules of paragraph (d)(2) of this section and provides this information to the holders of the instrument in a manner consistent with the issuer disclosure rules of §1.1275-2(e). If the issuer does not determine the denomination currency of the instrument, or if the issuer's determination is unreasonable, the holder of the instrument must determine the denomination currency under the rules of paragraph (d)(2) of this section. A holder that determines the denomination currency itself must explicitly disclose this fact on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the instrument.

(4) *Treatment of payments in currencies other than the denomination currency.* For purposes of applying the rules of paragraph (b) of this section to debt instruments described in paragraph (a)(1)(ii) or (iii) of this section, payments not denominated in (or determined by reference to) the denomination currency shall be treated as non-currency-related contingent payments. Accordingly, if the denomination currency of the instrument is determined to be the taxpayer's functional currency, the instrument shall be accounted for under §1.1275-4(b) rather than this section.

(e) *Instruments issued for nonpublicly traded property—(1) Applicability.* This paragraph (e) applies to debt instruments issued for nonpublicly traded property that would be described in paragraph (a)(1)(i), (ii), or (iii) of this section, but for the fact that such instruments are described in §1.1275-4(c)(1) rather than

§1.1275-4(b)(1). For example, this paragraph (e) generally applies to a contingent debt instrument denominated in a non-functional currency that is issued for non-publicly traded property. Generally the rules of §1.1275-4(c) apply except as set forth by the rules of this paragraph (e).

(2) *Separation into components.* An instrument described in this paragraph (e) is not accounted for using the noncontingent bond method of §1.1275-4(b) and paragraph (b) of this section. Rather, the instrument is separated into its component payments. Each noncontingent payment or group of noncontingent payments which is denominated in a single currency shall be considered a single component treated as a separate debt instrument denominated in the currency of the payment or group of payments. Each contingent payment shall be treated separately as provided in paragraph (e)(4) of this section.

(3) *Treatment of components consisting of one or more noncontingent payments in the same currency.* The issue price of each component treated as a separate debt instrument which consists of one or more noncontingent payments is the sum of the present values of the noncontingent payments contained in the separate instrument. The present value of any noncontingent payment shall be determined under §1.1274-2(c)(2), and the test rate shall be determined under §1.1274-4 with respect to the currency in which each separate instrument is considered denominated. No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273-1(c)) and the *de minimis* rules of section 1273(a)(3) and §1.1273-1(d) do not apply to the separate debt instrument. Interest income or expense is translated, and exchange gain or loss is recognized on the separate debt instrument as provided in §1.988-2(b)(2), if the instrument is denominated in a nonfunctional currency.

(4) *Treatment of components consisting of contingent payments—(i) General rule.* A component consisting of a contingent payment shall generally be treated in the manner provided in §1.1275-4(c)(4). However, except as provided in paragraph (e)(4)(ii) of this section, the test rate shall be determined by reference to the U.S. dollar unless the dollar does not reasonably reflect the economic substance of the contingent component. In such case, the test

rate shall be determined by reference to the currency which most reasonably reflects the economic substance of the contingent component. Any amount received in nonfunctional currency from a component consisting of a contingent payment shall be translated into functional currency at the spot rate on the date of receipt. Except in the case when the payment becomes fixed more than six months before the payment is due, no foreign currency gain or loss shall be recognized on a contingent payment component.

(ii) *Certain delayed contingent payments—(A) Separate debt instrument relating to the fixed component.* The rules of §1.1275-4(c)(4)(iii) shall apply to a contingent component the payment of which becomes fixed more than 6 months before the payment is due. For this purpose, the denomination currency of the separate debt instrument relating to the fixed payment shall be the currency in which payment is to be made and the test rate for such separate debt instrument shall be determined in the currency of that instrument. If the separate debt instrument relating to the fixed payment is denominated in nonfunctional currency, the rules of §1.988-2(b)(2) shall apply to that instrument for the period beginning on the date the payment is fixed and ending on the payment date.

(B) *Contingent component.* With respect to the contingent component, the issue price considered to have been paid by the issuer to the holder under §1.1275-4(c)(4)(iii)(A) shall be translated, if necessary, into the functional currency of the issuer or holder at the spot rate on the date the payment becomes fixed.

(5) *Basis different from adjusted issue price.* The rules of §1.1275-4(c)(5) shall apply to an instrument subject to this paragraph (e).

(6) *Treatment of a holder on sale, exchange, or retirement.* The rules of §1.1275-4(c)(6) shall apply to an instrument subject to this paragraph (e).

(f) *Rules for nonfunctional currency tax exempt obligations described in §1.1275-4(d).* [RESERVED]

(g) *Effective date.* This section shall apply to debt instruments issued 60 days or more after the date final regulations are published in the **Federal Register**.

Par. 4. In §1.1275-4, paragraph (a)(2)(iv) is revised to read as follows:

*§1.1275-4 Contingent payment debt instruments.*

(a)\*\*\*

(2)\*\*\*

(iv) A debt instrument subject to section 988 (except as provided in §1.988-6);

\*\*\*\*\*

David A. Mader,  
Acting Deputy Commissioner of  
Internal Revenue.

(Filed by the Office of the Federal Register on August 28, 2003, 8:45 a.m., and published in the issue of the Federal Register for August 29, 2003, 68 F.R. 51944)

## Notice of Proposed Rulemaking

### Section 1446 Regulations

#### REG-108524-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the obligation of a partnership to pay a withholding tax on effectively connected taxable income allocable under section 704 to a foreign partner. The regulations will affect partnerships engaged in a trade or business in the United States that have one or more foreign partners.

DATES: Written or electronic comments and requests to speak, with outlines of topics to be discussed at the public hearing scheduled for December 4, 2003, must be received by November 13, 2003.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-108524-00), room 5203, Internal Revenue Service, P.O. Box 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:LPD:PR (REG-108524-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to

the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David J. Sotos, at (202) 622-3860, or to be placed on the attendance list for the hearing, LaNita Van Dyke at (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington DC 20224. Comments on the collections of information should be received by November 3, 2003. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in this proposed regulation are in §§1.871-10, 1.1446-1, 1.1446-3, and 1.1446-4. This information is required to determine whether a partnership is required to pay a withholding tax with respect to a foreign partner and provide information concerning the tax paid on such partner's behalf, and to determine the foreign person required to report the effectively connected taxable income earned by such partnership and entitled to claim credit for the withholding tax paid by the partnership. This information will be used in issuing refunds to foreign persons claiming credit for withholding tax paid on their behalf, as well as for audit and examination purposes. The reporting requirements in §§1.871-10 and 1.1446-3 are mandatory. The reporting requirement in §1.1446-1 and 1.1446-4 are voluntary. The likely respondents include individuals, business or other for profit institutions, and small businesses or organizations.

Estimated total annual reporting burden: 7,805 hours.

Estimated average annual burden hours per respondent: 0.5 hours.

Estimated number of respondents: 15,775.

Estimated annual frequency of responses: on occasion and quarterly.

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

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

##### Background

This document contains proposed amendments to 26 CFR part 1 under section 1446 of the Internal Revenue Code (Code). Section 1446 was added to the Code by section 1246(a) of the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2085, 2582 (1986 Act)), to impose withholding at a rate of 20 percent on distributions to a foreign partner by a partnership that was engaged in a U.S. trade or business. Section 1012(s)(1)(A) of the

Technical and Miscellaneous Revenue Act of 1988 (Public Law 100-647, 102 Stat. 3342, 3526 (1988 Act)) revised section 1446 to require that a withholding tax (1446 tax) be imposed on effectively connected taxable income (ECTI) allocable to a partner that is a foreign person (foreign partner) at the highest tax rate applicable to such person. Finally, section 7811(i)(6) of the Omnibus Budget Reconciliation Act of 1989 (Public Law 101-239, 103 Stat. 2106, 2410 (1989 Act)), made certain technical amendments to section 1446.

Treasury and the IRS issued Rev. Proc. 88-21, 1988-1 C.B. 777, to provide guidance on the operation of the withholding tax imposed under section 1446 as enacted by the 1986 Act. After the 1988 Act, which revised the withholding approach to apply to a partner's allocable share of ECTI instead of to distributions, Treasury and the IRS published Rev. Proc. 89-31, 1989-1 C.B. 895, which made Rev. Proc. 88-21 obsolete. Rev. Proc. 89-31 was modified by Rev. Proc. 92-66, 1992-2 C.B. 428. Rev. Proc. 89-31, as modified by Rev. Proc. 92-66, provides current guidance to partnerships for calculating, paying over, and reporting the 1446 tax.

## Explanation of Provisions

### A. In General

Prior to the enactment of section 1446, a partnership generally was not required to withhold on income that was effectively connected with the conduct of a trade or business within the United States (a U.S. trade or business) and allocated or distributed to its foreign partners. Congress enacted section 1446 because it was concerned that passive foreign investors could escape U.S. tax on their partnership income. See S. Rep. No. 99-313, 99<sup>th</sup> Cong., 2d Sess. 414 (1986). As originally enacted, section 1446 generally required both domestic and foreign partnerships with any income, gain, or loss that was effectively connected with the conduct of a U.S. trade or business to withhold a tax equal to 20 percent of any amount distributed to a foreign partner. Through a series of modifications and refinements discussed below, this withholding tax regime

evolved from its original structure of withholding on distributions to foreign partners to its present form of, generally, withholding on an installment basis on partnership ECTI (whether distributed or not distributed), apart from special provisions for publicly traded partnerships.

In response to the enactment of section 1446, Treasury and the IRS issued Rev. Proc. 88-21 to provide guidance for partnerships to comply with section 1446. After Rev. Proc. 88-21 was issued, the 1988 Act amended section 1446 retroactively and provided that no withholding was required under section 1446 for partnership taxable years beginning before January 1, 1988.

Section 1446, as revised by the 1988 Act, shifted from imposing a withholding tax on partnership distributions to imposing a withholding tax on the amount of ECTI allocable to the partnership's foreign partners. More specifically, section 1446(a) requires partnerships that have ECTI in any taxable year, any portion of which is allocable under section 704 to a foreign partner, to pay the 1446 tax at such time and in such manner as prescribed in regulations. The amount of withholding tax payable by a partnership under section 1446 is equal to the applicable percentage of the partnership's ECTI allocable under section 704 to foreign partners. The applicable percentage for ECTI allocable to a foreign corporation is the highest rate of tax specified in section 11(b), and the applicable percentage for ECTI allocable to a non-corporate foreign partner is the highest rate of tax specified in section 1. Further, section 1446(d), as amended by the 1988 Act, provides that a foreign partner is entitled to a credit under section 33 for such partner's share of the 1446 tax, and, except as provided in regulations, such partner's share of the 1446 tax paid by the partnership is treated as distributed to such partner on the last day of the taxable year for which such tax was paid. The credit under section 33 is applied against the partner's U.S. tax liability for the taxable year in which the partner includes its allocable share of the partnership's effectively connected income.

Treasury and the IRS issued Rev. Proc. 89-31 to provide guidance to partnerships under section 1446, as amended by the 1988 Act. This revenue procedure made Rev. Proc. 88-21 obsolete. In general,

Rev. Proc. 89-31 provides guidance concerning the requirement to pay a withholding tax, the determination of whether a partner is a foreign person, the calculation of partnership ECTI, the amount of the withholding tax, and the procedures for reporting and paying over the 1446 tax. The revenue procedure generally follows the regime set forth in section 6655 for estimated tax payments by corporations, and requires a partnership to annualize its ECTI and pay over the 1446 tax in quarterly installments. Further, the revenue procedure provides special rules for publicly traded partnerships and tiered partnership structures. A partnership subject to section 1446 must continue to comply with Rev. Proc. 89-31, as modified by Rev. Proc. 92-66 (discussed below), until the partnership's first taxable year beginning after the date these regulations are issued in final form.

Section 7811(i)(6) of the 1989 Act amended section 1446 in three respects. First, the amendment provides that, except as provided in regulations, a foreign partner's share of the 1446 tax paid by a partnership is treated as distributed to such partner on the earlier of the day on which such tax is paid by the partnership or the last day of the partnership's taxable year for which such tax is paid. Second, the amendment grants Treasury and the IRS regulatory authority to apply the addition to tax under section 6655 to a partnership as if it were a corporation. Third, the amendment clarifies that the applicable percentage for a foreign corporate partner is the highest rate of tax specified in section 11(b)(1). The changes made by the 1989 Act are effective for partnership taxable years beginning after December 31, 1987, as if originally included as part of the 1988 Act amendments.

In 1992, Treasury and the IRS issued Rev. Proc. 92-66, which modified Rev. Proc. 89-31 in three respects. First, Rev. Proc. 92-66 provides that the applicable percentage to be used by publicly traded partnerships in calculating the 1446 tax is the highest rate of tax imposed under section 1, which at that time was 31 percent. Second, the revenue procedure allows a partnership to seek a refund from the IRS in certain circumstances for amounts it has paid under section 1446. Third, the revenue procedure provides that a foreign partnership subject to withholding under

section 1445(a) during a taxable year is allowed to credit the amount withheld under section 1445(a), to the extent such amount is allocable to foreign partners, against its liability to pay the 1446 tax for that year.

### B. Structure of the Proposed Regulations

In general, the proposed regulations follow the approach in Rev. Proc. 89-31 for computing, paying over and reporting the 1446 tax. The proposed regulations are set forth in six sections. Section 1.1446-1 contains rules regarding a partnership's requirement to pay a withholding tax, and how a partnership should determine the status of its partners (*i.e.*, domestic or foreign, corporate or non-corporate). Section 1.1446-2 contains rules for calculating partnership ECTI allocable to each foreign partner. Section 1.1446-3 contains rules pertaining to a partnership's obligation to pay the 1446 tax on an installment basis, including guidance on calculating the 1446 tax, reporting and paying over the 1446 tax, and penalties for underpayment of the 1446 tax. Section 1.1446-4 contains special rules applicable to publicly traded partnerships. These rules generally implement a withholding regime based upon the distribution of effectively connected income to foreign partners. These regulations also permit publicly traded partnerships to elect to withhold and pay over the 1446 tax based upon the general rules set forth in §§1.1446-1 through 1.1446-3 (withholding based upon ECTI allocable under section 704 to foreign partners). Section 1.1446-5 contains rules applicable to tiered partnership structures, including rules for looking through certain upper-tier foreign partnerships to determine the 1446 tax obligation of a lower-tier partnership. Finally, §1.1446-6 contains the proposed effective date of the regulations.

In addition to the proposed regulatory amendments under section 1446, these regulations also include proposed amendments to §§1.871-10, 1.1443-1, 1.1461-1 through 1.1461-3, 1.1462-1, 1.1463-1, 301.6109-1, and 301.6721-1, to coordinate the section 1446 withholding regime with existing regulations.

### C. Determining the Status and Classification of Partners—§1.1441-1

Section 1446 applies only to partnerships with ECTI allocable under section 704 to one or more foreign partners. Section 1446(e) defines a foreign partner as any partner who is not a United States person. Section 7701(a)(30) defines a United States person to include a citizen or resident of the United States, a domestic partnership, a domestic corporation, any estate other than a foreign estate within the meaning of section 7701(a)(31), and any trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust. Section 1446 and the legislative history are silent as to how a partnership is to determine the domestic or foreign status of its partners.

Rev. Proc. 89-31 contains rules for determining whether a partner is a foreign partner for purposes of section 1446. Under the revenue procedure, a partnership may determine a partner's status by relying upon a certification of non-foreign status provided by the partner, or by relying on any other means. See Rev. Proc. 89-31, §5.02 and §5.03.

In order to reduce the paperwork burden imposed on taxpayers and avoid conflicting information, the proposed regulations reflect an approach different from the approach taken in Rev. Proc. 89-31 for determining whether a partner is a foreign partner. The proposed regulations generally require a partnership to comply with the paperwork requirements used under section 1441 to determine the status (domestic or foreign) and the tax classification (corporate or non-corporate) of its partners. Under the proposed regulations, a partnership should obtain either a Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding," Form W-8IMY, "Certificate of Foreign Intermediary, Flow Through Entity, or Certain U.S. Branches for United States Tax Withholding," or Form W-9, "Request for Taxpayer Identification Number and Certification," from each of its partners. Additionally, special rules are provided with respect to domestic and foreign trusts all or a portion of which are treated as owned by a grantor or another

person under subpart E of subchapter J of the Code. The documentation requirement set forth in the proposed regulations will allow a partnership required to withhold under both section 1441 and section 1446 to receive one form instead of two from each of its partners, and thus will reduce the paperwork and recordkeeping burden imposed upon partners and partnerships. Further, the required documentation will also serve to establish a uniform basis for determining the foreign or non-foreign status of partners and to reduce the instances where a partnership receives inconsistent documentation.

In the absence of a valid Form W-8BEN, Form W-8IMY, or Form W-9 from a partner (or upon the receipt of a form that the partnership has actual knowledge or reason to know is incorrect or unreliable), the proposed regulations contain a presumption that the partner is a foreign person and that the partnership must pay 1446 tax on ECTI allocable to the partner. However, this presumption does not apply, and the partnership shall not be liable for 1446 tax with respect to a partner, to the extent the partnership relies on other means to ascertain the non-foreign status of a partner, and the partnership is correct in its determination that such partner is a U.S. person. This approach is similar to Rev. Proc. 89-31, which permitted partnerships to rely on other means to ascertain the non-foreign status of a partner. See Rev. Proc. 89-31, §5.03. Under the proposed regulations, when the presumption of foreign status applies, the following rules apply for purposes of determining the applicable rate that will apply in computing the 1446 tax. If the partnership knows that the partner is an individual and not an entity, the partnership shall compute the 1446 tax with respect to such partner using the highest rate in section 1. If the partnership knows that the partner is an entity that is a corporation under §301.7701-2(b)(8) (included on the *per se* list of entities under the entity classification regulations), the partnership shall treat the partner as a foreign corporation and compute the 1446 tax with respect to such partner using the highest rate in section 11(b)(1). In all other cases, including where the partnership cannot reliably determine the status of the partner, the proposed regulations

presume that the partner is either a corporate or non-corporate partner, based upon whichever classification results in a higher 1446 tax being due. This presumption is necessary to prevent a partner from obtaining a more favorable withholding result than would have been achieved if the partner complied with the documentation requirements. The duration and validity of the forms required for purposes of section 1446 is intended to be consistent with the standards applicable when these forms are submitted in the context of sections 1441, 1442, and 3406. These forms and their instructions will be modified as necessary to facilitate their use under section 1446.

#### *D. Determining a Foreign Partner's Allocable Share of Partnership ECTI—§1.1446-2*

The proposed regulations contain rules for computing partnership ECTI allocable to foreign partners. Consistent with Rev. Proc. 89-31, the partnership determines its ECTI allocable to a foreign partner using an aggregate approach. The partnership first determines the effectively connected partnership items allocable to each of the partnership's foreign partners. Partnership ECTI allocable to all foreign partners then is computed by combining all of the foreign partners' allocable shares of partnership ECTI.

The proposed regulations also provide guidance concerning capital losses, suspended losses, and loss carryovers and carrybacks when determining a foreign partner's allocable share of partnership ECTI. The proposed regulations permit capital losses allocable to a foreign partner to offset such partner's allocable share of capital gains consistent with section 1211(a). Solely for purposes of section 1446, the proposed regulations do not permit the partnership to consider section 1211(b), which permits an individual to use capital losses in excess of capital gains to the extent of \$3,000 per taxable year. Further, the proposed regulations do not permit the partnership to take into account in determining a foreign partner's allocable share of partnership ECTI any losses of a partner that are carried over or back or are suspended.

A number of issues arise under section 1446 where the partnership has cancellation of indebtedness income under section

61(a)(12), including difficulties arising because the exclusion of cancellation of indebtedness income under section 108 is applied at the partner level rather than at the partnership level. See section 108(d)(6). These proposed regulations do not specifically address the treatment of cancellation of indebtedness income of a partnership under section 1446. Comments are requested concerning the appropriate treatment under section 1446 of such income allocable to a foreign partner.

#### *E. Calculating, Paying Over, and Reporting the 1446 Tax—§1.1446-3*

Section 1446(f)(2) provides that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of section 1446, including regulations providing (1) that, for purposes of section 6655, the withholding tax imposed under section 1446 be treated as a tax imposed by section 11 and any partnership required to pay such tax be treated as a corporation, and (2) appropriate adjustments in applying section 6655 with respect to such withholding. Section 6655 generally requires a corporation to make estimated tax payments throughout its taxable year, and determines an addition to tax for any underpayment of the required installments.

Rev. Proc. 89-31 generally requires a partnership, other than a publicly traded partnership, to determine its ECTI allocable to foreign partners, and, ultimately, its 1446 tax obligation, by annualizing its effectively connected items under one of the three options generally available to corporations under section 6655 when paying estimated taxes. As an alternative, Rev. Proc. 89-31 permits a partnership to determine its 1446 tax obligation based upon a safe harbor. Under both the safe harbor and the annualization methods, a partnership must pay the 1446 tax on an installment basis.

The proposed regulations adopt, with some modifications, the estimated tax payment rules set forth in section 6655, including the imposition of an addition to tax for an underpayment of the 1446 tax. Consistent with Rev. Proc. 89-31, the proposed regulations require a partnership

to pay its 1446 tax obligation on an installment basis, and pay its 1446 tax either based upon annualizing its income or based upon a safe harbor. The proposed regulations broaden the approaches available in Rev. Proc. 89-31 in certain circumstances. Under the proposed regulations, a partnership that chooses to annualize its income may use certain methods in section 6655 that address the seasonality of income earned by a partnership. See section 6655(e). Further, the proposed regulations modify the safe harbor set forth in Rev. Proc. 89-31 so that a partnership does not need to have filed Form 1065, "U.S. Return of Partnership Income," and Form 8804, "Annual Return for Partnership Withholding Tax (Section 1446)," at the time it makes an installment payment. Instead, it is sufficient if the partnership timely files these forms (taking into account extensions).

#### *F. Special Rule for Tiered Trust or Estate Structures—§1.1446-3(d)(2)(iii)*

Treasury and the IRS are concerned about the potential abuse of tiered trust structures to claim inappropriate refunds of the 1446 tax, to avoid reporting by a beneficiary of ECTI earned by a partnership, or to avoid section 1446 entirely. Existing provisions contemplate that entitlement to a credit or refund of any section 1446 withholding tax follows the liability for tax. Section 1446(d) provides that each foreign partner of a partnership shall be allowed a credit under section 33 for such partner's share of the 1446 tax paid by the partnership. A foreign partner's share of any 1446 tax paid by the partnership is treated as distributed to the partner by such partnership. Section 1462 provides that income on which any tax is required to be withheld at the source under chapter 3 of the Code, including section 1446, shall be included in the return of the recipient of such income, and any amount of tax so withheld may be credited against the amount of income tax as computed in such return. The regulations under section 1462 explain that an amount withheld on a payment to a fiduciary, partnership, or intermediary is deemed to have been paid by the taxpayer ultimately liable for the tax upon such income. See §1.1462-1(b). Sections 702(b), 652(b), and 662(b) ensure that the character of income (*e.g.*,

income that is effectively connected income) of a partnership allocated to a trust (whether domestic or foreign) is preserved in the hands of a beneficiary (see Rev. Rul. 85-60, 1985-1 C.B. 187).

The proposed regulations include clarification of the regulations under section 1462 to coordinate with section 1446(d) to provide that a foreign trust's or estate's allocable share of ECTI is deemed to have been paid by the taxpayer ultimately liable for tax upon such income. In the case of a foreign grantor trust, the taxpayer ultimately liable for the tax upon such income is the grantor of such trust.

Further, §1.1446-3 of the proposed regulations includes two rules and several examples pertaining to tiered trust or estate structures. The rules are intended to match the credit claimed under section 33 with the taxpayer that reports and pays tax on the ECTI upon which the credit is based. The first rule applies where a foreign trust or estate is a partner in a partnership required to pay the 1446 tax and the beneficiary of the foreign trust or estate is either another foreign trust (with a foreign person as a beneficiary of such trust) or a foreign person. In such a circumstance, the proposed regulations provide that the foreign trust or estate is only entitled to claim the portion of the credit under section 33 that corresponds to the portion of the associated effectively connected income on which it bears the tax liability.

The second rule addresses the use of a domestic trust. The second rule applies where a partnership knows or has reason to know that a foreign person that is the ultimate beneficial owner of the effectively connected income holds its interest in the partnership through a domestic trust, and such domestic trust was formed or availed of with a principal purpose of avoiding the 1446 tax. The use of a domestic trust in a tiered trust structure may have a principal purpose of avoiding the 1446 tax even though the tax avoidance purpose is outweighed by other purposes when taken together. Where applicable, this rule allows the IRS to impose the 1446 tax obligation on such partnership as if each domestic trust in the chain is a foreign trust.

#### G. Publicly Traded Partnerships—§1.1446-4

Section 1446(f)(1) provides that the Secretary shall prescribe regulations to apply section 1446 in the case of publicly traded partnerships. In this regard, the legislative history to section 1446 specifically notes that special rules may be necessary in identifying a publicly traded partnership's partners as U.S. or foreign. See H.R. Rep. No. 100-795, 100<sup>th</sup> Cong., 2d Sess. 291 (1988); S. Rep. No. 100-445, 100<sup>th</sup> Cong., 2d Sess. 305 (1988).

Rev. Proc. 89-31 provides special rules for publicly traded partnerships. Under Rev. Proc. 89-31, the term *publicly traded partnership* means a regularly traded partnership within the meaning of the regulations under section 1445(e)(1), but not a publicly traded partnership treated as a corporation under the general rules of section 7704(a). Generally, publicly traded partnerships with effectively connected income, gain or loss are required to withhold based upon distributions made to foreign partners. Rev. Proc. 92-66 modified the applicable percentage for withholding on distributions to the highest rate of tax imposed under section 1, and applied that percentage to both corporate and non-corporate partners.

Under Rev. Proc. 89-31, a publicly traded partnership generally determines the tax status of its partners by receiving either a certificate of non-foreign status, a Form W-8, or a Form W-9 from its partners, or by relying on other means. Further, nominees that hold interests in a publicly traded partnership on behalf of one or more foreign partners may be responsible for the 1446 tax liability for foreign partners under certain circumstances. Finally, Rev. Proc. 89-31 permits publicly traded partnerships to elect to apply the general rules that determine the 1446 tax based on a foreign partner's allocable share of partnership ECTI rather than on distributions to foreign partners. Under Rev. Proc. 89-31, the publicly traded partnership makes this election by complying with the payment and reporting requirements of the general rules and attaching a statement to its annual return of withholding tax indicating that the election is being made.

The proposed regulations modify several of the rules for publicly traded partnerships set forth in Rev. Proc. 89-31. First, the proposed regulations define *publicly traded partnership* solely by reference to the definition in section 7704. Second, the proposed regulations provide that the documentation requirements and presumptions of §1.1446-1 apply to publicly traded partnerships, thereby requiring such partnerships to obtain a Form W-8BEN, Form W-8IMY, or Form W-9 from each of their partners if they do not rely on other means to determine the status of their partners. Third, the proposed regulations provide that the applicable percentage for withholding on distributions is the rate applicable under section 1446(b).

Comments are requested as to whether the special rules applicable to publicly traded partnerships should be extended to other partnerships. Specifically, Treasury and the IRS are considering whether these special rules should apply to partnerships that make an election under section 775 of the Code or partnerships with a specified minimum number of partners.

#### H. Tiered Partnership Structures—§1.1446-5

Special concerns arise when a foreign partnership (upper-tier partnership) is a partner in a second partnership (lower-tier partnership) that is subject to section 1446. Section 1446(f) provides the Secretary with regulatory authority to prescribe rules necessary to carry out the purposes of the section. The legislative history to section 1446 notes that in the context of tiered partnership structures, "rules may be necessary to prevent the imposition of more tax than will be properly due (for example, rules to prevent the tax from being imposed on more than one partnership and rules to determine the applicable percentages)." H.R. Rep. No. 100-795, 100<sup>th</sup> Cong., 2d Sess. 291 (1988); S. Rep. No. 100-445, 100<sup>th</sup> Cong., 2d Sess. 305 (1988).

Rev. Proc. 89-31 employs an entity approach in computing the 1446 tax obligation of a partnership that has a foreign partnership as one of its partners. Under the entity approach, a lower-tier partnership must pay a 1446 tax at the highest rate

in section 1 on an upper-tier foreign partnership's allocable share of ECTI, regardless of the composition of the upper-tier partnership. Rev. Proc. 89-31 provides the upper-tier partnership a credit for a portion of the 1446 tax paid by the lower-tier partnership to avoid multiple application of the 1446 tax. This approach may result in a partnership paying a 1446 tax that is greater in amount than would have been required if the partners of the upper-tier partnership had been direct partners of the lower-tier partnership, for example, where some of the partners of the upper-tier partnership are U.S. persons.

The proposed regulations modify the rules in Rev. Proc. 89-31 with respect to certain tiered partnership structures to address this situation. The proposed regulations provide that if a partner in a partnership that is required to pay the 1446 tax is a foreign partnership, it may submit a completed Form W-8IMY to the lower-tier partnership. If the upper-tier foreign partnership completes and submits Form W-8IMY to the lower-tier partnership, and passes along the Form W-8BEN, Form W-8IMY, or Form W-9 it received for some or all of its partners, as well as information describing how effectively connected items are allocated among its partners, the lower-tier partnership shall look through the upper-tier partnership to the partners of the upper-tier partnership (to the extent that it has received the appropriate documentation and allocation information and can reliably associate the allocation of its effectively connected items to the partners of the upper-tier partnership) to determine its 1446 tax obligation. To the extent the lower-tier partnership receives a valid Form W-8IMY from the upper-tier partnership but cannot reliably associate the upper-tier partnership's allocable share of effectively connected partnership items with a withholding certificate for each of the upper-tier partnership's partners, the lower-tier partnership shall withhold at the higher of the applicable percentages in section 1446(b).

Therefore, in appropriate circumstances, the lower-tier partnership may determine its 1446 tax obligation based on the status of its indirect partners. This approach generally is consistent with the paperwork requirements under section 1441 applicable to a nonwithholding foreign partnership and will ensure that the

1446 tax paid by the partnership more closely approximates the actual tax liability of the beneficial owner of the income in the case of a tiered partnership structure. An upper-tier foreign partnership with foreign partners remains obligated to file and report with respect to its 1446 tax obligation. Accordingly, the upper-tier partnership must comply with the general rules of section 1446, including requiring payment in installments, and reporting and passing along the credit under section 33 to its partners, which in these situations will also include the tax paid at the lower-tier partnership level.

Comments are requested on the general approach taken in these proposed regulations for situations involving two or more tiers of partnerships. Further, comments are requested as to the desirability and administrability of an alternative approach that allows a domestic upper-tier partnership with foreign partners to elect to pass information regarding its partners to the lower-tier partnership and have the lower-tier partnership pay the 1446 tax based upon the composition of the partners of the upper-tier partnership.

#### *I. Withholding in Excess of Partner's Actual Tax Liability*

Since the enactment of section 1446, Treasury and the IRS have received and considered several comments regarding the potential for section 1446 to require a partnership to pay a withholding tax in an amount that exceeds a foreign partner's actual tax liability for a taxable year. This situation may occur for several reasons, including that: (1) section 1446 does not take into account a partner's losses from outside the partnership during the year, or a partner's loss carryovers; and (2) section 1446 requires withholding at the maximum statutory rates generally applicable to a foreign partner with effectively connected income. Section 1446 does not contain provisions for reducing or eliminating the general withholding obligation like the provisions contained in section 1445 (which impose a withholding tax in the case of the disposition of an interest in United States real property). See section 1445(c). Rev. Proc. 89-31 provides that section 1446 applies instead of section 1445(e)(1) where the two sections overlap, and, accordingly, partnerships owning

U.S. real property are not permitted to reduce withholding on gains from the disposition of such property through the use of the procedures available under section 1445. See also §8.01 of Rev. Proc. 2000-35, 2000-2 C.B. 211.

Treasury and the IRS considered comments regarding alternative approaches for adjusting the withholding tax obligation under section 1446 to more closely approximate a foreign partner's actual U.S. tax liability. These proposed regulations contain provisions aimed at mitigating the potential for withholding in excess of the partner's actual tax liability (see *e.g.*, §1.1446-5). These proposed regulations do not contain other provisions that have been suggested because, among other reasons, of concerns regarding the administrability of such approaches. Comments are requested with respect to approaches that would permit an adjustment to the amount of 1446 tax obligation that are consistent with the statute and legislative history and administrable by partnerships, partners and the IRS. In particular, comments are requested on whether the rules coordinating sections 1445 and 1446 should be modified to address these concerns.

#### *J. Effective Date*

These regulations are proposed to apply to partnership taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**.

#### **Effect on Other Documents**

The following publications will be obsolete for partnership taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**:

Rev. Proc. 89-31, 1989-1 C.B. 895

Rev. Proc. 92-66, 1992-2 C.B. 428

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. It also has been determined that section 533(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations.



With respect to the collections of information contained in §1.871-10, §1.1446-1 (pertaining to domestic grantor trusts), and §1.1446-3 (pertaining to foreign trusts), it is hereby certified that these collections of information will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that only limited small entities are impacted by these collections and the burden associated with such collections is .5 hours. With respect to the collections of information in §§1.1446-3 (pertaining to a partnership required to notify its foreign partners of an installment payment of 1446 tax paid on behalf of such partner) and 1.1446-4, it is hereby certified that these sections will not impose a significant economic impact on a substantial number of small entities. This certification is based upon the fact that while approximately 15,000 small entities will be impacted by these sections, the estimated annual burden associated with these sections is only .5 hours per respondent. Moreover, the information collection in §1.1446-4 is voluntary. 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, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) 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*. All comments will be available for public inspection and copying. The Treasury Department and IRS request comments on the clarity of the proposed regulations and how they may be made easier to understand.

A public hearing has been scheduled for December 4, 2003, beginning at 10 a.m. in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must come to the Constitution Avenue entrance and present photo identification

to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 13, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these proposed regulations is David J. Sotos, Office of the Associate Chief Counsel (International). However, other personnel from the Treasury Department and IRS participated in their development.

\* \* \* \* \*

### Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are 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 \* \* \*  
§1.1446-3 also issued under 26 U.S.C. 1446(f).

§1.1446-4 also issued under 26 U.S.C. 1446(f). \* \* \*

Par. 2. In §1.871-10, paragraph (d)(3) is amended by adding a sentence at the end of that paragraph, and paragraph (e) is amended by revising the first sentence to read as follows:

*§1.871-10 Election to treat real property income as effectively connected with U.S. business.*

\* \* \* \* \*

(d) \* \* \*

(3) *Election by partnership.* \* \* \* If the nonresident alien or foreign corporation makes an election, such person must provide the partnership a Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for U.S. Withholding," and must indicate that the nonresident alien or foreign corporation has made the election under this section to treat real property income as effectively connected income.

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966, except the last sentence of paragraph (d)(3) shall apply to partnership taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**. \* \* \*

Par. 3. In §1.1443-1 is amended by:

1. Revising the first sentence of paragraph (a) and adding a sentence at the end of the paragraph.

2. Revising paragraph (c)(1).

The revision and additions read as follows:

*§1.1443-1 Foreign tax-exempt organizations.*

(a) *Income includible in computing unrelated business taxable income.* In the case of a foreign organization that is described in section 501(c), amounts paid or effectively connected taxable income allocable to the organization that are includible under section 512 in computing the organization's unrelated business taxable income are subject to withholding under §§1.1441-1, 1.1441-4, 1.1441-6, and 1.1446-1 through 1.1446-5, in the same manner as payments or allocations of effectively connected taxable income of the same amounts to any foreign person that is not a tax-exempt organization.\*\*\* See also §1.1446-3(c)(3).

\* \* \* \* \*

(c) \* \* \*

(1) *In general.* This section applies to payments made after December 31, 2000, except that the references in paragraph (a) of this section to effectively connected taxable income and withholding under section 1446 shall apply to partnership taxable

years beginning after the date these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

Par. 4. Sections 1.1446-0 through 1.1446-6 are added to read as follows.

*§1.1446-0 Table of contents* This section lists the captions contained in §§1.1446-1 through 1.1446-6.

*§1.1446-1 Withholding tax on foreign partners' share of effectively connected taxable income.*

- (a) In general.
- (b) Steps in determining 1446 tax obligation.
- (c) Determining whether a partnership has a foreign partner.
  - (1) In general.
  - (2) Forms W-8BEN, W-8IMY, and W-9.
- (i) In general.
- (ii) Effect of Forms W-8BEN, W-8IMY, W-9, and statement.
- (iii) Requirements for certificates to be valid.
  - (A) When period of validity expires.
  - (B) Required information for Forms W-8BEN and W-8IMY.
- (iv) Partner must provide new withholding certificate when there is a change in circumstances.
- (v) Partnership must retain withholding certificates.
  - (3) Presumption of foreign status in absence of valid Form W-8BEN, Form W-8IMY, Form W-9, or statement.
  - (4) Consequences when partnership knows or has reason to know that Form W-8BEN, Form W-8IMY, or Form W-9 is incorrect or unreliable and does not withhold.

*§1.1446-2 Determining a partnership's effectively connected taxable income allocable to foreign partners under section 704.*

- (a) In general.
- (b) Computation.
  - (1) In general.
  - (2) Income and gain rules.
- (i) Application of the principles of section 864.
  - (ii) Income treated as effectively connected.
  - (iii) Exempt income.
- (3) Deduction and losses.
  - (i) Oil and gas interests.

- (ii) Charitable contributions.
- (iii) Net operating losses and other suspended or carried losses.
- (iv) Interest deductions.
- (v) Limitation on capital losses.
- (vi) Other deductions.
- (vii) Limitations on deductions.
- (4) Other rules.
  - (i) Exclusion of items allocated to U.S. partners.
  - (ii) Partnership credits.
- (5) Examples.

*§1.1446-3 Time and manner of calculating and paying over the 1446 tax.*

- (a) In general.
  - (1) Calculating 1446 tax.
  - (2) Applicable percentage.
- (b) Installment payments.
  - (1) In general.
  - (2) Calculation.
    - (i) General application of the principles of section 6655.
    - (ii) Annualization methods.
    - (iii) Partner's estimated tax payments.
    - (iv) Partner whose interest terminates during the partnership's taxable year.
    - (v) Exceptions and modifications to the application of the principles under section 6655.
      - (A) Inapplicability of special rules for large corporations.
      - (B) Inapplicability of special rules regarding early refunds.
      - (C) Period of underpayment.
      - (D) Other taxes.
      - (E) 1446 tax treated as tax under section 11.
      - (F) Prior year tax safe harbor.
- (3) 1446 tax safe harbor.
  - (i) In general.
  - (ii) Permission to change to standard annualization method.
  - (c) Coordination with other withholding rules.
    - (1) Fixed or determinable, annual or periodical income.
    - (2) Real property gains.
      - (i) Domestic partnerships.
      - (ii) Foreign partnerships.
    - (3) Coordination with section 1443.
    - (d) Reporting and crediting the 1446 tax.
      - (1) Reporting 1446 tax.
        - (i) Reporting of installment tax payments, installment tax payment due dates, and notification to partners of installment tax payments.

- (ii) Payment due dates.
- (iii) Annual return and notification to partners.
- (iv) Information provided to beneficiaries of foreign trusts and estates.
- (v) Attachments required of foreign trusts and estates.
  - (vi) Attachments required of beneficiaries of foreign trusts and estates.
  - (vii) Information provided to beneficiaries of foreign trusts and estates that are partners in certain publicly traded partnerships.
- (2) Crediting 1446 tax against a partner's U.S. tax liability.
  - (i) In general.
  - (ii) Substantiation for purposes of claiming the credit under section 33.
  - (iii) Tiered structures including trusts or estates.
    - (A) Foreign estates and trusts.
    - (B) Use of domestic trusts to circumvent section 1446.
  - (iv) Refunds to withholding agent.
  - (v) 1446 tax treated as cash distribution to partners.
  - (vi) Examples.
  - (e) Liability of partnership for failure to withhold.
    - (1) In general.
    - (2) Proof that tax liability has been satisfied.
    - (3) Liability for interest and penalties.
  - (f) Effect of withholding on partner.

*§1.1446-4 Publicly traded partnerships.*

- (a) In general.
- (b) Definitions.
  - (1) Publicly traded partnership.
  - (2) Applicable percentage.
  - (3) Nominee.
  - (4) Qualified notice.
- (c) Time and manner of payment.
- (d) Rules for designation of nominees to withhold tax under section 1446.
- (e) Determining foreign status of partners.
  - (1) In general.
  - (2) Presumptions regarding payee's status in absence of documentation.
- (f) Distributions subject to withholding.
  - (1) In general.
  - (2) In-kind distributions.
  - (3) Ordering rule relating to distributions.
  - (4) Coordination with section 1445.
- (g) Election to withhold based upon ECTI allocable to foreign partners instead of withholding on distributions.

*§1.1446-5 Tiered partnership structures.*

- (a) In general.
- (b) Reporting requirements.
  - (1) In general.
  - (2) Publicly traded partnerships.
- (c) Look through rules for foreign upper-tier partnerships.
- (d) Examples.

*§1.1446-6 Effective date.*

*§1.1446-1 Withholding tax on foreign partners' share of effectively connected taxable income.*

(a) *In general.* If a domestic or foreign partnership has effectively connected taxable income as computed under §1.1446-2 (ECTI), for any partnership tax year, and any portion of such taxable income is allocable under section 704 to a foreign partner, then the partnership must pay a withholding tax under section 1446 (1446 tax) at the time and in the manner set forth in this section and §§1.1446-2 through 1.1446-5.

(b) *Steps in determining 1446 tax obligation.* In general, a partnership determines its 1446 tax as follows. The partnership determines whether it has any foreign partners in accordance with paragraph (c) of this section. If the partnership does not have any foreign partners (including any person presumed to be foreign under paragraph (c) of this section and any domestic trust treated as foreign under §1.1446-3(d)) during its taxable year, it generally will not have a 1446 tax obligation. If the partnership has one or more foreign partners, it then determines under §1.1446-2 whether it has ECTI any portion of which is allocable to one or more of the foreign partners. If the partnership has ECTI allocable to one or more of its foreign partners, the partnership computes its 1446 tax, pays over 1446 tax, and reports the amount paid in accordance with the rules in §1.1446-3. For special rules applicable to publicly traded partnerships, see §1.1446-4. For special rules applicable to tiered partnership structures, see §1.1446-5.

(c) *Determining whether a partnership has a foreign partner—*(1) *In general.* Except as otherwise provided in §1.1446-3, only a partnership that has at least one foreign partner during the partnership's taxable year can have a 1446 tax liability. The

term foreign partner means any partner of the partnership who is not a U.S. person within the meaning of section 7701(a)(30). Thus, a partner of the partnership is a foreign partner if the partner is a nonresident alien individual, foreign partnership, foreign corporation, foreign estate or trust, as those terms are defined under section 7701 and the regulations thereunder, or a foreign government within the meaning of section 892 and the regulations thereunder. For purposes of this section, a partner that is treated as a U.S. person for all income tax purposes (by election or otherwise, see *e.g.*, sections 953(d), 1504(d)) will not be a foreign partner, provided the partner has provided the partnership a valid Form W-9, "Request for Taxpayer Identification Number and Certification," or if the partnership uses other means to determine that the partner is not a foreign partner (see paragraph (c)(3) of this section). A partner that is treated as a U.S. person only for certain specified purposes is considered a foreign partner for purposes of section 1446, and a partnership must pay a withholding tax on the portion of ECTI allocable to that partner. For example, a partnership must generally pay 1446 tax on ECTI allocable to a foreign corporate partner that has made an election under section 897(i).

(2) *Forms W-8BEN, W-8IMY, and W-9—*(i) *In general.* Except as otherwise provided in this paragraph (c)(2) or paragraph (c)(3) of this section, a partnership must determine whether a partner is a foreign partner, and the partner's tax classification (*e.g.*, corporate or non-corporate), by obtaining from the partner a Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding," Form W-8IMY, "Certificate of Foreign Intermediary, Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding," or a Form W-9, as applicable. Specifically, a foreign partner that is a nonresident alien individual, a foreign estate or trust (other than a grantor trust described in this paragraph (c)(2)), a foreign corporation, or a foreign government should provide a valid Form W-8BEN. A partner that is a foreign partnership should provide a valid Form W-8IMY. A partner that is a U.S. person (other than a grantor trust described in this paragraph (c)(2)), including a domestic partnership,

should provide a valid Form W-9. An entity that is disregarded as an entity separate from its owner under §301.7701-3 of this chapter may not submit a Form W-8BEN, W-8IMY, or Form W-9. See §§301.7701-1 through 301.7701-3 of this chapter for determining the U.S. Federal tax classification of a partner. To the extent that a grantor or another person is treated as the owner of any portion of a trust under subpart E of subchapter J of the Internal Revenue Code, such trust shall not provide a Form W-8BEN or Form W-9 to the partnership, except to the extent that such trust is providing documentation on behalf of the grantor or other person treated as the owner of a portion of such trust as required by this paragraph (c)(2). Instead, if such trust is a foreign trust, the trust shall submit Form W-8IMY to the partnership identifying itself as a grantor trust and shall provide such documentation (*e.g.*, Forms W-8BEN, W-8IMY, or W-9) and information pertaining to its owner(s) to the partnership that permits the partnership to reliably associate (within the meaning of §1.1441-1(b)(2)(vii)) such portion of the trust's allocable share of partnership ECTI with the grantor or other person that is the owner of such portion of the trust. If such trust is a domestic trust, the trust shall furnish the partnership a statement under penalty of perjury that the trust is, in whole or in part, a grantor trust and identifying that portion of the trust that is treated as owned by a grantor or another person under subpart E of subchapter J of the Internal Revenue Code. The trust shall also provide such documentation and information (*e.g.*, Forms W-8BEN, W-8IMY, or W-9) pertaining to its owner(s) to the partnership that permits the partnership to reliably associate such portion of the trust's allocable share of partnership ECTI with the grantor or other person that is the owner of such portion of the trust. With respect to nominees, only nominees described in §1.1446-4(b)(3) holding interests in publicly traded partnerships subject to §1.1446-4 may submit a Form W-9. See §1.1446-4 for additional documentation that may be submitted by such a nominee. In all other cases where a nominee holds an interest in a partnership, the beneficial owner of the partnership interest, not the nominee, shall submit Form W-8BEN, Form W-8IMY, or Form W-9. A partnership that has obtained a

valid Form W-8BEN, Form W-8IMY, or Form W-9 from a partner, nominee, or beneficial owner prior to the due date for paying any 1446 tax may rely on it to the extent provided in this paragraph (c)(2).

(ii) *Effect of Forms W-8BEN, W-8IMY, W-9, and Statement.* In general, for purposes of this section, a partnership may rely on a valid Form W-8BEN, Form W-8IMY, Form W-9, statement described in §1.1446-4(e)(1), or statement described in this paragraph (c)(2) from a partner, nominee, beneficial owner, or grantor trust to determine whether that person, beneficial owner, or the owner of a grantor trust, is a domestic or foreign partner or a nominee, and if such person is a foreign partner, to determine whether or not such person is a corporation for U.S. tax purposes. To the extent a partnership receives a Form W-8IMY from a foreign grantor trust or a statement described in this paragraph (c)(2) from a domestic grantor trust, but does not receive a Form W-8BEN, Form W-8IMY, or Form W-9 identifying such grantor or other person, the rules of paragraph (c)(3) of this section shall apply. Further, a partnership may not rely on a Form W-8BEN, Form W-8IMY, Form W-9, or statement described in §1.1446-4(e)(1) or this paragraph (c)(2), and such form or statement is therefore not valid, if the partnership has actual knowledge or has reason to know that any information on the withholding certificate or statement is incorrect or unreliable and, if based on such knowledge or reason to know, it should pay a 1446 tax in an amount greater than would be the case if it relied on the information or certifications. A partnership has reason to know that information on a withholding certificate or statement is incorrect or unreliable if its knowledge of relevant facts or statements contained on the form or other documentation is such that a reasonably prudent person in the position of the withholding agent would question the claims made. See §§1.1441-1(e)(4)(viii) and 1.1441-7(b)(1) and (2). If the partnership does not know or have reason to know that a Form W-8BEN, Form W-8IMY, Form W-9, or statement received from a partner, nominee, beneficial owner, or grantor trust contains incorrect or unreliable information, but it subsequently determines that it does contain incorrect or unreliable information, and, based on such knowledge

the partnership should pay 1446 tax in an amount greater than would be the case if it relied on the information or certification, the partnership will not be subject to penalties for its failure to pay the 1446 tax in reliance on such form or statement for any installment payment date prior to the date that the determination is made. See §§1.1446-1(c)(4) and 1.1446-3 concerning penalties for failure to pay the withholding tax when a partnership knows or has reason to know that the form or statement is incorrect or unreliable.

(iii) *Requirements for certificates to be valid.* Except as otherwise provided in this paragraph (c), for purposes of this section, the validity of a Form W-9 shall be determined under section 3406 and §31.3406(h)-3(e) of this chapter which establish when such form may be reasonably relied upon. A Form W-8BEN, or Form W-8IMY is only valid for purposes of this section if its validity period has not expired, the partner submitting the form has signed it under penalties of perjury, and it contains all the required information.

(A) *When period of validity expires.* For purposes of this section, a Form W-8BEN or W-8IMY submitted by a partner shall be valid until the end of the period of validity determined for such form under §1.1441-1(e). With respect to a foreign partnership submitting Form W-8IMY, the period of validity of such form shall be determined under §1.1441-1(e) as if such foreign partnership submitted the form required of a nonwithholding foreign partnership. See §1.1441-1(e)(4)(ii).

(B) *Required information for Forms W-8BEN and W-8IMY.* Forms W-8BEN and W-8IMY submitted under this section must contain the partner's name, permanent address and Taxpayer Identification Number (TIN), the country under the laws of which the partner is formed, incorporated or governed (if the person is not an individual), the classification of the partner for U.S. federal tax purposes (e.g., partnership, corporation), and any other information required to be submitted by the forms or instructions to Form W-8BEN or Form W-8IMY, as applicable.

(iv) *Partner must provide new withholding certificate when there is a change in circumstances.* The principles of §1.1441-1(e)(4)(ii)(D) shall apply when

a change in circumstances has occurred (including situations where the status of a U.S. person changes) that requires a partner to provide a new withholding certificate.

(v) *Partnership must retain withholding certificates.* A partnership or nominee who has responsibility for paying the withholding tax under this section or §1.1446-4, must retain each withholding certificate and other documentation received from its direct and indirect partners (including nominees) for as long as it may be relevant to the determination of the withholding agent's tax liability under section 1461 and the regulations thereunder.

(3) *Presumption of foreign status in absence of valid Form W-8BEN, Form W-8IMY, Form W-9, or statement.* Except as otherwise provided in this paragraph (c)(3), a partnership that does not receive a valid Form W-8BEN, Form W-8IMY, Form W-9, statement described in §1.1446-4(e)(1), or statement required by paragraph (c)(2) of this section from a partner, nominee, beneficial owner, or grantor trust, or a partnership that receives a withholding certificate or statement but has actual knowledge or reason to know that the information on the certificate or statement is incorrect or unreliable, must presume that the partner is a foreign person. If the partnership knows that the partner is an individual and not an entity, the partnership shall treat the partner as a nonresident alien individual. If the partnership knows that the partner is an entity, the partnership shall treat the partner as a corporation if the entity is a corporation as defined in §301.7701-2(b)(8) of this chapter. In all other cases, the partnership shall treat the partner as either a nonresident alien individual or a foreign corporation, whichever classification results in a higher 1446 tax being due, and shall pay the 1446 tax in accordance with this presumption. The presumption set forth in this paragraph (c)(3) that a partner is a foreign person (either because a Form W-9 was not furnished by such partner or the partnership determines that such form is incorrect or unreliable) shall not apply to the extent that the partnership relies on other means to ascertain the non-foreign status of a partner and the partnership is correct in its determination that such partner is a U.S. person. A partnership is in no event required to rely upon other

means to determine the non-foreign status of a partner and may demand that a partner furnish a Form W-9. If a certification is not provided in such circumstances, the partnership may presume that the partner is a foreign partner, and for purposes of sections 1461 through 1463, will be considered to have been required to pay 1446 tax on such partner's allocable share of partnership ECTI.

(4) *Consequences when partnership knows or has reason to know that Form W-8BEN, Form W-8IMY, or Form W-9 is incorrect or unreliable and does not withhold.* If a partnership knows or has reason to know that a Form W-8BEN, Form W-8IMY, Form W-9, statement described in §1.1446-4(e)(1), or statement required by paragraph (c)(2) of this section submitted by a partner, nominee, beneficial owner, or grantor trust contains incorrect or unreliable information (either because the certificate or statement when given to the partnership contained incorrect information or because there has been a change in facts that makes information on the certificate or statement incorrect), and the partnership pays less than the full amount of withholding tax due on ECTI allocable to that partner, the partnership shall be fully liable under section 1461 and §1.1461-3 (§1.1461-1 for publicly traded partnerships subject to §1.1446-4), §1.1446-3, and for all applicable penalties and interest, for any failure to pay the 1446 tax for the period during which the partnership knew or had reason to know that the certificate contained incorrect or unreliable information and for all subsequent installment periods. If a partner, nominee, beneficial owner, or grantor trust, submits a new valid Form W-8BEN, Form W-8IMY, Form W-9, or statement, as applicable, the partnership may rely on that form for paying installments of 1446 tax beginning with the installment period during which such form is received.

*§1.1446-2 Determining a partnership's effectively connected taxable income allocable to foreign partners under section 704.*

(a) *In general.* A partnership's effectively connected taxable income (ECTI) is generally the partnership's taxable income as computed under section 703, with adjustments as provided in section 1446(c)

and this section, and computed with consideration of only those partnership items which are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. For purposes of determining the section 1446 withholding tax (1446 tax) under §1.1446-3, partnership ECTI allocable under section 704 to foreign partners is the sum of the allocable shares of ECTI of each of the partnership's foreign partners as determined under paragraph (b) of this section. The calculation of partnership ECTI allocable to foreign partners as set forth in paragraph (b) of this section, and the determination of the partnership's withholding tax obligation, is a partnership-level computation solely for purposes of determining the 1446 tax. Therefore, any deduction that is not taken into account in calculating a partner's allocable share of partnership ECTI (e.g., percentage depletion), but which is a deduction that under U.S. tax law the foreign partner is otherwise entitled to claim, can still be claimed by the foreign partner when computing its U.S. tax liability and filing its U.S. income tax return, subject to any restriction or limitation that otherwise may apply.

(b) *Computation—(1) In general.* A foreign partner's allocable share of partnership ECTI for the partnership's taxable year that is allocable under section 704 to a particular foreign partner is equal to that foreign partner's distributive share of partnership gross income and gain for the partnership's taxable year that is effectively connected and properly allocable to the partner under section 704 and the regulations thereunder, reduced by the foreign partner's distributive share of partnership deductions for the partnership taxable year that are connected with such income under section 873 or 882(c) and properly allocable to the partner under section 704 and the regulations thereunder, in each case, after application of the rules of this section. For these purposes, a foreign partner's distributive share of effectively connected gross income and gain and the deductions connected with such income shall be computed by considering allocations that are respected under the rules of section 704 and §1.704-1(b)(1), including special allocations in the partnership agreement (as defined in §1.704-1(b)(2)(ii)(h)), and adjustments to the basis of partnership

property described in section 743 pursuant to an election by the partnership under section 754 (see §1.743-1(j)). The character of effectively connected partnership items (capital versus ordinary) shall be separately considered only to the extent set forth in paragraph (b)(3)(v) of this section.

(2) *Income and gain rules.* For purposes of computing a foreign partner's allocable share of partnership ECTI under this paragraph (b), the following rules with respect to partnership income and gain shall apply.

(i) *Application of the principles of section 864.* The determination of whether a partnership's items of gross income are effectively connected shall be made by applying the principles of section 864 and the regulations thereunder.

(ii) *Income treated as effectively connected.* A partnership's items of gross income that are effectively connected includes any income that is treated as effectively connected income, including partnership income subject to a partner's election under section 871(d) or section 882(d), any partnership income treated as effectively connected with the conduct of a U.S. trade or business pursuant to section 897, and any other items of partnership income treated as effectively connected under another provision of the Code, without regard to whether those amounts are taxable to the partner.

(iii) *Exempt income.* A foreign partner's allocable share of partnership ECTI does not include income or gain exempt from U.S. tax by reason of a provision of the Internal Revenue Code. A foreign partner's allocable share of partnership ECTI also does not include income or gain exempt from U.S. tax by operation of any U.S. income tax treaty or reciprocal agreement. In the case of income excluded by reason of a treaty provision, such income must be derived by a resident of an applicable treaty jurisdiction, the resident must be the beneficial owner of the item, and all other requirements for benefits under the treaty must be satisfied. The partnership must have received from the partner a valid withholding certificate, that is Form W-8BEN or Form W-8IMY (see §1.1446-1(c)(2)(iii) regarding when a Form W-8BEN or Form W-8IMY is valid for purposes of this section), containing the information necessary to support the claim for treaty benefits required in the forms and

instructions to those forms. In addition, for purposes of this section, the withholding certificate must contain the beneficial owner's taxpayer identification number.

(3) *Deduction and losses.* For purposes of computing a foreign partner's allocable share of partnership ECTI under this paragraph (b), the following rules with respect to deductions and losses shall apply.

(i) *Oil and gas interests.* The deduction for depletion with respect to oil and gas wells shall be allowed, but the amount of such deduction shall be determined without regard to sections 613 and 613A.

(ii) *Charitable contributions.* The deduction for charitable contributions provided in section 170 shall not be allowed.

(iii) *Net operating losses and other suspended or carried losses.* The net operating loss deduction of any foreign partner provided in section 172 shall not be taken into account. Further, the partnership shall not take into account any suspended losses (e.g., losses in excess of a partner's basis in the partnership, see section 704(d)) or any capital loss carrybacks or carryovers available to a foreign partner.

(iv) *Interest deductions.* The rules of this paragraph (b)(3)(iv) shall apply for purposes of determining the amount of interest expense that is allocable to income which is (or is treated as) effectively connected with the conduct of a trade or business for purposes of calculating the foreign partner's allocable share of partnership ECTI. In the case of a non-corporate foreign partner, the rules of §1.861-9T(e)(7) shall apply. In the case of a corporate foreign partner, the rules of §1.882-5 shall apply by treating the partnership as a foreign corporation and using the partner's *pro-rata* share of the partnership's assets and liabilities for these purposes. For these purposes, the rules governing elections under §1.882-5(a)(7) shall be made at the partnership level.

(v) *Limitation on capital losses.* Losses from the sale or exchange of capital assets allocable under section 704 to a partner shall be allowed only to the extent of gains from the sale or exchange of capital assets allocable under section 704 to such partner.

(vi) *Other deductions.* No deduction shall be allowed for personal exemptions provided in section 151 or the additional

itemized deductions for individuals provided in part VII of subchapter B of the Internal Revenue Code (section 211 and following).

(vii) *Limitations on deductions.* Except as provided in paragraph (b)(3) or (4) of this section, any limitations on losses or deductions that apply at the partner level when determining ECTI allocable to a foreign partner shall not be taken into account.

(4) *Other rules—(i) Exclusion of items allocated to U.S. partners.* In computing ECTI allocable to a foreign partner, the partnership shall not take into account any item of income, gain, loss, or deduction to the extent allocable to any partner that is not a foreign partner, as that term is defined in §1.1446-1(c) of this section.

(ii) *Partnership credits.* See §1.1446-3(a) providing that the 1446 tax is computed without regard to a partner's distributive share of the partnership's tax credits.

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

*Example 1. Limitation on capital losses.* PRS partnership has two equal partners, A and B. A is a nonresident alien individual and B is a U.S. citizen. A provides PRS with a valid Form W-8BEN, and B provides PRS with a valid Form W-9. PRS has the following annualized tax items for the relevant installment period, all of which are effectively connected with its U.S. trade or business and are allocated equally between A and B: \$100 of long-term capital gain, \$400 of long-term capital loss, \$300 of ordinary income, and \$100 of ordinary deductions. Assume that these allocations are respected under section 704(b) and the regulations thereunder. Accordingly, A's allocable share of PRS's effectively connected items includes \$50 of long-term capital gain, \$200 of long-term capital loss, \$150 of ordinary income, and \$50 of ordinary deductions. In determining A's allocable share of partnership ECTI, the amount of the long-term capital loss that may be taken into account pursuant to paragraph (b)(3)(v) of this section is limited to A's allocable share of gain from the sale or exchange of capital assets. The amount of partnership ECTI allocable under section 704 to A is \$100 (\$150 of ordinary income less \$50 of ordinary deductions, plus \$50 of capital gains less \$50 of capital loss).

*Example 2. Limitation on capital losses—special allocations.* PRS partnership has two equal partners, A and B. A and B are both nonresident alien individuals. A and B each provide PRS with a valid Form W-8BEN. PRS has the following annualized tax items for the relevant installment period, all of which are effectively connected with its U.S. trade or business: \$200 of long-term capital gain, \$200 of long-term capital loss, and \$400 of ordinary income. A and B have equal shares in the ordinary income, however, pursuant to the partnership agreement, capital gains and losses are subject to special allocations.

The long-term capital gain is allocable to A, and the long-term capital loss is allocable to B. It is assumed that all of the partnership's allocations are respected under section 704(b) and the regulations thereunder. Pursuant to paragraph (b)(3)(v) of this section, A's allocable share of partnership ECTI is \$400 (\$200 of ordinary income plus \$200 of long-term capital gain), and B's allocable share of partnership ECTI is \$200 (\$200 of ordinary income).

*Example 3. Withholding tax obligation where partner has net operating losses.* PRS partnership has two equal partners, FC, a foreign corporation, and DC, a domestic corporation. FC and DC provide a valid Form W-8BEN and Form W-9, respectively, to PRS. Both FC and PRS are on a calendar taxable year. PRS is engaged in the conduct of a trade or business in the United States and for its first installment period during its taxable year has \$100 of annualized ECTI that is allocable to FC. As of the beginning of the taxable year, FC had an unused effectively connected net operating loss carryover in the amount of \$300. The net operating loss carryover is not taken into account in determining PRS's withholding tax liability for ECTI allocable under section 704 to FC. PRS must pay 1446 tax with respect to the \$100 of ECTI allocable to FC.

#### §1.1446-3 Time and manner of calculating and paying over the 1446 tax.

(a) *In general—(1) Calculating 1446 tax.* This section provides rules for calculating, reporting, and paying over the section 1446 withholding tax (1446 tax). A partnership's 1446 tax is equal to the amount determined under this section and shall be paid in installments during the partnership's taxable year (see paragraph (d)(1) of this section for installment payment due dates), with any remaining tax due paid with the partnership's annual return required to be filed pursuant to paragraph (d) of this section. For these purposes, a partnership shall not take into account either a partner's liability for any other tax imposed under any other provision of the Internal Revenue Code (e.g., section 55 or 884) or a partner's distributive share of the partnership's tax credits when determining the amount of the partnership's 1446 tax.

(2) *Applicable percentage.* In the case of a foreign partner that is a corporation, the applicable percentage is the highest rate of tax specified in section 11(b)(1) for such taxable year. Except to the extent provided in §1.1446-5, in the case of a foreign partner that is not taxable as a corporation (e.g., partnership, individual, trust or estate), the applicable percentage is the highest rate of tax specified in section 1.

(b) *Installment payments*—(1) *In general.* Except as provided in §1.1446-4 for certain publicly traded partnerships, a partnership must pay its 1446 tax by making installment payments of the 1446 tax based on the amount of partnership ECTI allocable under section 704 to its foreign partners, without regard to whether the partnership makes any distributions to its partners during the partnership's taxable year. The amount of the installment payments are determined in accordance with this paragraph (b), and the tax must be paid at the times set forth in paragraph (d) of this section. Subject to paragraph (b)(3) of this section, in computing its first installment of 1446 tax for a taxable year, a partnership must choose whether it will pay its 1446 tax for the entire taxable year by using the safe harbor set forth in paragraph (b)(3) of this section, or by using one of several annualization methods available under paragraph (b)(2)(ii) of this section for computing partnership ECTI allocable to foreign partners. In the case of any underpayment of an installment payment of 1446 tax by a partnership, the partnership shall be subject to an addition to tax equal to the amount determined under section 6655, as modified by this section, as if such partnership were a domestic corporation, as well as any other applicable interest and penalties. See §1.1446-3(f). Section 6425 (permitting an adjustment for an overpayment of estimated tax by a corporation) shall not apply to a partnership with respect to the payment of its 1446 tax.

(2) *Calculation*—(i) *General application of the principles of section 6655.* Installment payments of 1446 tax required during the partnership's taxable year are based upon partnership ECTI for the portion of the partnership taxable year to which they relate, and, except as set forth in this paragraph (b)(2) or paragraph (b)(3) of this section, shall be calculated using the principles of section 6655. Under the principles of section 6655, the partnership's effectively connected items are annualized to determine each foreign partner's allocable share of partnership ECTI under §1.1446-2. Each foreign partner's allocable share of partnership ECTI is then multiplied by the applicable percentage for each foreign partner. This computation will yield an annualized 1446 tax with respect to such partner. The installment of 1446 tax due with respect

to a foreign partner's allocable share of partnership ECTI equals the excess of the section 6655(e)(2)(B)(ii) percentage of the annualized 1446 tax for that partner (or, if applicable, the adjusted seasonal amount) for the relevant installment period, over the aggregate of any amounts paid under section 1446 with respect to that partner in prior installments during the partnership's taxable year.

(ii) *Annualization methods.* A partnership that chooses to annualize its income for the taxable year shall use one of the annualization methods set forth in section 6655(e) and the regulations thereunder, and as described in the forms and instructions for Form 8804, "Annual Return for Partnership Withholding Tax (Section 1446)," Form 8805, "Foreign Partner's Information Statement of Section 1446 Withholding Tax," and Form 8813, "Partnership Withholding Tax Payment Voucher."

(iii) *Partner's estimated tax payments.* In computing its installment payments of 1446 tax, a partnership may not take into account a partner's estimated tax payments.

(iv) *Partner whose interest terminates during the partnership's taxable year.* With respect to a partner whose interest in the partnership terminates prior to the end of the period for which the partnership is making an installment payment, the partnership shall take into account the income that is allocable to the partner for the portion of the partnership taxable year that the person was a partner.

(v) *Exceptions and modifications to the application of the principles under section 6655.* To the extent not otherwise modified in §§1.1446-1 through 1.1446-6, or inconsistent with those rules, the principles of section 6655 apply to the calculation of the installment payments of 1446 tax made by a partnership, except that:

(A) *Inapplicability of special rules for large corporations.* The principles of section 6655(d)(2), concerning large corporations (as defined in section 6655(g)(2)), shall not apply.

(B) *Inapplicability of special rules regarding early refunds.* The principles of section 6655(h), applicable to amounts excessively credited or refunded under section 6425, shall not apply. See paragraph (b)(1) of this section providing that section

6425 shall not apply for purposes of the 1446 tax.

(C) *Period of underpayment.* The period of the underpayment set forth in section 6655(b)(2) shall end on the earlier of the 15<sup>th</sup> day of the 4<sup>th</sup> month following the close of the partnership's taxable year (or, in the case of a partnership described in §1.6081-5(a)(1) of this chapter, the 15<sup>th</sup> day of the 6<sup>th</sup> month following the close of the partnership's taxable year), or with respect to any portion of the underpayment, the date on which such portion is paid.

(D) *Other taxes.* Section 6655 shall be applied without regard to any references to alternative minimum taxable income and modified alternative minimum taxable income.

(E) *1446 tax treated as tax under section 11.* The principles of section 6655(g)(1) shall be applied to treat the 1446 tax as a tax imposed by section 11.

(F) *Prior year tax safe harbor.* The safe harbor set forth in section 6655(d)(1)(B)(ii) shall not apply and instead the safe harbor set forth in paragraph (b)(3) of this section applies.

(3) *1446 tax safe harbor*—(i) *In general.* The addition to tax under section 6655 shall not apply to a partnership with respect to a current installment of 1446 tax if—

(A) The average of the amount of the current installment and prior installments during the taxable year is at least 25 percent of the total 1446 tax that would be payable on the amount of the partnership's ECTI allocable under section 704 to foreign partners for the prior taxable year;

(B) The prior taxable year consisted of twelve months;

(C) The partnership timely files (including extensions) an information return under section 6031 for the prior year; and

(D) The amount of ECTI for the prior taxable year is not less than 50 percent of the ECTI shown on the annual return of section 1446 withholding tax that is (or will be) timely filed for the current year.

(ii) *Permission to change to standard annualization method.* Except as otherwise provided in this paragraph (b)(3), if a partnership chooses to pay its 1446 tax for the first installment period based upon the safe harbor method set forth in this paragraph (b)(3), the partnership must use the safe harbor method for each

installment payment made during the partnership's taxable year. Notwithstanding the foregoing, if a partnership paying over 1446 tax during the taxable year pursuant to this paragraph (b)(3) determines during an installment period (based upon the standard option annualization method set forth in section 6655(e) and the regulations thereunder, as modified by the forms and instructions to Forms 8804, 8805, and 8813) that it will not qualify for the safe harbor in this paragraph (b)(3) because the prior year's ECTI will not meet the 50-percent threshold in paragraph (b)(3)(i)(D) of this section, then the partnership is permitted, without being subject to the addition to tax under section 6655, to pay over its 1446 tax for the period in which such determination is made, and all subsequent installment periods during the taxable year, using the standard option annualization method. A change pursuant to this paragraph shall be disclosed in a statement attached to the Form 8804 the partnership files for the taxable year and shall include information to allow the Service to determine whether the change was appropriate.

(c) *Coordination with other withholding rules*—(1) *Fixed or determinable, annual or periodical income*. Fixed or determinable, annual or periodical income subject to tax under section 871(a) or section 881 is not subject to withholding under section 1446, and such income is independently subject to the withholding requirements of sections 1441 and 1442 and the regulations thereunder.

(2) *Real property gains*—(i) *Domestic partnerships*. A domestic partnership that is otherwise subject to the withholding requirements of sections 1445 and 1446 will be subject to the payment and reporting requirements of section 1446 only and not section 1445(e)(1) and the regulations thereunder, with respect to partnership gain from the disposition of a U.S. real property interest (as defined in section 897(c)), provided that the partnership complies fully with the requirements under section 1446 and the regulations thereunder, including any reporting obligations, with respect to dispositions of U.S. real property interests. A partnership that has complied with such requirements will be deemed to satisfy the withholding requirements of section 1445 and

the regulations thereunder. In the event that amounts are withheld under section 1445(a) at the time of the disposition of a U.S. real property interest, such amounts may be credited against the section 1446 tax.

(ii) *Foreign partnerships*. A foreign partnership that is subject to withholding under section 1445(a) during its taxable year may credit the amount withheld under section 1445(a) against its section 1446 tax liability for that taxable year only to the extent such gain is allocable to foreign partners.

(3) *Coordination with section 1443*. A partnership that has ECTI allocable under section 704 to a foreign organization described in section 1443(a) shall be required to withhold under this section.

(d) *Reporting and crediting the 1446 tax*—(1) *Reporting 1446 tax*. This paragraph (d) sets forth the rules for reporting and crediting the 1446 tax paid by a partnership. To the extent that 1446 tax is paid on behalf of a domestic trust (including a grantor or other person treated as an owner of a portion of such trust) or a grantor or other person treated as the owner of a portion of a foreign trust, the rules of this paragraph (d) applicable to a foreign trust or its beneficiaries shall be applied to such domestic or foreign trust and its beneficiaries or owners, as applicable, so that appropriate credit for the 1446 tax may be claimed by the trust, beneficiary, grantor, or other person.

(i) *Reporting of installment tax payments and notification to partners of installment tax payments*. Each partnership required to make an installment payment of 1446 tax must file Form 8813, "*Partnership Withholding Tax Payment Voucher (Section 1446)*," in accordance with the instructions of that form. When making a payment of 1446 tax, a partnership must notify each foreign partner of the 1446 tax paid on its behalf. A foreign partner generally may credit a 1446 tax paid by the partnership on the partner's behalf against the partner's estimated tax that the partner must pay during the partner's own taxable year. No particular form is required for a partnership's notification to a foreign partner, but each notification must include the partnership's name, the partnership's Taxpayer Identification Number

(TIN), the partnership's address, the partner's name, the partner's TIN, the partner's address, the annualized ECTI estimated to be allocated to the foreign partner, and the amounts of tax paid on behalf of the partner for the current and prior installment periods during the partnership's taxable year.

(ii) *Payment due dates*. The 1446 tax is calculated based on partnership ECTI allocable under section 704 to foreign partners during the partnership's taxable year, as determined under section 706. Payments of the 1446 tax generally must be made during the partnership's taxable year in which such income is derived. A partnership must pay to the Internal Revenue Service a portion of its estimated annual 1446 tax in installments on or before the 15<sup>th</sup> day of the fourth, sixth, ninth, and twelfth months of the partnership's taxable year as provided in section 6655. Any additional amount determined to be due is to be paid with the filing of the annual return of tax required under this section and clearly designated as for the prior taxable year. Form 8813 should not be submitted for a payment made under the preceding sentence.

(iii) *Annual return and notification to partners*. Every partnership (except a publicly traded partnership that has not elected to apply the general withholding tax rules under section 1446) that has effectively connected gross income for the partnership's taxable year allocable under section 704 to one or more of its foreign partners (or is treated as having paid 1446 tax under §1.1446-5(a)), must file Form 8804, "*Annual Return for Partnership Withholding Tax (Section 1446)*." Additionally, every partnership that is required to file Form 8804 also must file Form 8805, "*Foreign Partner's Information Statement of Section 1446 Withholding Tax*," and furnish this form to the Internal Revenue Service and to each of its partners with respect to which the 1446 tax was paid. Forms 8804 and 8805 are separate from Form 1065, "*U.S. Return of Partnership Income*," and the attachments thereto, and are not to be filed as part of the partnership's Form 1065. A partnership must generally file Forms 8804 and 8805 on or before the due date for filing the partnership's Form 1065. See §1.6031(a)-1(c) for rules concerning the due date of a partnership's Form 1065.



However, with respect to partnerships described in §1.6081-5(a)(1), Forms 8804 and 8805 are not due until the 15<sup>th</sup> day of the sixth month following the close of the partnership's taxable year. Any additional tax owed under section 1446 for the prior taxable year of the partnership must be paid to the Internal Revenue Service with the Form 8804.

(iv) *Information provided to beneficiaries of foreign trusts and estates.* A foreign trust or estate that is a partner in a partnership subject to withholding under section 1446 shall be provided Form 8805 by the partnership. The foreign trust or estate must provide to each of its beneficiaries a copy of the Form 8805 furnished by the partnership. In addition, the foreign trust or estate must provide a statement for each of its beneficiaries to inform each beneficiary of the amount of the credit that may be claimed under section 33 (as determined under this section) for the 1446 tax paid by the partnership. Until an official IRS form is available, the statement from a foreign trust or estate that is described in this paragraph (d)(1)(iv) shall contain the following information—

(A) Name, address, and TIN of the foreign trust or estate;

(B) Name, address, and TIN of the partnership;

(C) The amount of the partnership's ECTI allocated to the foreign trust or estate for the partnership taxable year (as shown on the Form 8805 provided to the trust or estate);

(D) The amount of 1446 tax paid by the partnership on behalf of the foreign trust or estate;

(E) Name, address, and TIN of the beneficiary of the foreign trust or estate;

(F) The amount of the partnership's ECTI allocated to the trust or estate for purposes of section 1446 that is to be included in the beneficiary's gross income; and

(G) The amount of 1446 tax paid by the partnership on behalf of the foreign trust or estate that the beneficiary is entitled to claim on its return as a credit under section 33.

(v) *Attachments required of foreign trusts and estates.* The statement furnished to each foreign beneficiary under this paragraph (d)(1) must also be attached to the foreign trust or estate's U.S. Federal income tax return filed for the taxable year

including the installment period to which the statement relates.

(vi) *Attachments required of beneficiaries of foreign trusts and estates.* The beneficiary of the foreign trust or estate must attach the statement provided by the trust or estate, along with a copy of the Form 8805 furnished by the partnership to such trust or estate, to its U.S. income tax return for the year in which it claims a credit for the 1446 tax. See §1.1446-3(d)(2)(ii) for additional rules regarding a partner or beneficial owner claiming a credit for 1446 tax.

(vii) *Information provided to beneficiaries of foreign trusts and estates that are partners in certain publicly traded partnerships.* A statement similar to the statement required by paragraph (d)(1)(iv) of this section shall be provided by trusts or estates that hold interests in publicly traded partnerships subject to §1.1446-4.

(2) *Crediting 1446 tax against a partner's U.S. tax liability—*(i) *In general.* A partnership's payment of 1446 tax on the portion of ECTI allocable to a foreign partner relates to the partner's U.S. income tax liability for the partner's taxable year in which the partner is subject to U.S. tax on that income. Subject to paragraphs (d)(2)(ii) and (iii) of this section, a partner may claim as a credit under section 33 the 1446 tax paid by the partnership with respect to ECTI allocable to that partner. The partner may not claim an early refund of these amounts under the estimated tax rules.

(ii) *Substantiation for purposes of claiming the credit under section 33.* A partner may credit the amount paid under section 1446 with respect to such partner against its U.S. income tax liability only if it attaches proof of payment to its U.S. income tax return for the partner's taxable year in which the items comprising such partner's allocable share of partnership ECTI are included in the partner's income. Except as provided in the next sentence, proof of payment consists of a copy of the Form 8805 the partnership provides to the partner (or in the case of a beneficiary of a foreign trust or estate, the statement required under paragraph (d)(1)(iv) of this section to be provided by such trust or estate and the related Form 8805 furnished to such trust or estate), but only if the name and TIN on the Form 8805 (or the statement provided by a foreign trust or

estate) match the name and TIN on the partner's U.S. tax return, and such form (or statement) identifies the partner (or beneficiary) as the person entitled to the credit under section 33. In the case of a partner of a publicly traded partnership that is subject to withholding on distributions under §1.1446-4, proof of payment consists of a copy of the Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," provided to the partner by the partnership.

(iii) *Tiered structures including trusts or estates—*(A) *Foreign trusts and estates.* Section 1446 tax paid on the portion of ECTI allocable under section 704 to a foreign trust or estate that the foreign trust or estate may claim as a credit under section 33 shall bear the same ratio to the total 1446 tax paid on behalf of the trust or estate as the total ECTI allocable to such trust or estate and not distributed (or treated as distributed) to the beneficiaries of such trust or estate, and, accordingly not deducted under section 651 or section 661 in calculating the trust or estate's taxable income, bears to the total ECTI allocable to such trust or estate. Any 1446 tax that a foreign trust or estate is not entitled to claim as a credit under this paragraph (d)(2) may be claimed as a credit by the beneficiary or beneficiaries of such trust or estate that includes the partnership's ECTI (distributed or deemed distributed) allocated to the trust or estate in gross income under section 652 or section 662 (with the same character as effectively connected income as in the hands of the trust or estate). The trust or estate must provide each beneficiary with a copy of the Form 8805 provided to it by the partnership and prepare the statement required by paragraph (d)(1)(iv) of this section.

(B) *Use of domestic trusts to circumvent section 1446.* This paragraph (d)(2)(iii)(B) shall apply if a partnership knows or has reason to know that a foreign person that is the ultimate beneficial owner of the ECTI holds its interest in the partnership through a domestic trust (and possibly other entities), and such domestic trust was formed or availed of with a principal purpose of avoiding the 1446 tax. The use of a domestic trust in a tiered trust structure may have a principal purpose of avoiding the 1446 tax even though the tax avoidance purpose is outweighed by other purposes

when taken together. In such case, a partnership is required to pay 1446 tax under this paragraph as if the domestic trust was a foreign trust for purposes of section 1446 and the regulations thereunder. Accordingly, all applicable penalties and interest shall apply to the partnership for its failure to pay 1446 tax under this paragraph (d)(2)(iii)(B), commencing with the installment period during which the partnership knew or had reason to know that this paragraph (d)(2)(iii)(B) applied.

(iv) *Refunds to withholding agent.* A partnership (or nominee pursuant to §1.1446-4) may apply for a refund of the 1446 tax paid only to the extent allowable under section 1464 and the regulations thereunder.

(v) *1446 tax treated as cash distribution to partners.* Amounts paid by a partnership under section 1446 with respect to a partner are treated as distributed to that partner on the earliest of the day on which such tax was paid by the partnership, the last day of the partnership taxable year for which the tax was paid, or, the last day during the partnership's taxable year on which the partner owned an interest in the partnership. Thus, for example, 1446 tax paid by a partnership after the close of a partnership taxable year that relates to ECTI allocable to a foreign partner for the prior taxable year will be considered distributed by the partnership to the respective foreign partner on the last day of the partnership's prior taxable year.

(vi) *Examples.* The following examples illustrate the application of this section:

*Example 1. Simple trust that reports entire amount of ECTI.* PRS is a partnership that has two partners, FT, a foreign trust, and A, a U.S. person. FT is a simple trust under section 651. FT and A each provide PRS with a valid Form W-8BEN and Form W-9, respectively. FT has one beneficiary, NRA, a nonresident alien individual. In computing its installment obligation during the 2004 taxable year, PRS has \$200 of annualized income, all of which is ordinary ECTI. The \$200 of income will be allocated equally to FT and A under section 704 and it is assumed that such an allocation will be respected under section 704(b) and the regulations thereunder. FT's allocable share of ECTI is \$100. PRS withholds \$35 under section 1446 with respect to the \$100 of ECTI allocable to FT. FT's only income for its tax year is the \$100 of income from PRS. Pursuant to the terms of the trust's governing instrument and local law, the \$100 of ECTI is not included in FT's fiduciary accounting income and the deemed distribution of the \$35 withholding tax paid under paragraph (d)(2)(v) of this section is not included in FT's fiduciary accounting income. Accordingly, the \$100 of ECTI is not income required to be distributed by

FT, and FT may not claim a deduction under section 651 for this amount. FT must report the \$100 of ECTI in its gross income and may claim a credit under section 33 in the amount of \$35 for the 1446 tax paid by PRS. NRA is not required to include any of the ECTI in gross income and accordingly may not claim a credit for any amount of the \$35 of 1446 tax paid by PRS.

*Example 2. Simple trust that distributes a portion of ECTI to the beneficiary.* Assume the same facts as in *Example 1*, except that PRS distributes \$60 to FT, which is included in FT's fiduciary accounting income under local law. FT will report the \$100 of ECTI in its gross income and may claim a deduction for the \$60 required to be distributed under section 651(a) to NRA. Pursuant to paragraph (d)(2)(iii) of this section, FT may claim a credit under section 33 in the amount of \$14 for the 1446 tax paid by PRS (\$40/\$100 multiplied by \$35). NRA is required to include the \$60 of the ECTI in gross income under section 652 (as ECTI) and may claim a credit under section 33 in the amount of \$21 for the 1446 tax paid by PRS (\$35 less \$14 or \$60/\$100 multiplied by \$35).

*Example 3. Complex trust that distributes entire ECTI to the beneficiary.* Assume the same facts as in *Example 1*, except that FT is a complex trust under section 661. PRS distributes \$60 to FT, which is included in FT's fiduciary accounting income. FT distributes the \$60 of fiduciary accounting income to NRA and also properly distributes an additional \$40 to NRA from FT's principal. FT will report the \$100 of ECTI in its gross income and may deduct the \$60 required to be distributed to NRA under section 661(a)(1) and may deduct the \$40 distributed to NRA under section 661(a)(2). FT may not claim a credit under section 33 for any of the \$35 of 1446 tax paid by PRS. NRA is required to include \$100 of the ECTI in gross income under section 662 (as ECTI) and may claim a credit under section 33 in the amount of \$35 for the 1446 tax paid by PRS (\$35 less \$0).

(e) *Liability of partnership for failure to withhold—(1) In general.* Every partnership required to pay a 1446 tax is made liable for that tax by section 1461. Therefore, a partnership that is required to pay a 1446 tax but fails to do so, or pays less than the amount required under this section, is liable under section 1461 for the payment of the tax required to be withheld under chapter 3 of the Internal Revenue Code and the regulations thereunder unless the partnership can demonstrate pursuant to paragraph (e)(2) of this section, to the satisfaction of the Commissioner or his delegate, that the full amount of effectively connected taxable income allocable to such partner was included in income on the partner's U.S. Federal income tax return and the full amount of tax due on such return was paid by such partner to the Internal Revenue Service. See paragraph (e)(3) of this section and section 1463 regarding the partnership's liability for penalties and interest even though a foreign partner has

satisfied the underlying tax liability. See §1.1461-3 for applicable penalties when a partnership fails to pay 1446 tax. See paragraph (b) of this section for an addition to tax under section 6655 when there is an underpayment of 1446 tax.

(2) *Proof that tax liability has been satisfied.* Proof of payment of tax may be established for purposes of paragraph (e)(1) of this section on the basis of a Form 4669, "Statement of Payments Received," or such other form as the Internal Revenue Service may prescribe in published guidance (see §601.601(d)(2) of this chapter), establishing the amount of tax, if any, actually paid by the partner on the income. Such partnership's liability for tax, and the requirement that such partnership file Forms 8804 and 8805 shall be deemed to have been satisfied with respect to such partner as of the date on which the partner's income tax return was filed and all tax required to be shown on the return is paid in full.

(3) *Liability for interest and penalties.* Notwithstanding paragraph (e)(2) of this section, a partnership that fails to pay over tax under section 1446 is not relieved from liability under section 6655 or for interest under section 6601. See §1.1463-1. Such liability may exist even if there is no underlying tax liability due from a foreign partner on its allocable share of partnership ECTI. The addition to tax under section 6655 or the interest charge under section 6601 that is required by those sections shall be imposed as set forth in those sections, as modified by this section. For example, under section 6601, interest shall accrue beginning on the last date for paying the tax due under section 1461 (which is the due date, without extensions, for filing the Forms 8804 and 8805). The interest shall stop accruing on the 1446 tax liability on the date, and to the extent, that the unpaid tax liability under section 1446 is satisfied. A foreign partner is permitted to reduce any addition to tax under section 6654 or 6655 by the amount of any section 6655 addition to tax paid by the partnership with respect to its failure to pay adequate installment payments of the 1446 tax on ECTI allocable to the foreign partner.

(f) *Effect of withholding on partner.* The payment of the 1446 tax by a partnership does not excuse a foreign partner to which a portion of ECTI is allocable from filing a U.S. tax or informational return, as appropriate, with respect to that

income. Information concerning installment payments of 1446 tax paid during the partnership's taxable year on behalf of a foreign partner shall be provided to such foreign partner in accordance with paragraph (d) of this section and such information may be taken into account by the foreign partner when computing the partner's estimated tax liability during the taxable year. Form 1040NR, "U.S. Nonresident Alien Income Tax Return," Form 1065, "U.S. Return of Partnership Income," Form 1120F, "U.S. Income Tax Return of a Foreign Corporation," or such other return as appropriate, must be filed by the partner, and any tax due must be paid, by the filing deadline (including extensions) generally applicable to such person. Pursuant to §1.1446-3(d), a partner may generally claim a credit under section 33 for its share of any 1446 tax paid by the partnership against the amount of income tax (or 1446 tax in the case of tiers of partnerships) as computed in such partner's return.

#### §1.1446-4 Publicly traded partnerships.

(a) *In general.* This section sets forth rules for applying the section 1446 withholding tax (1446 tax) to publicly traded partnerships. A publicly traded partnership (as defined in paragraph (b) of this section) that has effectively connected gross income, gain or loss must pay 1446 tax by withholding from distributions to a foreign partner. Publicly traded partnerships that withhold on distributions must pay over and report any 1446 tax as provided in paragraph (c), and generally are not to pay over and report the 1446 tax under the rules in §1.1446-3. However, under paragraph (g) of this section, a publicly traded partnership may elect not to apply the rules of this section, and instead, to pay the 1446 tax based on the effectively connected taxable income (ECTI) allocable under section 704 to foreign partners under the general rules of §§1.1446-1 through 1.1446-3. The amount of the withholding tax on distributions, other than distributions excluded under paragraph (f) of this section, that are made during any partnership taxable year, equals the applicable percentage (defined in paragraph (b)(2) of this section) of such distributions.

(b) *Definitions*—(1) *Publicly traded partnership.* For purposes of this section, the term publicly traded partnership has the same meaning as in section 7704 (including the regulations thereunder), but does not include a publicly traded partnership treated as a corporation under that section.

(2) *Applicable percentage.* For purposes of this section, applicable percentage shall have the meaning as set forth in §1.1446-3(a)(2).

(3) *Nominee.* For purposes of this section, the term nominee means a domestic person that holds an interest in a publicly traded partnership on behalf of a foreign person.

(4) *Qualified notice.* For purposes of this section, a qualified notice is a notice given by a publicly traded partnership regarding a distribution that is attributable to effectively connected income, gain or loss of the partnership, and in accordance with the notice requirements with respect to dividends described in 17 CFR 240.10b-17(b)(1) or (3) issued pursuant to the Securities Exchange Act of 1934, 15 U.S.C. section 78(a).

(c) *Time and manner of payment.* The withholding tax required under this section is to be paid pursuant to the rules and procedures of section 1461, §§1.1461-1, 1.1461-2, and 1.6302-2. However, the reimbursement and set-off procedures set forth in those regulations shall not apply. A publicly traded partnership must use Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," and Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," to report withholding from distributions under this section. See §1.1461-1(b). See §1.1446-3(d)(1)(vii) requiring a foreign trust or estate that holds an interest in a publicly traded partnership to provide a statement to the beneficiaries of such foreign trust or estate with respect to the credit to be claimed under section 33. For penalties and additions to the tax for failure to comply with this section, see §§1.1461-1 and 1.1461-3.

(d) *Rules for designation of nominees to withhold tax under section 1446.* A nominee that receives a distribution from a publicly traded partnership subject to withholding under this section, and which is to be paid to (or for the account of) any

foreign person, may be treated as a withholding agent under this section. A nominee is treated as a withholding agent under this section only to the extent of the amount specified in the qualified notice (as defined in paragraph (b)(4) of this section) that the nominee receives. Where a nominee is designated as a withholding agent with respect to a foreign partner of the partnership, then the obligation to withhold on distributions to such foreign partner in accordance with the rules of this section shall be imposed solely on the nominee. A nominee under this section shall identify itself as a nominee by providing Form W-9, "Request for Taxpayer Identification Number and Certification," to the partnership, along with the statement required by paragraph (e)(1) of this section. If a nominee furnishes Form W-9 and the statement required by paragraph (e)(1) of this section to the partnership, but a qualified notice is not received by the nominee from the partnership, the nominee shall not be a withholding agent subject to the rules of this section and the partnership shall presume that such nominee is a nonresident alien individual or foreign corporation, whichever classification results in a higher 1446 tax being due, and pay a withholding tax consistent with such presumption. A nominee responsible for withholding under the rules of this section shall be subject to liability under sections 1461 and 6655, as well as for all applicable penalties and interest, as if such nominee was a partnership responsible for withholding under this section.

(e) *Determining foreign status of partners*—(1) *In general.* Except as provided in paragraph (d) of this section permitting nominees to submit a Form W-9 to a publicly traded partnership, the rules of §1.1446-1 shall apply in determining whether a partner of a publicly traded partnership is a foreign partner for purposes of the 1446 tax (see §1.1446-4(a)) and a nominee obligated to withhold under this section shall be entitled to rely on a Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding," Form W-8IMY, "Certificate of Foreign Intermediary, Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding," or Form W-9, "Request for Taxpayer Identification Number," received from persons on whose behalf it holds interests

in the partnership to the same extent a partnership is entitled to rely on such forms under those rules. In addition to the rules stated in §§1.1446-1 through 1.1446-3 with respect to certificates establishing a partner as a domestic or foreign person, a nominee shall attach a brief statement to the Form W-9 that it furnishes to the partnership, informing the partnership that the nominee holds interests in the partnership on behalf of one or more foreign persons, including information that permits the partnership to determine the partnership interest held on behalf of such foreign persons. A statement furnished by a nominee pursuant to §1.6031(c)-1T satisfies the requirements of the previous sentence.

(2) *Presumptions regarding payee's status in absence of documentation.* The rules of §1.1446-1(c)(3) shall apply to determine a partner's status in the absence of documentation.

(f) *Distributions subject to withholding—(1) In general.* Except as provided in this paragraph (f)(1), a publicly traded partnership must withhold at the applicable percentage with respect to any actual distribution made to a foreign partner. The amount of a distribution subject to 1446 tax includes the amount of any 1446 tax required to be withheld on the distribution and, in the case of a partnership that receives a partnership distribution from another partnership in which it is a partner (*i.e.*, a tiered structure described in §1.1446-5), any 1446 tax that was withheld from such distribution. For example, a foreign publicly traded partnership, UTP, owns an interest in domestic publicly traded partnership, LTP. UTP does not provide LTP any documentation with respect to its domestic or foreign status. LTP and UTP each have a calendar taxable year. LTP makes a distribution subject to section 1446 of \$100 to UTP during its taxable year beginning January 1, 2004, and withholds 35 percent (the highest rate in section 1) of that distribution under section 1446. UTP receives a net distribution of \$65 which it immediately redistributes to its partners. UTP has a liability to pay 35 percent of the total actual and deemed distribution it makes to its foreign partners as a section 1446 withholding tax. UTP may credit the \$35 withheld by LTP against this liability as if it were paid by UTP. When UTP distributes the \$65 it actually receives from LTP to its partners, UTP is treated

for purposes of section 1446 as if it made a distribution of \$100 to its partners (\$65 actual distribution and \$35 deemed distribution). UTP's partners (U.S. and foreign) may claim a credit against their U.S. income tax liability for their allocable share of the \$35 of 1446 tax paid on their behalf.

(2) *In-kind distributions.* If a publicly traded partnership distributes property other than money, the partnership shall not release the property until it has funds sufficient to enable the partnership to pay over in money the required 1446 tax.

(3) *Ordering rule relating to distributions.* Distributions from publicly traded partnerships are deemed to be paid out of the following types of income in the order indicated—

(i) Amounts attributable to income described in section 1441 or 1442 that are not effectively connected, without regard to whether such amounts are subject to withholding because of a treaty or statutory exemption;

(ii) Amounts attributable to recurring dispositions of crops and timber that are subject to withholding under §1.1445-5(c)(3)(iv) of the regulations, which continue to be subject to the rules of §1.1445-5(c)(3);

(iii) Amounts effectively connected with a U.S. trade or business, but not subject to withholding under section 1446 (*e.g.*, exempt by treaty);

(iv) Amounts subject to withholding under section 1446; and

(v) Amounts not listed in paragraphs (f)(3)(i) through (iv) of this section.

(4) *Coordination with section 1445(e)(1).* Except as otherwise provided in this section, a publicly traded partnership that complies with the requirements of withholding under section 1446 and this section will be deemed to have satisfied the requirements of section 1445(e)(1) and the regulations thereunder. Notwithstanding the excluded amounts set forth in paragraph (f)(3) of this section, distributions subject to withholding at the applicable percentage shall include the following—

(i) Amounts subject to withholding under section 1445(e)(1) upon distribution pursuant to an election under §1.1445-5(c)(3) of the regulations; and

(ii) Amounts not subject to withholding under section 1445 because the distributee is a partnership or is a foreign corporation

that has made an election under section 897(i).

(g) *Election to withhold based upon ECTI allocable to foreign partners instead of withholding on distributions.* A publicly traded partnership may elect to comply with the requirements of §§1.1446-1 through 1.1446-3 (relating to withholding on ECTI allocable to foreign partners) and §1.1446-5 (relating to tiered partnership structures) instead of the rules of this section. A publicly traded partnership shall make the election described in this paragraph (g) by complying with the payment and reporting requirements of §§1.1446-1 through 1.1446-3 and by complying with the information reporting requirements of this paragraph (g). The election is made by attaching a statement to a timely filed Form 8804, "Annual Return for Partnership Withholding Tax (Section 1446)," that is required to be filed by the partnership for the taxable year, indicating that the partnership is a publicly traded partnership that is electing to pay the 1446 tax under section 1446 based upon ECTI allocable under section 704 to its foreign partners. Once made, an election under this paragraph (g) may be revoked only with the consent of the Commissioner.

#### §1.1446-5 Tiered partnership structures.

(a) *In general.* The rules of this section shall apply in cases where a partnership (lower-tier partnership) that has effectively connected taxable income (ECTI), has a partner that is itself a partnership (upper-tier partnership). A partnership that directly or indirectly (through a chain of partnerships) owns a partnership interest in a lower-tier partnership shall be allowed a credit against its own section 1446 withholding tax (1446 tax) for the tax paid by the lower-tier partnership on its behalf. If an upper-tier domestic partnership directly owns an interest in a lower-tier partnership, the lower-tier partnership is not required to pay a withholding tax with respect to the upper-tier partnership's allocable share of effectively connected taxable income (ECTI), regardless of whether the upper-tier domestic partnership's partners are foreign.

(b) *Reporting requirements—(1) In general.* To the extent that an upper-tier partnership that is a foreign partnership is a partner in a lower-tier partnership,

and the lower-tier partnership has made 1446 tax installment payments on ECTI allocable to the upper-tier partnership, the upper-tier partnership shall receive a copy of the statements and forms filed by the lower-tier partnership allocable to its partnership interest in the lower-tier partnership under §§1.1446-1 through 1.1446-3 (e.g., Form 8805, “*Foreign Partner’s Information Statement of Section 1446 Withholding Tax*”). The upper-tier partnership may treat the 1446 tax paid by the lower-tier partnership on its behalf as a credit against its liability to pay 1446 tax, as if the upper-tier partnership actually paid over the amounts at the time that the amounts were paid by the lower-tier partnership. See §1.1462-1(b). However, the upper-tier partnership may not obtain a refund for the amounts paid by the lower-tier partnership, but instead, must file such forms as prescribed by §1.1446-3 and this section to allow the credits under section 33 to be properly claimed by the beneficial owners of such income. See §1.1462-1. The upper-tier partnership must file Form 8804, “*Annual Return for Partnership Withholding Tax (Section 1446)*,” and Form 8805, “*Foreign Partner’s Information Statement of Section 1446 Withholding Tax*,” with respect to its 1446 tax obligation, passing the credit for 1446 tax paid by the lower-tier partnership to its partners.

(2) *Publicly traded partnerships.* In the case of an upper-tier foreign partnership that is a publicly traded partnership, the rules of §1.1446-4(c) shall apply.

(c) *Look through rules for foreign upper-tier partnerships.* For purposes of computing the 1446 tax obligation of a lower-tier partnership, if an upper-tier partnership owns an interest in the lower-tier partnership, the upper-tier partnership’s allocable share of the lower-tier partnership’s ECTI shall be treated as allocable to the partners of the upper-tier partnership (as if they were direct partners in the lower-tier partnership) to the extent that—

(1) The upper-tier partnership furnishes the lower-tier partnership with a valid Form W-8IMY, “*Certificate of Foreign Intermediary, Flow Through Entity, or Certain U.S. Branches for United States Tax Withholding*,” indicating that it is a look-through foreign partnership for purposes of section 1446, and

(2) The lower-tier partnership can reliably associate (within the meaning of §1.1441-1(b)(2)(vii)) the effectively connected partnership items allocable to the upper-tier partnership with a Form W-8BEN, “*Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding*,” Form W-8IMY, or Form W-9, an “*Request for Taxpayer Identification Number and Certification*,” for each of the upper-tier partnership’s partners. The principles of §1.1441-1(b)(2)(vii) shall apply to determine whether a lower-tier partnership can reliably associate effectively connected partnership items allocable to the upper-tier partnership to the partners of the upper-tier partnership. The upper-tier partnership shall provide the lower-tier partnership with a withholding certificate for each partner in the upper-tier partnership and information regarding the allocation of effectively connected items to the respective partners of the upper-tier partnership. To the extent the lower-tier partnership receives a valid Form W-8IMY from the upper-tier partnership but cannot reliably associate the upper-tier partnership’s allocable share of effectively connected partnership items with a withholding certificate for each of the upper-tier partnership’s partners, the lower-tier partnership shall withhold at the higher of the applicable percentages in section 1446(b). If a lower-tier partnership has not received a valid Form W-8IMY from the upper-tier partnership, the lower-tier partnership shall withhold at the higher of the applicable percentages in section 1446(b). See §1.1446-1(c)(3). The approach set forth in this paragraph (c) shall not apply to partnerships whose interests are publicly traded. See §1.1446-4.

(d) *Examples.* The following examples illustrate the provisions of §1.1446-5:

*Example 1—Sufficient documentation—tiered partnership structure.* (i) Nonresident alien (NRA) and foreign corporation (FC) are partners in PRS, a foreign partnership, and share profits and losses in PRS 70 and 30 percent, respectively. All of PRS’s partnership items are allocated based upon each partner’s respective ownership interest and it is assumed that these allocations are respected under section 704(b) and the regulations thereunder. NRA and FC each furnish PRS with a valid Form W-8BEN establishing themselves as a foreign individual and foreign corporation, respectively. PRS holds a 40 percent interest in the profits, losses and capital of LTP, a lower-tier partnership. NRA holds the remaining 60 percent interest in profits, losses and capital of LTP. LTP has \$100 of annualized ECTI for the relevant installment period. PRS has no income

other than the income allocated from LTP. PRS provides LTP with a valid Form W-8IMY indicating that it is a foreign partnership and attaches the valid Form W-8BENs executed by NRA and FC, as well as a statement describing the allocation of PRS’s effectively connected items among its partners. Further, NRA provides a valid Form W-8BEN to LTP.

(ii) LTP must pay 1446 tax on the \$60 allocable to its direct partner NRA using the highest rate in section 1.

(iii) With respect to the effectively connected partnership items that LTP can reliably associate with NRA through PRS (70 percent of PRS’s allocable share, or \$28), LTP will pay 1446 tax on NRA’s allocable share of LTP’s partnership ECTI (as determined by looking through PRS) using the applicable percentage for non-corporate partners (the highest rate in section 1).

(iv) With respect to the effectively connected partnership items that LTP can reliably associate with FC through PRS (30 percent of PRS’s allocable share, or \$12), LTP will pay 1446 tax on FC’s allocable share of LTP’s ECTI (as determined by looking through PRS) using the applicable percentage for corporate partners.

(v) LTP’s payment of the 1446 tax is treated as a distribution to NRA and PRS, its direct partners, that those partners may credit against their respective tax obligations. PRS will report its 1446 tax obligation with respect to its direct foreign partners, NRA and FC, on the Form 8804 and Form 8805 that it files with the Internal Revenue Service and will credit the amount withheld by LTP. Thus, PRS will pass along to NRA and FC the credit for the 1446 tax withheld by LTP which will be treated as a distribution to them.

*Example 2—Insufficient documentation—tiered partnership structure.* PRS is a domestic partnership that has two equal partners A and UTP. A is a nonresident alien individual and UTP is a foreign partnership that has two equal foreign partners, C and D. Neither A nor UTP provide PRS with a valid Form W-8BEN, Form W-8IMY, or Form W-9. Neither C nor D provide UTP with a valid Form W-8BEN, Form W-8IMY, or Form W-9. PRS must presume that UTP is a foreign person subject to withholding under section 1446 at the higher of the highest rate under section 1 or 11(b)(1). PRS has also not received any documentation with respect to A. PRS must presume that A is a foreign person, and, if PRS knows that A is an individual, compute and pay 1446 tax based on that knowledge.

#### §1.1446-6 Effective date.

Sections 1.1446-1 through 1.1446-5 shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

Par. 5. Section 1.1461-1 is amended as follows:

1. Paragraph (a)(1) is amended by adding three sentences at the end of the paragraph.

2. The second sentence of paragraph (c)(1)(i) is removed and two sentences are added in its place.

3. Paragraph (c)(1)(ii)(A)(8) is redesignated as paragraph (c)(1)(ii)(A)(9), and a new paragraph (c)(1)(ii)(A)(8) is added.

4. The first sentence of paragraph (c)(2)(i) is removed and two sentences are added in its place.

5. The first sentence of paragraph (c)(3) is removed and two sentences are added in its place.

6. Paragraph (i) is revised.

The additions and revisions read as follows:

*§1.1461-1 Payment and returns of tax withheld.*

(a) \* \* \*

(1) \* \* \* With respect to withholding under section 1446, this section shall only apply to publicly traded partnerships that have not made an election under §1.1446-4(g). See §1.1461-3 for penalties applicable to partnerships that fail to withhold under section 1446 on effectively connected taxable income allocable to foreign partners, including a publicly traded partnership that has made an election under §1.1446-4(g). The previous two sentences shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(i) \* \* \* Notwithstanding the preceding sentence, any person that withholds or is required to withhold an amount under sections 1441, 1442, 1443, or §1.1446-4(a) must file a Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," for the payment withheld upon whether or not that person is engaged in a trade or business and whether or not the payment is an amount subject to reporting. The reference in the previous sentence to withholding under §1.1446-4 shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

(ii) \* \* \*

(A) \* \* \*

(8) A partner receiving a distribution from a publicly traded partnership subject to withholding under section 1446 and §1.1446-4. This paragraph

(c)(1)(ii)(A)(8) shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

(2) *Amounts subject to reporting*—(i) *In general*. Subject to the exceptions described in paragraph (c)(2)(ii) of this section, amounts subject to reporting on Form 1042-S are amounts paid to a foreign payee or partner (including persons presumed to be foreign) that are amounts subject to withholding as defined in §1.1441-2(a) or §1.1446-4(a). The reference in the previous sentence to withholding under §1.1446-4 shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

(3) *Required information*. The information required to be furnished under this paragraph (c)(3) shall be based upon the information provided by or on behalf of the recipient of an amount subject to reporting (as corrected and supplemented based on the withholding agent's actual knowledge) or the presumption rules of §§1.1441-1(b)(3), 1.1441-4(a); 1.1441-5(d) and (e); 1.1441-9(b)(3), 1.1446-1(c)(3) or 1.6049-5(d). The reference in the previous sentence to presumption rules applicable to withholding under section 1446 shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

\* \* \*

\* \* \* \* \*

(i) *Effective date*. Unless otherwise provided in this section, this section shall apply to returns required for payments made after December 31, 2000.

Par. 6. Section 1.1461-2 is amended by:

1. Removing the first sentence of paragraph (a)(1) and adding two sentences in its place.

2. Revising paragraphs (b) and (d).

The revisions and addition read as follows:

*§1.1461-2 Adjustments for overwithholding or underwithholding of tax.*

(a) *Adjustments of overwithheld tax*—(1) *In general*. Except for partnerships or nominees required to withhold under section 1446, a withholding agent that has overwithheld under chapter 3 of the Internal Revenue Code, and made a deposit of the tax as provided in §1.6302-2(a) may adjust the overwithheld amount either pursuant to the reimbursement procedure described in paragraph (a)(2) of this section or pursuant to the set-off procedure described in paragraph (a)(3) of this section. References in the previous sentence excepting from this section certain partnerships withholding under section 1446 shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

\* \* \*

\* \* \* \* \*

(b) *Withholding of additional tax when underwithholding occurs*. A withholding agent may withhold from future payments (or a partner's allocable share of ECTI under section 1446) made to a beneficial owner the tax that should have been withheld from previous payments (or paid under section 1446 with respect to a partner's allocable share of ECTI) to such beneficial owner under chapter 3 of the Internal Revenue Code. In the alternative, the withholding agent may satisfy the tax from property that it holds in custody for the beneficial owner or property over which it has control. Such additional withholding or satisfaction of the tax owed may only be made before the date that the annual return (e.g. Form 1042, Form 8804) is required to be filed (not including extensions) for the taxable year in which the underwithholding occurred. See §1.6302-2 for making deposits of tax or §1.1461-1(a) for making payment of the balance due for a calendar year. See also §§1.1461-1, 1.1461-3, and 1.1446-1 through 1.1446-5 for rules relating to withholding under section 1446. References in this paragraph (b) to withholding under section 1446 shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

(d) *Effective date.* Unless otherwise provided in this section, this section applies to payments made after December 31, 2000.

Par. 7. Section 1.1461-3 is added to read as follows.

*§1.1461-3 Withholding under section 1446.*

For rules relating to the withholding tax liability of a partnership or nominee under section 1446, see §§1.1446-1 through 1.1446-6. For penalties and additions to the tax for failure to timely pay the tax required to be paid under section 1446, see sections 6655 (in the case of publicly traded partnerships that have not made an election under §1.1446-4(g), see section 6656), 6672, and 7202 and the regulations under those sections. For penalties and additions to the tax for failure to file returns or furnish statements in accordance with the regulations under section 1446, see sections 6651, 6662, 6663, 6721, 6722, 6723, 6724(c), 7201, 7203, and the regulations under those sections. This section shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

Par. 8. Section 1.1462-1 is amended by revising paragraphs (b) and (c) to read as follows:

*§1.1462-1 Withheld tax as credit to recipient of income.*

\* \* \* \* \*

(b) *Amounts paid to persons who are not the beneficial owner.* Amounts withheld at source under chapter 3 of the Internal Revenue Code on payments to (or effectively connected taxable income allocable to) a fiduciary, partnership, or intermediary is deemed to have been paid by the taxpayer ultimately liable for the tax upon such income. Thus, for example, if a beneficiary of a trust is subject to the taxes imposed by section 1, 2, 3, or 11 upon any portion of the income received from a foreign trust, the part of any amount withheld at source which is properly allocable to the income so taxed to such beneficiary shall be credited against the amount of the income tax computed upon the beneficiary's return, and any excess shall be refunded. See §1.1446-3 for examples applying this

rule in the context of a partnership interest held through a foreign trust or estate. Further, if a partnership withholds an amount under chapter 3 of the Internal Revenue Code with respect to the distributive share of a partner that is a partnership or with respect to the distributive share of partners in an upper-tier partnership, such amount is deemed to have been withheld by the upper-tier partnership. See §1.1446-5 for rules applicable to tiered partnership structures. References in this paragraph (b) to withholding under section 1446 shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

(c) *Effective date.* Unless otherwise provided in this section, this section applies to payments made after December 31, 2000.

Par. 9. Section 1.1463-1 is amended by:

1. Adding two sentences at the end of paragraph (a).

2. Revising paragraph (b).

The addition and revision read as follows:

*§1.1463-1 Tax paid by recipient of income.*

(a) \* \* \* See §1.1446-3(f) for additional rules where the tax was required to be withheld under section 1446. The reference in the previous sentence to withholding under section 1446 shall apply to partnership taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

(b) *Effective date.* Unless otherwise provided in this section, this section applies to failures to withhold occurring after December 31, 2000.

**PART 301—PROCEDURE AND ADMINISTRATION**

Par. 10. The authority for 26 CFR part 301 continues to read in part as follows:

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

Par. 11. In §301.6109-1 is amended as follows:

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

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

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

4. In paragraph (c), the first three sentences are revised and a sentence is added at the end of the paragraph.

The amendments and additions read as follows:

*§301.6109-1 Identifying numbers.*

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(viii) A foreign person that furnishes a withholding certificate described in §1.1446-1(c)(2) or (3) of this chapter. This paragraph (b)(2)(viii) shall apply to partnership taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**.

(c) *Requirement to furnish another's number.* Every person required under this title to make a return, statement, or other document must furnish such taxpayer identifying numbers of other U.S. persons and foreign persons that are described in paragraph (b)(2)(i), (ii), (iii), (vi), (vii), or (viii) of this section as required by the forms and the accompanying instructions. The taxpayer identifying number of any person furnishing a withholding certificate referred to in paragraph (b)(2)(vi) or (viii) of this section shall also be furnished if it is actually known to the person making a return, statement, or other document described in this paragraph (c). If the person making the return, statement, or other document does not know the taxpayer identifying number of the other person, and such other person is one that is described in paragraph (b)(2)(i), (ii), (iii), (vi), (vii), or (viii) of this section, such person must request the other person's number. \* \* \* References in this paragraph (c) to paragraph (b)(2)(viii) of this section shall apply to partnership taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

Par. 12. In §301.6721-1, paragraph (g)(4) is revised to read as follows:

*§301.6721-1 Failure to file correct information returns.*

\* \* \* \* \*

(g) \*\*\*

(4) *Other items.* The term *information return* also includes any form, statement,

or schedule required to be filed with the Internal Revenue Service with respect to any amount from which tax is required to be deducted and withheld under chapter 3 of the Internal Revenue Code (or from which tax would be required to be so deducted and withheld but for an exemption under the Internal Revenue Code or any treaty obligation of the United States), generally Forms 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," and 8805, "Foreign Partner's Information Statement of Section 1446 Withholding Tax." The provisions of this paragraph (g)(4) referring to Form 8805, shall apply to partnership taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

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

(Filed by the Office of the Federal Register on September 2, 2003, 8:45 a.m., and published in the issue of the Federal Register for September 3, 2003, 68 F.R. 52465)

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## Update to Publication 1220 Announcement 2003-61

The purpose of this announcement is to clarify instructions in the Publication 1220, *Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically or Magnetically* (Rev. 9-2003).

For Form 1099-Q, Tax Year (TY) 2003, recipient copy distribution codes may be reported in the Special Data Entry field, Positions 663-722 in the Payee "B" Record.

For TY2003, Form 1099-Q and Form 5498-ESA are used for the reporting of Coverdell IRA distributions and contributions. Coverdell IRA distributions and contributions were previously reported on Form 1099-R and Form 5498 respectively. With the creation of the new forms, coding specifications for Coverdell IRA information were removed from Forms 1099-R and 5498. These changes impact the prior year correction procedures for Forms 1099-R and 5498. If you are required to make corrections electronically or magnetically to IRA Coverdell information previously reported on Form 1099-R and/or Form 5498, contact the Information Reporting Program Customer Service Section for instructions. The toll-free number is 866-455-7438 or outside the U.S. at 304-263-8700.



# 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.  
Y—Corporation.  
Z—Corporation.

## Numerical Finding List<sup>1</sup>

Bulletins 2003–27 through 2003–42

### Announcements:

2003-45, 2003-28 I.R.B. 73  
2003-46, 2003-30 I.R.B. 222  
2003-47, 2003-29 I.R.B. 124  
2003-48, 2003-28 I.R.B. 73  
2003-49, 2003-32 I.R.B. 339  
2003-50, 2003-30 I.R.B. 222  
2003-51, 2003-37 I.R.B. 555  
2003-52, 2003-32 I.R.B. 345  
2003-53, 2003-32 I.R.B. 345  
2003-54, 2003-40 I.R.B. 762  
2003-55, 2003-38 I.R.B. 597  
2003-56, 2003-39 I.R.B. 694  
2003-57, 2003-37 I.R.B. 555  
2003-58, 2003-40 I.R.B. 746  
2003-59, 2003-40 I.R.B. 746  
2003-61, 2003-42 I.R.B. 890  
2003-62, 2003-41 I.R.B. 821

### Notices:

2003-38, 2003-27 I.R.B. 9  
2003-39, 2003-27 I.R.B. 10  
2003-40, 2003-27 I.R.B. 10  
2003-41, 2003-28 I.R.B. 49  
2003-42, 2003-28 I.R.B. 49  
2003-43, 2003-28 I.R.B. 50  
2003-44, 2003-28 I.R.B. 52  
2003-45, 2003-29 I.R.B. 86  
2003-46, 2003-28 I.R.B. 53  
2003-47, 2003-30 I.R.B. 132  
2003-48, 2003-30 I.R.B. 133  
2003-49, 2003-32 I.R.B. 294  
2003-50, 2003-32 I.R.B. 295  
2003-51, 2003-33 I.R.B. 361  
2003-52, 2003-32 I.R.B. 296  
2003-53, 2003-33 I.R.B. 362  
2003-54, 2003-33 I.R.B. 363  
2003-55, 2003-34 I.R.B. 395  
2003-56, 2003-34 I.R.B. 396  
2003-57, 2003-34 I.R.B. 397  
2003-58, 2003-35 I.R.B. 429  
2003-59, 2003-35 I.R.B. 429  
2003-60, 2003-39 I.R.B. 643  
2003-61, 2003-42 I.R.B. 851  
2003-62, 2003-38 I.R.B. 576  
2003-63, 2003-38 I.R.B. 577  
2003-64, 2003-39 I.R.B. 646  
2003-65, 2003-40 I.R.B. 748  
2003-67, 2003-40 I.R.B. 753  
2003-68, 2003-41 I.R.B. 824  
2003-69, 2003-42 I.R.B. 851

### Proposed Regulations:

REG-209377-89, 2003-36 I.R.B. 521  
REG-208199-91, 2003-40 I.R.B. 757  
REG-106486-98, 2003-42 I.R.B. 853  
REG-108639-99, 2003-35 I.R.B. 431  
REG-106736-00, 2003-28 I.R.B. 60  
REG-108524-00, 2003-42 I.R.B. 869  
REG-140378-01, 2003-41 I.R.B. 825  
REG-107618-02, 2003-27 I.R.B. 13  
REG-122917-02, 2003-27 I.R.B. 15  
REG-128203-02, 2003-41 I.R.B. 828  
REG-131997-02, 2003-33 I.R.B. 366  
REG-133791-02, 2003-35 I.R.B. 493  
REG-138495-02, 2003-37 I.R.B. 541  
REG-138499-02, 2003-37 I.R.B. 541  
REG-140808-02, 2003-38 I.R.B. 582  
REG-140930-02, 2003-38 I.R.B. 583  
REG-141669-02, 2003-34 I.R.B. 408  
REG-142538-02, 2003-38 I.R.B. 590  
REG-143679-02, 2003-38 I.R.B. 592  
REG-144908-02, 2003-38 I.R.B. 593  
REG-162625-02, 2003-35 I.R.B. 500  
REG-163974-02, 2003-38 I.R.B. 595  
REG-108676-03, 2003-36 I.R.B. 523  
REG-112039-03, 2003-35 I.R.B. 504  
REG-113112-03, 2003-40 I.R.B. 761  
REG-116914-03, 2003-32 I.R.B. 338  
REG-121122-03, 2003-37 I.R.B. 550  
REG-129709-03, 2003-35 I.R.B. 506  
REG-130262-03, 2003-37 I.R.B. 553  
REG-132483-03, 2003-34 I.R.B. 410

### Revenue Procedures:

2003-45, 2003-27 I.R.B. 11  
2003-46, 2003-28 I.R.B. 54  
2003-47, 2003-28 I.R.B. 55  
2003-48, 2003-29 I.R.B. 86  
2003-49, 2003-29 I.R.B. 89  
2003-50, 2003-29 I.R.B. 119  
2003-51, 2003-29 I.R.B. 121  
2003-52, 2003-30 I.R.B. 134  
2003-53, 2003-31 I.R.B. 230  
2003-54, 2003-31 I.R.B. 236  
2003-55, 2003-31 I.R.B. 242  
2003-56, 2003-31 I.R.B. 249  
2003-57, 2003-31 I.R.B. 257  
2003-58, 2003-31 I.R.B. 262  
2003-59, 2003-31 I.R.B. 268  
2003-60, 2003-31 I.R.B. 274  
2003-61, 2003-32 I.R.B. 296  
2003-62, 2003-32 I.R.B. 299  
2003-63, 2003-32 I.R.B. 304  
2003-64, 2003-32 I.R.B. 306  
2003-65, 2003-32 I.R.B. 336

### Revenue Procedures— Continued:

2003-66, 2003-33 I.R.B. 364  
2003-67, 2003-34 I.R.B. 397  
2003-68, 2003-34 I.R.B. 398  
2003-69, 2003-34 I.R.B. 403  
2003-70, 2003-34 I.R.B. 406  
2003-71, 2003-36 I.R.B. 517  
2003-72, 2003-38 I.R.B. 578  
2003-73, 2003-39 I.R.B. 647

### Revenue Rulings:

2003-70, 2003-27 I.R.B. 3  
2003-71, 2003-27 I.R.B. 1  
2003-72, 2003-33 I.R.B. 346  
2003-73, 2003-28 I.R.B. 44  
2003-74, 2003-29 I.R.B. 77  
2003-75, 2003-29 I.R.B. 79  
2003-76, 2003-33 I.R.B. 355  
2003-77, 2003-29 I.R.B. 75  
2003-78, 2003-29 I.R.B. 76  
2003-79, 2003-29 I.R.B. 80  
2003-80, 2003-29 I.R.B. 83  
2003-81, 2003-30 I.R.B. 126  
2003-82, 2003-30 I.R.B. 125  
2003-83, 2003-30 I.R.B. 128  
2003-84, 2003-32 I.R.B. 289  
2003-85, 2003-32 I.R.B. 291  
2003-86, 2003-32 I.R.B. 290  
2003-87, 2003-29 I.R.B. 82  
2003-88, 2003-32 I.R.B. 292  
2003-89, 2003-37 I.R.B. 525  
2003-90, 2003-33 I.R.B. 353  
2003-91, 2003-33 I.R.B. 347  
2003-92, 2003-33 I.R.B. 350  
2003-93, 2003-33 I.R.B. 346  
2003-94, 2003-33 I.R.B. 357  
2003-95, 2003-33 I.R.B. 358  
2003-96, 2003-34 I.R.B. 386  
2003-97, 2003-34 I.R.B. 380  
2003-98, 2003-34 I.R.B. 378  
2003-99, 2003-34 I.R.B. 388  
2003-100, 2003-34 I.R.B. 385  
2003-101, 2003-36 I.R.B. 513  
2003-102, 2003-38 I.R.B. 559  
2003-103, 2003-38 I.R.B. 568  
2003-104, 2003-39 I.R.B. 636  
2003-105, 2003-40 I.R.B. 696  
2003-107, 2003-41 I.R.B. 815  
2003-109, 2003-42 I.R.B. 839

### Tax Conventions:

2003-58, 2003-40 I.R.B. 746  
2003-59, 2003-40 I.R.B. 746  
2003-62, 2003-41 I.R.B. 821

<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2003-1 through 2003-26 is in Internal Revenue Bulletin 2003-27, dated July 7, 2003.

**Treasury Decisions:**

9061, 2003-27 I.R.B. 5  
9062, 2003-28 I.R.B. 46  
9063, 2003-36 I.R.B. 510  
9064, 2003-36 I.R.B. 508  
9065, 2003-36 I.R.B. 515  
9066, 2003-36 I.R.B. 509  
9067, 2003-32 I.R.B. 287  
9068, 2003-37 I.R.B. 538  
9069, 2003-37 I.R.B. 525  
9070, 2003-38 I.R.B. 574  
9071, 2003-38 I.R.B. 560  
9072, 2003-37 I.R.B. 527  
9073, 2003-38 I.R.B. 570  
9074, 2003-39 I.R.B. 601  
9075, 2003-39 I.R.B. 608  
9076, 2003-38 I.R.B. 562  
9077, 2003-39 I.R.B. 634  
9078, 2003-39 I.R.B. 630  
9079, 2003-40 I.R.B. 729  
9080, 2003-40 I.R.B. 696  
9081, 2003-35 I.R.B. 420  
9082, 2003-41 I.R.B. 807  
9083, 2003-40 I.R.B. 700  
9084, 2003-40 I.R.B. 742  
9085, 2003-41 I.R.B. 775  
9086, 2003-41 I.R.B. 817  
9087, 2003-41 I.R.B. 781  
9088, 2003-42 I.R.B. 841

## Findings List of Current Actions on Previously Published Items<sup>1</sup>

Bulletins 2003-27 through 2003-42

### Notices:

#### 87-5

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 87-66

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 87-79

Modified by  
Notice 2003-65, 2003-40 I.R.B. 748

#### 89-79

Modified and superseded by  
Rev. Proc. 2003-47, 2003-28 I.R.B. 55

#### 89-94

Modified by  
Notice 2003-50, 2003-32 I.R.B. 295

#### 94-46

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 95-50

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 95-53

Modified and superseded by  
Notice 2003-55, 2003-34 I.R.B. 395

#### 2001-4

Section III.C. superseded for 2004 and subsequent calendar years by  
Rev. Proc. 2003-64, 2003-32 I.R.B. 306

#### 2001-70

Amplified by  
Notice 2003-45, 2003-29 I.R.B. 86

#### 2001-74

Amplified by  
Notice 2003-45, 2003-29 I.R.B. 86

#### 2002-1

Amplified by  
Notice 2003-49, 2003-32 I.R.B. 294

#### 2003-36

Modified by  
Notice 2003-59, 2003-35 I.R.B. 429

### Proposed Regulations:

#### REG-EE-86-88 (LR-279-81)

Withdrawn by  
REG-122917-02, 2003-27 I.R.B. 15

### Proposed Regulations— Continued:

#### REG-105606-99

Withdrawn by  
REG-133791-02, 2003-35 I.R.B. 493

### Revenue Procedures:

#### 66-50

Modified, amplified, and superseded by  
Rev. Proc. 2003-62, 2003-32 I.R.B. 299

#### 68-23

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 68-41

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 77-12

Amplified, modified, and superseded by  
Rev. Proc. 2003-51, 2003-29 I.R.B. 121

#### 81-40

Modified and superseded by  
Rev. Proc. 2003-62, 2003-32 I.R.B. 299

#### 89-12

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 89-21

Superseded by  
Rev. Proc. 2003-53, 2003-31 I.R.B. 230

#### 89-31

Obsoluted by  
REG-108524-00, 2003-42 I.R.B. 869

#### 90-19

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 90-32

Section 4 superseded by  
Rev. Proc. 2003-55, 2003-31 I.R.B. 242  
Section 5 superseded by  
Rev. Proc. 2003-56, 2003-31 I.R.B. 249  
Section 6 superseded by  
Rev. Proc. 2003-57, 2003-31 I.R.B. 257  
Section 7 superseded by  
Rev. Proc. 2003-59, 2003-31 I.R.B. 268  
Section 8 superseded by  
Rev. Proc. 2003-60, 2003-31 I.R.B. 274

#### 91-11

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 91-13

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 91-39

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

### Revenue Procedures— Continued:

#### 92-33

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 92-35

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 92-66

Obsoluted by  
REG-108524-00, 2003-42 I.R.B. 869

#### 92-88

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 93-17

Obsoluted by  
REG-132483-03, 2003-34 I.R.B. 408

#### 94-46

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 95-10

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 95-11

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 95-39

Obsoluted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

#### 96-17

Modified and superseded by  
Rev. Proc. 2003-69, 2003-34 I.R.B. 402

#### 96-30

Modified and amplified by  
Rev. Proc. 2003-48, 2003-29 I.R.B. 86

#### 96-38

Obsoluted by  
Rev. Proc. 2003-71, 2003-36 I.R.B. 517

#### 2000-12

Modified by  
Rev. Proc. 2003-64, 2003-32 I.R.B. 306

#### 2000-15

Superseded by  
Rev. Proc. 2003-61, 2003-32 I.R.B. 296

#### 2000-20

Modified by  
Rev. Proc. 2003-72, 2003-38 I.R.B. 578

<sup>1</sup> A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2003-1 through 2003-26 is in Internal Revenue Bulletin 2003-27, dated July 7, 2003.

**Revenue Procedures— Continued:**

**2002-9**

Modified by  
Rev. Proc. 2003-45, 2003-27 I.R.B. 11  
Amplified and modified by  
Rev. Proc. 2003-50, 2003-29 I.R.B. 119  
Modified and amplified by  
Rev. Proc. 2003-63, 2003-32 I.R.B. 304  
Rev. Rul. 2003-81, 2003-30 I.R.B. 126

**2002-13**

Revoked by  
Rev. Proc. 2003-68, 2003-34 I.R.B. 398

**2002-29**

Modified by  
Rev. Proc. 2003-72, 2003-38 I.R.B. 578

**2002-33**

Amplified and modified by  
Rev. Proc. 2003-50, 2003-29 I.R.B. 119

**2002-34**

Superseded by  
Rev. Proc. 2003-52, 2003-30 I.R.B. 134

**2002-45**

Revoked by  
Rev. Proc. 2003-68, 2003-34 I.R.B. 398

**2002-60**

Superseded by  
Rev. Proc. 2003-73, 2003-39 I.R.B. 647

**2003-3**

Modified by  
Rev. Proc. 2003-48, 2003-29 I.R.B. 86

**2003-15**

Modified and superseded by  
Rev. Proc. 2003-49, 2003-29 I.R.B. 89

**2003-28**

Modified by  
Ann. 2003-35, 2003-38 I.R.B. 597

**2003-44**

Modified by  
Rev. Proc. 2003-72, 2003-38 I.R.B. 578

**Revenue Rulings:**

**53-56**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**54-139**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**54-396**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**55-105**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**55-372**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-128**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-160**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-212**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-220**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-271**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-344**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-448**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-451**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-586**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-680**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-681**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**57-116**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**57-296**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**57-542**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**58-92**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**58-618**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**59-108**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**59-120**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**59-122**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**59-233**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**59-326**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**59-356**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**59-400**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**59-412**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**60-49**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**60-246**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**60-262**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**60-307**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**61-96**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**63-157**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**63-224**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**63-248**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**64-147**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**64-177**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**64-285**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**65-110**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**62-260**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**65-273**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**66-4**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**66-23**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**66-610**

Partially obsolated by  
Rev. Rul. 2003-105, 2003-40 I.R.B. 696

**66-290**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**67-186**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**67-189**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**67-326**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**68-309**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**68-388**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**68-434**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**68-477**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**68-522**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**68-608**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**68-640**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**68-641**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**69-18**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**69-20**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**69-241**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**69-361**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**69-426**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**69-485**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**69-517**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**70-6**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**70-111**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**70-229**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**70-230**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**70-264**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**70-286**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**70-378**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**70-409**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**70-496**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-13**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-384**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-440**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-453**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-454**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-495**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-518**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-565**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**71-582**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**72-61**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**72-116**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**72-212**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**72-357**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**72-472**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**72-526**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**72-599**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**72-603**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**73-46**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**73-119**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**73-182**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**73-257**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**73-277**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**73-473**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**73-490**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**73-498**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-6**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-59**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-73**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-83**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-87**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-211**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-376**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**74-476**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-521**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**74-610**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-53**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-54**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-105**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-106**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-107**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-111**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-134**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-160**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-174**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-179**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-212**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-248**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-298**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-341**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**75-426**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-468**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-515**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**75-561**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**76-44**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**76-67**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**76-90**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**76-225**

Revoked by  
T.D. 9068, 2003-37 538

**76-239**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**76-329**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**76-347**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**76-535**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-41**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-81**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-150**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-256**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-284**

Obsolated by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**77-321**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-343**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-405**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-456**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-482**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**77-483**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**78-89**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**78-287**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**78-420**  
Obsoleted by  
Rev. Rul. 2003-105, 2003-40 I.R.B. 696

**78-441**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**79-29**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**79-50**  
Obsoleted by  
Rev. Rul. 2003-105, 2003-40 I.R.B. 696

**79-71**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**79-82**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**79-104**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**79-116**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**79-314**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**79-410**  
Amplified by  
Rev. Rul. 2003-90, 2003-33 I.R.B. 353

**79-424**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**80-78**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**80-79**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**80-101**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**80-167**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**80-170**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**80-358**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**81-190**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**81-225**  
Clarified and amplified by  
Rev. Rul. 2003-92, 2003-33 I.R.B. 350

**81-247**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**82-164**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**82-226**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**83-101**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**83-119**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**84-28**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**84-30**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**Revenue Rulings— Continued:**

**85-55**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**85-136**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**86-52**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**87-1**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**87-95**  
Superseded by  
Rev. Rul. 2003-109, 2003-42 I.R.B. 839

**88-7**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**89-72**  
Obsoleted by  
Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**94-56**  
Superseded by  
Rev. Rul. 2003-109, 2003-42 I.R.B. 839

**2003-58**  
Distinguished by  
Rev. Rul. 2003-102, 2003-38 I.R.B. 559

**Treasury Decisions:**

**9033**  
Removed by  
T.D. 9065, 2003-36 I.R.B. 515