Internal Revenue
bulletin

Bulletin No. 2000–30
July 24, 2000

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

T.D. 8889, page 124.

Final regulations under section 894 of the Code clarify the availability of treaty benefits with respect to an item of U.S. source income paid to an entity that is treated as fiscally transparent under the laws of one or more jurisdictions (including the United States) with respect to that item of income. These regulations provide rules for determining whether an entity is fiscally transparent under the laws of a jurisdiction and for determining whether such income is derived by persons entitled to treaty benefits.

T.D. 8890, page 122.

Final regulations under section 671 of the Code define the term "grantor" for purposes of determining who is the grantor of a trust.

Notice 2000–39, page 132.

Individual retirement accounts; net income calculation. This notice provides a new method for calculating net income attributable to IRA contributions returned pursuant to section 408(d)(4) of the Code and to IRA contributions recharacterized pursuant to section 408A(d)(6).

EMPLOYEE PLANS

Notice 2000–40, page 134.

Weighted average interest rate update. The weighted average interest rate for July 2000 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.

EXEMPT ORGANIZATIONS

Announcement 2000–61, page 136.

A list is provided of organizations now classified as private foundations.

Announcement 2000–62, page 137.

A list is provided of organizations that no longer qualify as organizations to which contributions are deductible under section 170 of the Code.

ADMINISTRATIVE

Announcement 2000–58, page 135.

This document announces the terms and conditions under which the Service will settle taxpayer claims for the Targeted Jobs Tax Credit in circumstances where the taxpayer requested but never received certification because the certification program shut down after the credit expired on December 31, 1994.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and 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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Section 671.—Trust Income, Deductions, and Credits Attributable to Grantors and Others As Substantial Owners

26 CFR 1.671–2: Applicable principles.

T.D. 8890

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Definition of Grantor

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations defining the term *grantor* for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code. These regulations provide necessary guidance in determining who is the grantor of a trust in applying those Code sections. These regulations affect trusts and any person creating or funding a trust.

DATES: *Effective Date*: These regulations are effective July 5, 2000.

Applicability Dates: For dates of applicability of §1.671–2(e), see §1.671–2(e)(7).

FOR FURTHER INFORMATION CONTACT: James A. Quinn at (202) 622-3060 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Background

On June 5, 1997, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–252487–96, 1997–1 C.B. 806) under section 671 of the Internal Revenue Code (Code) in the **Federal Register** (62 F.R. 30785). Comments responding to the notice were received and a public hearing was held on August 27, 1997. After consideration of the comments, the proposed regulations under section 671 were re-issued as proposed (64 F.R. 43323) and temporary regulations (64 F.R. 43267) on August 10, 1999.

The proposed and temporary regulations provide a definition of grantor for purposes of part I of subchapter J, chapter 1 of the Code. No comments were received in response to the Notice of Proposed Rulemaking published on August 10, 1999, in the **Federal Register**, and no one requested to speak at the public hearing scheduled for November 2, 1999. Accordingly, the public hearing was canceled on October 28, 1999 (64 F.R. 58006). This document finalizes the proposed regulations and removes the temporary regulations.

Special Analyses

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

Drafting Information

The principal author of these regulations is James A. Quinn of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for section 1.671–2T and adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.671–2 also issued under 26 U.S.C. 643(a)(7) and 672(f)(6). * * *

§1.643(h)–1 [Amended]

Par. 2. Section 1.643(h)–1 is amended as follows:

1. In paragraph (a)(2)(i) the language "§1.671–2T(e)(2)" is removed, and "§1.671–2(e)(2)" is added in its place.
2. In paragraph (b)(1) the language "§1.671–2T(e)(2)" is removed, and "§1.671–2(e)(2)" is added in its place.
3. In paragraph (b)(2) the language "§1.671–2T(e)" is removed, and "§1.671–2(e)" is added in its place.
4. In paragraph (g) *Example 1* the language "§1.671–2T(e)(2)" is removed, and "§1.671–2(e)(2)" is added in its place.

Par. 3. Section 1.671–2(e) is revised to read as follows:

§1.671–2 Applicable principles.

* * * * *

(e)(1) For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. For purposes of this section, the term *property* includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also §1.672(f)–5(a).

(2)(i) A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

(ii) For purposes of this paragraph (e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

(iii) For purposes of this paragraph (e), a gratuitous transfer does not include a distribution to a trust with respect to an interest held by such trust in either a trust described in paragraph (e)(3) of this section or an entity other than a trust. For example, a distribution to a trust by a corporation with respect to its stock described in section 301 is not a gratuitous transfer.

(3) A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in §301.7701–4(c) of this chapter, liquidating trusts described in §301.7701–4(d) of this chapter, or environmental remediation trusts described in §301.7701–4(e) of this chapter.

(4) If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.

(5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.

(6) The following examples illustrate the rules of this paragraph (e). Unless otherwise indicated, all trusts are domestic trusts, and all other persons are United States persons. The examples are as follows:

Example 1. A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under paragraph (e)(1) of this section, both A and B are grantors of T.

Example 2. A makes an investment in a fixed investment trust, T, that is classified as a trust under §301.7701–4(c)(1) of this chapter. A is a grantor of T. B subsequently acquires A's entire interest in T. Under paragraph (e)(3) of this section, B is a grantor of T with respect to such interest.

Example 3. A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers $100 to FT out of A's funds. A is reimbursed by B for the $100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B and B's children. Both A and B are treated as grantors of FT under paragraph (e)(1) of this section. In addition, B is treated as the owner of the entire trust under section 677. Because A is reimbursed for the $100 transferred to FT on behalf of B, A is not treated as transferring any property to FT. Therefore, A is not an owner of any portion of FT under sections 671 through 677 regardless of whether A retained any power over or interest in FT described in sections 673 through 677. Furthermore, A is not treated as an owner of any portion of FT under section 679. Both A and B are responsible parties for purposes of the requirements in section 6048.

Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

Example 5. A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under paragraph (e)(2)(ii) of this section. Therefore, A has made a gratuitous transfer to T, and, under paragraph (e)(1) of this section, A is a grantor of T.

Example 6. A borrows cash from T, a trust. A has not made any gratuitous transfers to T. Arm's length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(2)(ii) of this section. Therefore, under paragraph (e)(1) of this section, A is not a grantor of T with respect to the interest payments.

Example 7. A, B's brother, creates a trust, T, for B's benefit and transfers $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair market value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of $100,000. Under paragraph (e)(2)(ii) of this section, the $900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

Example 8. G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

Example 9. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

(7) The rules of this section are applicable to any transfer to a trust, or transfer of an interest in a trust, on or after August 10, 1999.

§1.671–2T [Removed]

Par. 4. Section 1.671–2T is removed.

§1.672(f)–2 [Amended]

Par. 5. Section 1.672(f)–2 is amended as follows:

1. In paragraph (b)(1) the language "§1.671–2T(e)(2)" is removed, and "§1.671–2(e)(2)" is added in its place.
2. In paragraph (d) *Example 1* the language "§1.671–2T(e)" is removed, and "§1.671–2(e)" is added in its place.

§1.672(f)–3 [Amended]

Par. 6. Section 1.672(f)–3 is amended as follows:

1. In paragraph (a)(1) the language "§1.671–2T(e)" is removed, and "§1.671–2(e)" is added in its place.
2. In paragraph (a)(4) *Example 2* the language "§1.671–2T(e)" is removed, and "§1.671–2(e)" is added in its place.
3. In paragraph (b)(1) the language "§1.671–2T(e)(2)" is removed, and "§1.671–2(e)(2)" is added in its place.
4. In paragraph (b)(1) the language "§1.671–2T(e)" is removed, and "§1.671–2(e)" is added in its place.
5. In paragraph (b)(4) *Example 1* the language "§1.671–2T(e)" is removed, and "§1.671–2(e)" is added in its place.
6. In paragraph (b)(4) *Example 2* the language "§1.671–2T(e)" is removed and "§1.671–2(e)" is added in its place.

§1.672(f)–4 [Amended]

Par. 7. Section 1.672(f)–4 is amended as follows:

1. In paragraph (c)(1) the language "§1.671–2T(e)(2)" is removed, and "§1.671–2(e)(2)" is added in its place.
2. In paragraph (c)(1) the language "§1.671–2T(e)(4)" is removed, and "§1.671–2(e)(4)" is added in its place.
3. In paragraph (d)(1) the language "§1.671–2T(e)(2)(ii)" is removed, and "§1.671–2(e)(2)(ii)" is added in its place.
4. In paragraph (g) *Example 4* the language "§1.671–2T(e)" is removed, and "§1.671–2(e)" is added in its place.

§1.672(f)–5 [Amended]

Par. 8. In §1.672(f)–5, paragraph (a)(1) is amended by removing the language "§1.671–2T(e)(2)" and adding "§1.671–2(e)(2)" in its place.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved June 28, 2000.

Jonathan Talisman,
Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 3, 2000, 8:45 a.m., and published in the issue of the Federal Register for July 5, 2000, 65 F.R. 41332)

Section 894.—Income Affected by Treaty

26 CFR 1.894–1: Income affected by treaty.

T.D. 8889

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Guidance Regarding Claims for Certain Income Tax Convention Benefits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to treaty withholding rates for items of income received by entities that are fiscally transparent in the United States and/or a foreign jurisdiction. The regulations affect the determination of tax treaty benefits available to foreign persons with respect to such items of income.

DATES: *Effective Dates*: These regulations are effective June 30, 2000.

Applicability Dates: These regulations apply to items of income paid on or after June 30, 2000.

FOR FURTHER INFORMATION CONTACT: Shawn R. Pringle, (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations relating to the Income Tax Regulations (CFR part 1) under section 894 of the Internal Revenue Code (Code). On June 30, 1997, the IRS and Treasury issued temporary regulations (T.D. 8722, 1997–2 C.B. 81) in the **Federal Register** (62 F.R. 35673, as corrected at 62 F.R. 46876, 46877) under section 894 of the Code relating to eligibility for benefits under income tax treaties for payments to entities. A notice of proposed rulemaking (REG–104893–97, 1997–2 C.B. 646) cross-referencing the temporary regulations was also published in the same issue of the **Federal Register** (62 F.R. 35755).

Need for Changes

Since the publication of T.D. 8722 and proposed regulation §1.894(d)(REG–104893–97, 62 F.R. 35755), the IRS and Treasury have received numerous comments. This Treasury decision contains changes made in response to some of those comments.

Explanation of Provisions

I. *General*

These final section 894 regulations clarify the availability of treaty benefits with respect to an item of U.S. source income paid to an entity that is treated as fiscally transparent under the laws of one or more jurisdictions (including the United States) with respect to that item of income. An entity that is treated as fiscally transparent in one jurisdiction but not another is referred to as a hybrid entity. If an item of U.S. source income is paid to a hybrid entity, the United States may regard the entity as fiscally transparent with respect to the item of income and the foreign treaty jurisdiction may regard the entity as deriving the item of income. Alternatively, the United States may regard the entity as deriving the item of income under U.S. tax principles, but a foreign treaty jurisdiction may regard the entity as fiscally transparent and may therefore regard the interest holders as deriving the item of income. This dual classification may give rise to inappropriate and unintended results under tax treaties, such as double non–taxation or double taxation of the item of income, unless the tax treaties are interpreted to resolve the conflict of laws.

These final regulations clarify how to apply U.S. treaties when the entity classification law of the United States and a foreign treaty jurisdiction conflict by providing that a reduced treaty rate for an item of U.S. source income is available only if the income is derived by a foreign recipient resident in the applicable treaty jurisdiction. This general rule, which has been simplified but not substantially changed from the rule contained in the temporary and proposed section 894 regulations, is discussed in greater detail below.

These final regulations are fully consistent with existing U.S. treaties. They rely on the basic principle that tax treaties are intended to relieve double taxation or excessive taxation. Accordingly, the United States and its treaty partners agree to cede part or all of their taxation rights on income arising from sources within their respective borders on the mutual understanding that the other party is asserting tax jurisdiction over the items of income. This objective is generally achieved through treaty provisions that limit or eliminate the tax that the source state may impose on income arising within its borders to the extent that the income is considered to be derived by a resident of the other jurisdiction. In general, an item of income will be considered derived by a resident for treaty purposes only when the residence country is asserting taxing jurisdiction over the item of income. However, the source state does not necessarily require, as a condition for ceding its taxing jurisdiction, that the income actually be taxed in the residence state or taxed at a rate commensurate with the rate imposed in the source state. The source state and the residence state may come to different conclusions regarding the appropriate taxation principles that apply to a particular type of taxpayer or a particular type of income. Such differences reflect how each state has decided to assert its taxing jurisdiction over that taxpayer or item of income and may or may not affect the source state's willingness to forego its taxing rights in whole or in part during the treaty negotiation process.

The approach adopted in these final regulations is consistent with the evolving multilateral consensus among the member countries of the Organization for Economic Cooperation and Development (OECD) on the appropriate method for source countries to follow to determine if they should provide treaty benefits on items of income paid to fiscally transparent entities, particularly when an entity classification conflict exists between the source and residence states. This evolving multilateral consensus is described in greater detail in the OECD report, "The Application of the OECD Model Tax Convention to Partnerships" (OECD Partnership Report). The report generally provides that a source state is required to grant treaty benefits on income paid to an entity only if the income is considered to be derived by a resident of a treaty partner for purposes of the treaty partner's tax laws. IRS and Treasury will continue to coordinate these issues with U.S. tax treaty partners both bilaterally and multilaterally to resolve substantive issues arising from application of the principles set forth in the section 894 regulations and the OECD Partnership Report.

These regulations apply with respect to all U.S. income tax treaties regardless of whether such treaties contain partnership provisions, unless the competent authorities agree otherwise. As with the proposed and temporary regulations, the final regulations address only the treatment of U.S. source income that is not effectively connected with the conduct of a U.S. trade or business. The IRS and Treasury may issue additional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions, with respect to the income of fiscally transparent entities, particularly where a conflict in entity classification exists.

II. *Objective Versus Subjective Regulatory Approach*

The temporary and proposed section 894 regulations adopted an objective approach to determining whether the United States should grant treaty benefits on U.S. source items of income paid to entities. Application of the regulations did not turn on whether there existed a tax avoidance motive for choosing a particular transaction or structure.

Commentators recommended a narrower approach that would deny treaty benefits on items of income paid to an entity only if the entity served a tax avoidance purpose. As part of this approach, commentators requested implementation of a ruling procedure that could be used to claim treaty benefits by rebutting any deemed tax avoidance motive for the items of income paid to an entity. This suggestion was not adopted. These final regulations are intended to provide objective rules regarding eligibility for treaty benefits on certain items of U.S. source income paid to entities. Although a ruling procedure was not adopted, taxpayers may still invoke the Mutual Agreement Procedures under an applicable treaty in appropriate circumstances.

III. *Simplified Standard For Determining When U.S. Source Income is Derived by a Treaty Resident*

The proposed and temporary regulations provided that the tax imposed by sections 871(a), 881(a), 1461, and 4948(a) on an item of income received by an entity is eligible for reduction under the terms of an income tax treaty to which the United States is a party if such item of income is treated as derived by a resident of an applicable treaty jurisdiction, such resident is a beneficial owner of the item of income, and all other applicable requirements for benefits under the treaty are satisfied. The proposed and temporary regulations further provided that an item of income received by an entity is treated as derived by a resident only to the extent the item of income is subject to tax in the hands of a resident of such jurisdiction. Numerous comments were received stating that this general rule needed clarification. As a result, the IRS and Treasury are eliminating the use of the terms beneficial ownership and subject to tax from the general rule, as described in greater detail below.

A. *Beneficial ownership*

Commentators requested clarification regarding the relationship between beneficial owner and the §1.881–3 anti-conduit regulations issued under the authority of section 7701(l). The anti-conduit rules under section 7701(l) are incorporated into the U.S. determination of beneficial owner. They are not separate additional requirements.

The concept of beneficial owner was included in the proposed regulations to explain the circumstances under which a hybrid entity may beneficially own an item of income for purposes of an income tax treaty, in light of the then proposed withholding regulations under §1.1441–1(c)(6)(ii)(B). However, the definition of beneficial owner in §1.1441–1(c)(6) of the amended final regulations (T.D. 8881, 2000–23 I.R.B 1158) does not apply to claims for reduced withholding under an income tax treaty. Accordingly, because there is no longer a need to clarify the meaning of the term under the section 1441 regulations in the treaty context, these final regulations no longer provide specific rules for this determination. The concept of beneficial owner nevertheless remains an important condition for claiming tax treaty benefits that is determined under U.S. tax principles, including the anti-conduit rules.

B. *Subject to tax*

Commentators suggested that the term subject to tax in the proposed and temporary regulations was ambiguous and could be misinterpreted. Commentators suggested that the term subject to tax could be interpreted as requiring that an actual tax be paid rather than requiring an exercise of taxing jurisdiction by the applicable treaty jurisdiction, whether or not there is an actual tax paid. Commentators suggested that such an interpretation would lead to anomalous results, for example, in cases when the applicable treaty jurisdiction provides an exemption from income for U.S. source dividends under its tax laws.

The IRS and Treasury agree that the term subject to tax could cause unintentional confusion and that a more direct and simpler way of ensuring that an item of income is subject to the taxing jurisdiction of the residence country is to determine if the item of income is derived by a resident of a treaty jurisdiction. The concept of derived by a resident is a more useful surrogate for the concept of subject to the taxing jurisdiction of the residence state, the necessary prerequisite for the grant of treaty benefits on an item of income.

C. *New general rule based on "derived by" standard*

The regulations now provide three specific situations in which income is derived by a resident of a treaty jurisdiction, and thus considered subject to the taxing jurisdiction of the residence jurisdiction and eligible for treaty benefits.

In the first situation, an item of income paid to an entity is considered to be derived by the entity if the entity is not fiscally transparent with respect to the item of income under the laws of the entity's jurisdiction. The entity's jurisdiction is generally the place of the entity's organization, although it may be the place of management and control of the entity if it is a resident in a jurisdiction by reason of such factors.

In the second situation, regardless of whether the entity is found to be fiscally transparent with respect to the item of income under the laws of the entity's jurisdiction, an interest holder in the entity may derive the item of income if that interest holder can establish that, under the laws of the jurisdiction in which the interest holder is a resident, the entity is fiscally transparent with respect to the item of income. Under this test, the interest holder itself must not be considered fiscally transparent with respect to the item of income under the laws of its jurisdiction in order to claim the treaty benefit of that jurisdiction.

In the third situation, an item of income paid to a type of entity specifically listed in a treaty as a resident of that treaty jurisdiction is treated as derived by a resident of that jurisdiction. The reason for this rule is that the two treaty partners reached an explicit agreement on the appropriate treatment of that entity and treaty benefits accordingly should be provided on items of income paid to it.

In some circumstances, both the entity and the interest holders in the entity will be treated as deriving the item of income under the foregoing tests. In that event, both the interest holder and the entity may be entitled to treaty benefits if all other conditions are satisfied. See §1.1441–6(b)(2) for procedures for dual rate claims under separate income tax treaties.

IV. *Determining Fiscal Transparency*

A. *Generally*

The concept of fiscally transparent therefore is critical to the determination of whether an item of income is derived by an entity or an interest holder in an entity. Paragraph (d)(4)(ii) of the proposed and temporary regulations provided that an entity is treated as fiscally transparent by a jurisdiction to the extent the jurisdiction requires interest holders in the entity to take into account separately on a current basis their respective shares of the items of income paid to the entity and to determine the character of such item as if such items were realized directly from the source from which realized by the entity for purposes of the tax laws of the jurisdiction. The proposed and temporary regulations further provided that entities that are fiscally transparent for U.S. federal income tax purposes include partnerships, common trust funds described under section 584, simple trusts, grantor trusts, as well as certain other entities (including entities that have a single interest holder) that are treated as partnerships or as disregarded entities for U.S. federal income tax purposes.

The IRS and Treasury received numerous comments regarding the definition of fiscally transparent under the proposed regulations. The comments stated that it is unclear, in situations when multiple foreign jurisdictions are involved, which jurisdiction's laws apply in determining whether an entity is fiscally transparent. The comments further stated that the requirement that all items of income be separately stated is not consistent with the U.S. tax rules regarding partnerships, which permit partners not to state separately certain items if the outcome is the same whether or not the item is separately stated. Commentators also suggested that the regulations were unclear as to whether fiscal transparency is an item by item determination or a determination made with respect to the entity as a whole.

In response to the comments, several simplifying and clarifying changes were made to the regulations. When an entity is invoking the treaty, paragraph (d)(3)(ii) of the final regulations provides a definition for purposes of determining whether the entity will be treated as fiscally transparent under the laws of the entity's jurisdiction with respect to an item of income received by the entity. When an interest holder in an entity is invoking the treaty, paragraph (d)(3)(iii) of the final regulations provides a definition for purposes of determining whether the entity will be fiscally transparent under the laws of the interest holder's jurisdiction. This clarifies which jurisdiction's laws apply in determining fiscal transparency in cases in which multiple foreign jurisdictions are involved.

Paragraphs (d)(3)(ii) and (iii) of the final regulations generally retain the definition of fiscally transparent as provided by the proposed and temporary regulations, with certain clarifications and modifications. They provide that an entity will be fiscally transparent only if inclusion by the interest holders in the entity is required whether or not an item of income is distributed to such interest holders and, generally, the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. They also provide that fiscal transparency is determined on an item of income by item of income basis. Accordingly, for example, an entity can be fiscally transparent with respect to interest income, but not with respect to dividend income. The regulations further provide, however, that if an item of income is not separately taken into account by its interest holders, the entity may still be fiscally transparent with respect to that item of income if failure to take the item of income into account separately does not result in a treatment under the tax laws of the applicable treaty jurisdiction different from that which would be required if the interest holder did separately take the share of such item into account. This is consistent with the U.S. tax provisions with respect to partnerships.

Because the final regulations adopt an item by item determination of fiscal transparency, the provision in the proposed regulations stating that partnerships, common trust funds described in section 584, simple trusts, grantor trusts and certain other entities are fiscally transparent for U.S. federal income tax purposes has been deleted from the final regulations. The foregoing language implied that fiscal transparency is determined with respect to the entity as a whole. Although the final regulations remove this language, it is anticipated that such entities ordinarily will be fiscally transparent for federal income tax purposes with regard to all items of income received by them.

B. *Investment vehicles*

Commentators also requested clarification regarding the treatment of investment vehicles that may be allowed an exclusion or deduction from income for amounts distributed to interest holders. The final regulations clarify that if an entity such as an investment company is not otherwise fiscally transparent as defined in paragraphs (d)(3)(ii) and (iii) of the final regulations, it will not be deemed to be fiscally transparent merely because it is allowed to exclude or deduct from income amounts distributed to interest holders. Examples provide further guidance with respect to foreign investment vehicles, most of which will not be fiscally transparent under the final regulations.

C. *Treatment of tax exempt organizations*

In addition to the foregoing, several commentators suggested that the regulations undermine reciprocal treaty exemptions for pension funds and other tax exempt organizations by, for example, denying treaty benefits under circumstances when the fund or organization invests in U.S. LLCs that are treated as partnerships for purposes of U.S. tax law and as corporations under the laws of the applicable treaty jurisdiction. Treasury does not believe that the regulations conflict with U.S. treaty obligations to provide reduced treaty rates to pension funds and other tax exempt organizations investing in the United States. In most cases, the denial of benefits described by commentators can be avoided by ensuring that the pension fund or tax exempt organization invests directly or through an entity treated as fiscally transparent under the laws of the jurisdiction of the fund or organization, with the result that the fund or organization will still be able to claim exemptions under the applicable treaty. In addition, treaties may be negotiated that permit pensions and other tax exempt organizations to invest in the United States through nonfiscally transparent entities and still obtain reduced treaty rates. (See for example paragraph 2(b) of Article XXI of the U.S.-Canada treaty, with respect to pension funds). Further, paragraph (d)(4) gives the competent authorities the flexibility, in appropriate circumstances, to enter into a mutual reciprocal understanding that would depart from the rules of paragraph (d) with respect to certain classes of entities.

D. *Treatment of complex trusts*

The proposed and temporary regulations did not specifically address the treatment of section 661 trusts that are permitted to accumulate income from year to year. Commentators suggested that they should be treated as fiscally transparent for U.S. tax purposes because, under section 662, the distributable net income of such trusts retains its character in the hands of the beneficiaries if it is distributed in the current year and not accumulated. The definitions of fiscally transparent as set forth in the final regulations provide that, in order for the entity to be fiscally transparent with respect to an item of income, the interest holder must be required to take that item of income into account in a taxable year whether or not the item is distributed, and generally the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity.

Thus, to the extent the beneficiaries of a trust are required under section 662 to take an item of the trust's income into account in a taxable year, whether or not the item is distributed, and the character and source of the item in the hands of the beneficiaries are determined as if such item were realized directly from the source from which realized by the entity, the trust will be treated as fiscally transparent for U.S. tax purposes with respect to that item of income. If inclusion by the interest holders is not required whether or not such item of income is distributed, or the character and source of the item in the hands of the interest holder are not determined as if such item were realized directly from the source from which realized by the entity, the trust will not be treated as fiscally transparent for U.S. tax purposes. In determining whether a trust, or any other entity, is fiscally transparent with respect to an item of income under the laws of any other jurisdiction, the treatment of that item of income under the laws of that jurisdiction controls, not the treatment under U.S. laws.

E. *Effect of Anti-Deferral Regimes*

Commentators also argued that controlled foreign corporations should be treated as fiscally transparent to the extent interest holders are required to account for the controlled foreign corporation's net passive income on a current basis. This suggestion was rejected because the nature of an inclusion under an anti-deferral regime is that of a deemed distribution of after-tax profits of the controlled foreign corporation, while an inclusion because an entity is fiscally transparent is in the nature of a share of the item of income itself, as if the interest holder realized the income directly. This follows from the definition of fiscal transparency contained in paragraph (d)(3)(iii), relating to whether an entity is fiscally transparent under the laws of the interest holder's jurisdiction.

V. *Treatment of Payments To and From Domestic Reverse Hybrid Entities*

Section 1.894–1T(d)(3) provided guidance on the appropriate treatment of items of income paid to an entity that is treated as a domestic corporation for U.S. tax purposes but is treated as fiscally transparent under the laws of an interest holder's jurisdiction (a "domestic reverse hybrid" entity). That section provided that §1.894–1T(d)(1) may not be applied to reduce the amount of federal income tax on U.S. source income received by a domestic reverse hybrid entity through application of an income tax treaty. Commentators expressed concern that this rule did not provide sufficient guidance and could lead to inappropriate results, noting that an item of income paid *by* a domestic reverse hybrid entity could be viewed as neither "received by" the interest holder nor "subject to tax" because the interest holder's jurisdiction would treat the domestic reverse hybrid entity as fiscally transparent. Thus, the interest holder's jurisdiction would view the interest holder as "receiving" the items of income paid *to* the domestic reverse hybrid entity and as being "subject to tax" on those items of income on an immediate basis, but may not recognize the items of income paid *by* the domestic reverse hybrid entity to the interest holder.

The IRS and Treasury are also aware of certain abusive structures involving domestic reverse hybrid entities, which are designed to manipulate differences in U.S. and foreign entity classification rules to produce inappropriate reductions in U.S. tax. These transactions give rise to some of the same concerns that led to the promulgation of the temporary and proposed regulations and caused Congress to enact section 894(c). Treasury and the IRS expect to issue guidance shortly regarding payments by domestic reverse hybrid entities to their interest holders in a separate regulation package. Thus, these final regulations reserve on the question of eligibility for treaty benefits with respect to payments by domestic reverse hybrid entities.

Effective Date

The final regulations apply to items of income paid on or after June 30, 2000. Withholding agents should consider the effect of these regulations on their withholding obligations, including the need to obtain a new withholding certificate to confirm claims of treaty benefits for items of income paid on or after the effective date.

Special Analyses

It has been determined that this treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required.

Drafting Information

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

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Adoption of Amendments to the Regulations

Accordingly, CFR 26 part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 is amended by revising the entry for section 1.894–1 to read in part as follows:

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

Section 1.894–1 also issued under 26 U.S.C. 894 and 7701(l). * * *

Par. 2. In §1.894–1, paragraph (d) is revised to read as follows:

§1.894–1 Income affected by treaty.

* * * * *

(d) *Special rule for items of income received by entities*—(1) *In general*. The tax imposed by sections 871(a), 881(a), 1443, 1461, and 4948(a) on an item of income received by an entity, wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income is derived by a resident of the applicable treaty jurisdiction. For this purpose, an item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity or, in certain circumstances, both. An item of income paid to an entity shall be considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's jurisdiction, as defined in paragraph (d)(3)(ii) of this section, with respect to the item of income. An item of income paid to an entity shall be considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income and if the entity is considered to be fiscally transparent under the laws of the interest holder's jurisdiction with respect to the item of income, as defined in paragraph (d)(3)(iii) of this section. Notwithstanding the preceding two sentences, an item of income paid directly to a type of entity specifically identified in a treaty as a resident of a treaty jurisdiction shall be treated as derived by a resident of that treaty jurisdiction.

(2) *Application to domestic reverse hybrid entities*—(i) *In general*. An income tax treaty may not apply to reduce the amount of federal income tax on U.S. source payments received by a domestic reverse hybrid entity. Further, notwithstanding paragraph (d)(1) of this section, the foreign interest holders of a domestic reverse hybrid entity are not entitled to the benefits of a reduction of U.S. income tax under an income tax treaty on items of income received from U.S. sources by such entity. A domestic reverse hybrid entity is a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction,

with respect to the item of income received by the domestic entity.

(ii) *Payments by domestic reverse hybrid entities*. [Reserved].

(3) *Definitions*—(i) *Entity*. For purposes of this paragraph (d), the term *entity* shall mean any person that is treated by the United States or the applicable treaty jurisdiction as other than an individual. The term *entity* includes disregarded entities, including single member disregarded entities with individual owners.

(ii) *Fiscally transparent under the law of the entity's jurisdiction*—(A) *General rule*. For purposes of this paragraph (d), an entity is fiscally transparent under the laws of the entity's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder in the entity, wherever resident, to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. However, the entity will be fiscally transparent with respect to the item of income even if the item of income is not separately taken into account by the interest holder, provided the item of income, if separately taken into account by the interest holder, would not result in an income tax liability for that interest holder different from that which would result if the interest holder did not take the item into account separately, and provided the interest holder is required to take into account on a current basis the interest holder's share of all such nonseparately stated items of income paid to the entity, whether or not distributed to the interest holder. In determining whether an entity is fiscally transparent with respect to an item of income in the entity's jurisdiction, it is irrelevant that, under the laws of the entity's jurisdiction, the entity is permitted to exclude such item from gross income or that the entity is required to include such item in gross income but is entitled to a deduction for distributions to its interest holders.

(B) *Special definitions*. For purposes of this paragraph (d)(3)(ii), an entity's jurisdiction is the jurisdiction where the entity is organized or incorporated or may otherwise be considered a resident under the laws of that jurisdiction. An interest holder will be treated as taking into account that person's share of income paid to an entity on a current basis even if such amount is taken into account by the interest holder in a taxable year other than the taxable year of the entity if the difference is due solely to differing taxable years.

(iii) *Fiscally transparent under the law of an interest holder's jurisdiction*—(A) *General rule*. For purposes of this paragraph (d), an entity is treated as fiscally transparent under the law of an interest holder's jurisdiction with respect to an item of income to the extent that the laws of the interest holder's jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. However, an entity will be fiscally transparent with respect to the item of income even if the item of income is not separately taken into account by the interest holder, provided the item of income, if separately taken into account by the interest holder, would not result in an income tax liability for that interest holder different from that which would result if the interest holder did not take the item into account separately, and provided the interest holder is required to take into account on a current basis the interest holder's share of all such nonseparately stated items of income paid to the entity, whether or not distributed to the interest holder. An entity will not be treated as fiscally transparent with respect to an item of income under the laws of the interest holder's jurisdiction, however, if, under the laws of the interest holder's jurisdiction, the interest holder in the entity is required to include in gross income a share of all or a part of the entity's income on a current basis year under any type of anti-deferral or comparable mechanism. In determining whether an entity is fiscally transparent with respect to an item of income under the laws of an interest holder's jurisdiction, it is irrelevant how the entity is treated under the laws of the entity's jurisdiction.

(B) *Special definitions*. For purposes of this paragraph (d)(3)(iii), an interest holder's jurisdiction is the jurisdiction where the interest holder is organized or incorporated or may otherwise be considered a resident under the laws of that jurisdiction. An interest holder will be treated as taking into account that person's share of income paid to an entity on a current basis even if such amount is taken into account by such person in a taxable year other than the taxable year of the entity if the difference is due solely to differing taxable years.

(iv) *Applicable treaty jurisdiction*. The term *applicable treaty jurisdiction* means the jurisdiction whose income tax treaty with the United States is invoked for purposes of reducing the rate of tax imposed under sections 871(a), 881(a), 1461, and 4948(a).

(v) *Resident*. The term *resident* shall have the meaning assigned to such term in the applicable income tax treaty.

(4) *Application to all income tax treaties*. Unless otherwise explicitly agreed upon in the text of an income tax treaty, the rules contained in this paragraph (d) shall apply in respect of all income tax treaties to which the United States is a party. Notwithstanding the foregoing sentence, the competent authorities may agree on a mutual basis to depart from the rules contained in this paragraph (d) in appropriate circumstances. However, a reduced rate under a tax treaty for an item of U.S. source income paid will not be available irrespective of the provisions in this paragraph (d) to the extent that the applicable treaty jurisdiction would not grant a reduced rate under the tax treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the relevant competent authorities or by a public notice of the treaty jurisdiction. The Internal Revenue Service shall announce the terms of any such mutual agreement or public notice of the treaty jurisdiction. Any denial of tax treaty benefits as a consequence of such a mutual agreement or notice shall affect only payment of U.S. source items of income made after announcement of the terms of the agreement or of the notice.

(5) *Examples*. This paragraph (d) is illustrated by the following examples:

Example 1. Treatment of entity treated as part-

nership by U.S. and country of organization. (i) *Facts*. Entity A is a business organization formed under the laws of Country X that has an income tax treaty in effect with the United States. A is treated as a partnership for U.S. federal income tax purposes. A is also treated as a partnership under the laws of Country X, and therefore Country X requires the interest holders in A to separately take into account on a current basis their respective shares of the items of income paid to A, whether or not distributed to the interest holders, and the character and source of the items in the hands of the interest holders are determined as if such items were realized directly from the source from which realized by A. A receives royalty income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States.

(ii) *Analysis*. A is fiscally transparent in its jurisdiction within the meaning of paragraph (d)(3)(ii) of this section with respect to the U.S. source royalty income in Country X and, thus, A does not derive such income for purposes of the U.S.-X income tax treaty.

Example 2. Treatment of interest holders in entity treated as partnership by U.S. and country of organization. (i) *Facts*. The facts are the same as under *Example 1*. A's partners are M, a corporation organized under the laws of Country Y that has an income tax treaty in effect with the United States, and T, a corporation organized under the laws of Country Z that has an income tax treaty in effect with the United States. M and T are not fiscally transparent under the laws of their respective countries of incorporation. Country Y requires M to separately take into account on a current basis M's respective share of the items of income paid to A, whether or not distributed to M, and the character and source of the items of income in M's hands are determined as if such items were realized directly from the source from which realized by A. Country Z treats A as a corporation and does not require T to take its share of A's income into account on a current basis whether or not distributed.

(ii) *Analysis*. M is treated as deriving its share of the U.S. source royalty income for purposes of the U.S.-Y income tax treaty because A is fiscally transparent under paragraph (d)(3)(iii) with respect to that income under the laws of Country Y. Under Country Z law, however, because T is not required to take into account its share of the U.S. source royalty income received by A on a current basis whether or not distributed, A is not treated as fiscally transparent. Accordingly, T is not treated as deriving its share of the U.S. source royalty income for purposes of the U.S.-Z income tax treaty.

Example 3. Dual benefits to entity and interest holder. (i) *Facts.* The facts are the same as under *Example 2*, except that A is taxable as a corporation under the laws of Country X. Article 12 of the U.S.-X income tax treaty provides for a source country reduced rate of taxation on royalties of 5-percent. Article 12 of the U.S.-Y income tax treaty provides that royalty income may only be taxed by the beneficial owner's country of residence.

(ii) *Analysis*. A is treated as deriving the U.S. source royalty income for purposes of the U.S.-X income tax treaty because it is not fiscally transparent with respect to the item of income within the meaning of paragraph (d)(3)(ii) of this section in Country X, its country of organization. M is also treated as deriving its share of the U.S. source royalty income for purposes of the U.S.-Y income tax treaty because A is fiscally transparent under paragraph (d)(3)(iii) of this section with respect to that income under the laws of Country Y. T is not treated as deriving the U.S. source royalty income for purposes of the U.S.-Z income tax treaty because under Country Z law A is not fiscally transparent. Assuming all other requirements for eligibility for treaty benefits have been satisfied, A is entitled to the 5-percent treaty reduced rate on royalties under the U.S.-X income tax treaty with respect to the entire royalty payment. Assuming all other requirements for treaty benefits have been satisfied, M is also entitled to a zero rate under the U.S.-Y income tax treaty with respect to its share of the royalty income.

Example 4. Treatment of grantor trust. (i) *Facts*. Entity A is a trust organized under the laws of Country X, which does not have an income tax treaty in effect with the United States. M, the grantor and owner of A for U.S. income tax purposes, is a resident of Country Y, which has an income tax treaty in effect with the United States. M is also treated as the grantor and owner of the trust under the laws of Country Y. Thus, Country Y requires M to take into account all items of A's income in the taxable year, whether or not distributed to M, and determines the character of each item in M's hands as if such item was realized directly from the source from which realized by A. Country X does not treat M as the owner of A and does not require M to account for A's income on a current basis whether or not distributed to M. A receives interest income from U.S. sources that is neither portfolio interest nor effectively connected with the conduct of a trade or business in the United States.

(ii) *Analysis*. A is not fiscally transparent under the laws of Country X within the meaning of paragraph (d)(3)(ii) of this section with respect to the U.S. source interest income, but A may not claim treaty benefits because there is no U.S.-X income tax treaty. M, however, does derive the income for purposes of the U.S.-Y income tax treaty because under the laws of Country Y, A is fiscally transparent.

Example 5. Treatment of complex trust. (i) *Facts*. The facts are the same as in *Example 4* except that M is treated as the owner of the trust only under U.S. tax law, after application of section 672(f), but not under the law of Country Y. Although the trust document governing A does not require that A distribute any of its income on a current basis, some distributions are made currently to M. There is no requirement under Country Y law that M take into account A's income on a current basis whether or not distributed to him in that year. Under the laws of Country Y, with respect to current distributions, the character of the item of income in the hands of the interest holder is determined as if such item were realized directly from the source from which realized by A. Accordingly, upon a current distribution of interest income to M, the interest income retains its source as U.S. source income.

(ii) *Analysis*. M does not derive the U.S. source interest income because A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source interest income under the laws of Country Y. Although the character of the interest in the hands of M is determined as if realized directly from the source from which realized by A, under the laws of Country Y, M is not required to take into account his share of A's interest income on a current basis whether or not distributed. Accordingly, neither A nor M is entitled to claim treaty benefits, since A is a resident of a non-treaty jurisdiction and M does not derive the U.S. source interest income for purposes of the U.S.-Y income tax treaty.

Example 6. Treatment of interest holders required to include passive income under anti-deferral regime. (i) *Facts*. The facts are the same as under *Example 2*. However, Country Z does require T, who is treated as owning 60-percent of the stock of A, to take into account its respective share of the royalty income of A under an anti-deferral regime applicable to certain passive income of controlled foreign corporations.

(ii) *Analysis*. T is still not eligible to claim treaty benefits with respect to the royalty income. T is not treated as deriving the U.S. source royalty income for purposes of the U.S.-Z income tax treaty under paragraph (d)(3)(iii) of this section because T is only required to take into account its pro rata share of the U.S. source royalty income by reason of Country Z's anti-deferral regime.

Example 7. Treatment of contractual arrangements operating as collective investment vehicles. (i) *Facts*. A is a contractual arrangement without legal personality for all purposes under the laws of Country X providing for joint ownership of securities. Country X has an income tax treaty in effect with the United States. A is a collective investment fund which is of a type known as a Common Fund under Country X law. Because of the absence of legal personality of the arrangement, A is not liable to tax at the entity level in Country X and is not a resident within the meaning of the Residence Article of the U.S.-X income tax treaty. A is treated as a partnership for U.S. income tax purposes and receives U.S. source dividend income. Under the laws of Country X, however, investors in A only take into account their respective share of A's income upon distribution from the Common Fund. Some of A's interest holders are residents of Country X and some of Country Y. Country Y has no income tax treaty in effect with the United States.

(ii) *Analysis*. A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because the interest holders in A are not required to take into account their respective shares of such income in the taxable year whether or not distributed. Because A is an arrangement without a legal personality that is not considered a resident of Country X under the Residence Article of the U.S.-X income tax treaty, however, A does not derive the income for purposes of the U.S.-X income tax treaty. Further, because A is not fiscally transparent under paragraph (d)(3)(iii) of this section with respect to the U.S. source dividend income, A's interest holders that are residents of Country X do not derive the income as residents of Country X for purposes of the U.S.-X income tax treaty.

Example 8. Treatment of person specifically listed as resident in applicable treaty. (i) *Facts*. The facts are the same as in *Example 7* except that A (the Common Fund) is organized in Country Z and the Residence Article of the U.S.-Z income tax treaty provides that "the term 'resident of a Contracting State' includes, in the case of Country Z, Common Funds...."

(ii) *Analysis*. A is treated, for purposes of the

U.S.-Z income tax treaty as deriving the dividend income as a resident of Country Z under paragraph (d)(1) of this section because the item of income is paid directly to A, A is a Common Fund under the laws of Country Z, and Common Funds are specifically identified as residents of Country Z in the U.S.-Z treaty. There is no need to determine whether A meets the definition of fiscally transparent under paragraph (d)(3)(ii) of this section.

Example 9. Treatment of investment company when entity receives distribution deductions, and all distributions sourced by residence of entity. (i) *Facts*. Entity A is a business organization formed under the laws of Country X, which has an income tax treaty in effect with the United States. A is treated as a partnership for U.S. income tax purposes. Under the laws of Country X, A is an investment company taxable at the entity level and a resident of Country X. It is also entitled to a distribution deduction for amounts distributed to its interest holders on a current basis. A distributes all its net income on a current basis to its interest holders and, thus, in fact, has no income tax liability to Country X. A receives U.S. source dividend income. Under Country X law, all amounts distributed to interest holders of this type of business entity are treated as dividends from sources within Country X and Country X imposes a withholding tax on all payments by A to foreign persons. Under Country X laws, the interest holders in A do not have to separately take into account their respective shares of A's income on a current basis if such income is not, in fact, distributed.

(ii) *Analysis*. A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividends because the interest holders in A do not have to take into account their respective share of the U.S. source dividends on a current basis whether or not distributed. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section because there is a change in source of the income received by A when A distributes the income to its interest holders and, thus, the character and source of the income in the hands of A's interest holder are not determined as if such income were realized directly from the source from which realized by A. Accordingly, A is treated as deriving the U.S. source dividends for purposes of the U.S.-Country X treaty.

Example 10. Item by item determination of fiscal transparency. (i) *Facts*. Entity A is a business organization formed under the laws of Country X, which has an income tax treaty in effect with the United States. A is treated as a partnership for U.S. income tax purposes. Under the laws of Country X, A is an investment company taxable at the entity level and a resident of Country X. It is also entitled to a distribution deduction for amounts distributed to its interest holders on a current basis. A receives both U.S. source dividend income and interest income from U.S. sources that is neither portfolio interest nor effectively connected with the conduct of a trade or business in the United States. Country X law sources all distributions attributable to dividend income based on the residence of the investment company. In contrast, Country X law sources all distributions attributable to interest income based on the residence of the payor of the interest. No withholding applies with respect to distributions attributable to U.S. source interest and the character of the distributions attributable to the interest income remains the same in the hands of A's interest holders as if such items were realized directly from the source from which realized by A. However, under Country X law the interest holders in A do not have to take into account their respective share of the interest income received by A on a current basis whether or not distributed.

(ii) *Analysis*. An item by item analysis is required under paragraph (d) of this section. The analysis is the same as *Example 9* with respect to the dividend income. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the interest income because, although the character of the distributions attributable to the interest income in the hands of A's interest holders is determined as if realized directly from the source from which realized by A, under Country X law the interest holders in A do not have to take into account their respective share of the interest income received by A on a current basis whether or not distributed. Accordingly, A derives the U.S. source interest income for purpose of the U.S.-X treaty.

Example 11. Treatment of charitable organizations. (i) *Facts*. Entity A is a corporation organized under the laws of Country X that has an income tax treaty in effect with the United States. Entity A is established and operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. Entity A receives U.S. source dividend income from U.S. sources. A provision of Country X law generally exempts Entity A's income from Country X tax due to the fact that Entity A is established and operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. But for such provision, Entity A's income would be subject to tax by Country X.

(ii) *Analysis*. Entity A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because, under Country X law, the dividend income is treated as an item of income of A and no other persons are required to take into account their respective share of the item of income on a current basis, whether or not distributed. Accordingly, Entity A is treated as deriving the U.S. source dividend income.

Example 12. Treatment of pension trusts. (i) *Facts*. Entity A is a trust established and operated in Country X exclusively to provide pension or other similar benefits to employees pursuant to a plan. Entity A receives U.S. source dividend income. A provision of Country X law generally exempts Entity A's income from Country X tax due to the fact that Entity A is established and operated exclusively to provide pension or other similar benefits to employees pursuant to a plan. Under the laws of Country X, the beneficiaries of the trust are not required to take into account their respective share of A's income on a current basis, whether or not distributed and the character and source of the income in the hands of A's interest holders are not determined as if realized directly from the source from which realized by A.

(ii) *Analysis*. A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because under the laws of Country X, the beneficiaries of A are not required to take into account their respective share of A's income on a current basis, whether or not distributed. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because under the laws of Country X, the character and source of the income in the hands of A's interest holders are not determined as if realized directly from the source from which realized by A. Accordingly, A derives the U.S. source dividend income for purposes of the U.S.-X income tax treaty.

(6) *Effective date*. This paragraph (d) applies to items of income paid on or after June 30, 2000.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

Approved June 28, 2000.

Jonathan Talisman,
Deputy Assistant Secretary
of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on June 30, 2000, 8:45 a.m., and published in the issue of the Federal Register for July 3, 2000, 65 F.R. 40993)

Part III. Administrative, Procedural, and Miscellaneous

Earnings Calculation for Returned or Recharacterized IRA Contributions

Notice 2000–39

I. PURPOSE

This notice permits a new method to be used for calculating the net income attributable to IRA contributions made after 1999 that are distributed as a returned contribution pursuant to § 408(d)(4) of the Internal Revenue Code ("Code") or recharacterized pursuant to § 408A(d)(6). However, until further guidance is issued, net income may continue to be calculated under the existing method set forth in the Income Tax Regulations.

II. BACKGROUND

A. Returned Contributions under § 408(d)(4)

Section 408(d)(4) provides that an IRA contribution will not be included in the IRA owner's gross income when distributed as a returned contribution if (1) it is received by the IRA owner on or before the day prescribed by law, including extensions, for filing the owner's Federal income tax return for the year of the contribution, (2) no deduction is allowed with respect to the contribution, and (3) the distribution is accompanied by the amount of net income attributable to the contribution.

Section 1.408–4(c)(2)(ii) of the Income Tax Regulations prescribes the method for calculating the amount of net income attributable to a contribution distributed pursuant to § 408(d)(4). That method, referred to in this notice as the "old method," bases the calculation of the amount of net income attributable to a contribution on the income earned by the IRA during the period beginning on the first day of the taxable year in which the contribution is made and ending on the date of the distribution from the account. Under the old method, net income cannot be a negative amount.

B. Recharacterizations under § 408A(d)(6)

Section 408A(d)(6) provides that a contribution made to one type of IRA may be recharacterized as having been made to another type of IRA if (1) the recharacterization transfer occurs on or before the date prescribed by law for filing the IRA owner's Federal income tax return for the year for which the contribution was made, (2) no deduction is allowed with respect to the contribution to the transferor IRA, and (3) the transfer is accompanied by any net income allocable to the contribution.

Section 1.408A–5, Q&A–2(c), provides that if a contribution being recharacterized is in an IRA that at any time contained other contributions, the net income attributable to the contribution being recharacterized is calculated in the manner prescribed by § 1.408–4(c)(2)(ii) (the old method), except that net income can be a negative amount. Section 1.408A, Q&A-2(b), provides that if an IRA is established with a contribution and no other contributions or distributions are made, then the subsequent recharacterization transfer of the entire account balance of the IRA will satisfy the requirement that the transfer be accompanied by any net income allocable to the contribution.

C. Requests for Alternative Method

The Internal Revenue Service has received comments that the old method for calculating net income attributable to an IRA contribution often does not reflect the actual earnings and losses of the IRA during the time it held the contribution. This is because, under the old method, account activity in the part of the year that precedes the date the contribution is made is taken into account in the calculation of the net income attributable to the contribution. In addition, IRA owners and other interested parties have indicated that net income should be permitted to be a negative amount.

In response to these comments, the Service and Treasury are providing a new method for calculating net income that generally bases the calculation of the amount of net income attributable to a contribution on the actual earnings and losses of the IRA during the time it held the contribution. Until further guidance is issued, net income may be calculated under either the new method or the old method. However, it is intended that future guidance will provide that the new method is the only method for calculating net income, and comments are requested regarding the new method and the effective date of mandatory use of the new method.

III. NEW METHOD FOR NET INCOME CALCULATION UNDER § 408(d)(4)

Under the new method, for purposes of returned contributions under § 408(d)(4), the net income attributable to a contribution made to an IRA after December 31, 1999, is determined by allocating to the contribution a pro-rata portion of the earnings accrued by the IRA during the period the IRA held the contribution. The new method is represented by the following formula:

$$\text{Net Income} = \text{Contribution x } \frac{\text{Adjusted Closing Balance - Adjusted Opening Balance}}{\text{Adjusted Opening Balance}}$$

The "adjusted opening balance" is the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions made to the IRA during the computation period (including the contribution that is distributed as a returned contribution pursuant to § 408(d)(4)).

The "adjusted closing balance" is the fair market value of the IRA at the end of the computation period plus the amount of any distributions made from the IRA during the computation period.

The "computation period" is the period beginning immediately prior to the time the particular contribution is made to the IRA and ending immediately prior to the removal of the contribution being returned.

For purposes of the above calculation, when an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. In addition, solely for purposes of determining net income, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

Under the new method set forth above, net income may be a negative number.

In the case of multiple regular contributions to an IRA, the last regular contribution made to the IRA for a particular taxable year is deemed to be the contribution that is distributed as a returned contribution under § 408(d)(4), up to the amount of the contribution identified by the IRA owner as the amount distributed as a returned contribution. For purposes of this notice, a "regular contribution" is an IRA contribution made by the IRA owner that is neither a trustee-to-trustee transfer from another IRA nor a rollover from another IRA or retirement plan.

In the case of an individual who owns multiple IRAs, the net income calculation is performed only on the IRA designated by the owner as containing the contribution that is to be distributed as a returned contribution, and that IRA is the IRA that must distribute the contribution.

Under the new method described above, if an IRA is established with a contribution and no other contributions or distributions are made to or from that IRA, then the subsequent distribution of the entire account balance of the IRA pursuant to § 408(d)(4) will satisfy the requirement of that Code section that the return of a contribution be accompanied by the amount of net income attributable to the contribution.

The following examples illustrate the new method net income calculation under § 408(d)(4):

Example 1. (i) On May 1, 2000, when her IRA is worth $4,800, Taxpayer A makes a $1,600 regular contribution to her IRA. Taxpayer A requests that $400 of the May 1, 2000, contribution be returned to her pursuant to § 408(d)(4). Pursuant to this request, on February 1, 2001, when the IRA is worth $7,600, the IRA trustee distributes to Taxpayer A the $400 plus attributable net income. During this time, no other contributions have been made to the IRA and no distributions have been made.

(ii) The adjusted opening balance is $6,400 [$4,800 + $1,600] and the adjusted closing balance is $7,600. Thus, the net income attributable to the $400 May 1, 2000, contribution is $75 [$400 x ($7,600 - $6,400) ÷ $6,400]. Therefore, the total to be distributed on February 1, 2001, pursuant to § 408(d)(4) is $475.

Example 2. (i) Beginning in 2000, Taxpayer B contributes $200 on the 15th of each month by payroll deduction to an IRA for 2000, resulting in an excess regular contribution of $400 for the year. Taxpayer B requests that the $400 excess regular contribution be returned to her pursuant to § 408(d)(4). Pursuant to this request, on March 1, 2001, when the IRA is worth $16,000, the IRA trustee distributes to Taxpayer B the $400 plus attributable net income. The excess regular contributions to be returned are deemed to be the last two made in 2000: the $200 December 15 contribution, when the IRA was worth $12,000 immediately prior to the contribution; and the $200 November 15 contribution, when the IRA was worth $11,000 immediately prior to the contribution. No distributions have been made from the IRA and no contributions, other than the payroll deduction contributions (including $200 in January and February 2001), have been made.

(ii) For the December 15 contribution, the adjusted opening balance is $12,600 [$12,000 + $200 + $200 + $200] and the adjusted closing balance is $16,000. Thus, the net income attributable to the December 15 contribution is $54 [$200 x ($16,000 - $12,600) ÷ $12,600]. For the November 15 contribution, the adjusted opening balance is $11,800 [$11,000 + $200 + $200 + $200 + $200] and the adjusted closing balance is $16,000. Thus, the net income attributable to the November 15 contribution is $71 [$200 x ($16,000 - $11,800) ÷ $11,800]. Therefore, the total to be distributed as returned contributions on March 1, 2001, to correct the excess regular contribution is $525 [$200 + $200 + $54 + $71].

IV. NEW METHOD FOR NET INCOME CALCULATION UNDER § 408A(d)(6)

Under the new method, for purposes of recharacterizations under § 408A(d)(6), the net income allocable to a contribution made to an IRA after December 31, 1999, is determined by allocating to the contribution a pro-rata portion of the earnings accrued by the IRA during the period the IRA held the contribution. The new method is represented by the following formula:

$$\text{Net Income} = \text{Contribution} \times \frac{\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance}}{\text{Adjusted Opening Balance}}$$

The "adjusted opening balance" is the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions made to the IRA during the computation period (including the contribution that is recharacterized pursuant to § 408A(d)(6)).

The "adjusted closing balance" is the fair market value of the IRA at the end of the computation period plus the amount of any distributions made from the IRA during the computation period.

The "computation period" is the period beginning immediately prior to the time the particular contribution being recharacterized is made to the IRA and ending immediately prior to the recharacterizing transfer of the contribution.

For purposes of the above calculation, when an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. In addition, solely for purposes of determining net income, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

In the case of an individual with multiple IRAs, the net income calculation is performed only on the IRA designated by the owner as containing the particular contribution to be recharacterized, and that IRA is the IRA from which the recharacterizing transfer must be made.

As under the old method, net income may be a negative amount. Also, as under the old method, in the case of multiple contributions made to an IRA for a particular year that are eligible for recharacterization, the IRA owner can choose (by dollar amount, not by specific assets acquired with those dollars) which contribution, or portion thereof, is to be recharacterized.

Also as under the old method, if an IRA is established with a contribution and no other contributions or distributions are made to or from that IRA, then the subsequent recharacterization transfer of the entire account balance of the IRA pursuant to § 408A(d)(6) will satisfy the requirement of that Code section that the transfer be accompanied by any net income allocable to the contribution.

The following examples illustrate the new method net income calculation under § 408A(d)(6):

Example 3. (i) On March 1, 2000, when her Roth IRA is worth $80,000, Taxpayer C makes a $160,000 conversion contribution to the Roth IRA. Subsequently, Taxpayer C discovers that she was ineligible to make a Roth conversion contribution in 2000 and so she requests that the $160,000 be recharacterized to a traditional IRA pursuant to § 408A(d)(6). Pursuant to this request, on March 1, 2001, when the IRA is worth $225,000, the Roth IRA trustee transfers to a traditional IRA the $160,000 plus allocable net income. No other contributions have been made to the Roth IRA and no distributions have been made.

(ii) The adjusted opening balance is $240,000 [$80,000 + $160,000] and the adjusted closing balance is $225,000. Thus the net income allocable to the $160,000 is -$10,000 [$160,000 x ($225,000 - $240,000) ÷ $240,000]. Therefore, in order to recharacterize the March 1, 2000, $160,000 conversion contribution on March 1, 2001, the Roth IRA trustee must transfer from Taxpayer C's Roth IRA to her traditional IRA $150,000 [$160,000 - $10,000].

Example 4. (i) On April 1, 2000, when her traditional IRA is worth $100,000, Taxpayer D converts the entire amount, consisting of 100 shares of stock in ABC Corp. and 100 shares of stock in XYZ Corp., by transferring the shares to a Roth IRA. At the time of the conversion, the 100 shares of stock in ABC Corp. are worth $50,000 and the 100 shares of stock in XYZ Corp. are also worth $50,000. Taxpayer D decides that she would like to recharacterize the ABC Corp. shares back to a traditional IRA. However, D may choose only by dollar amount the contribution or portion thereof that is to be recharacterized. On the date of transfer, November 1, 2000, the 100 shares of stock in ABC Corp. are worth $40,000 and the 100 shares of stock in XYZ Corp. are worth $70,000. No other contributions have been made to the Roth IRA and no distributions have been made.

(ii) If D requests that $50,000 (which was the value of the ABC Corp. shares at the time of conversion) be recharacterized, the net income allocable to the $50,000 is $5,000 [$50,000 x ($110,000 - $100,000) ÷ $100,000]. Therefore, in order to recharacterize $50,000 of the April 1, 2000, conversion contribution on November 1, 2000, the Roth IRA trustee must transfer from Taxpayer D's Roth IRA to a traditional IRA assets with a value of $55,000 [$50,000 + $5,000].

(iii) If, on the other hand, D requests that $40,000 (which was the value of the ABC Corp. shares on November 1) be recharacterized, the net income allocable to the $40,000 is $4,000 [$40,000 x ($110,000 - $100,000) ÷ $100,000]. Therefore, in order to recharacterize $40,000 of the April 1, 2000, conversion contribution on November 1, 2000, the Roth IRA trustee must transfer from Taxpayer D's Roth IRA to a traditional IRA assets with a value of $44,000 [$40,000 + $4,000].

(iv) Regardless of the amount of the contribution recharacterized, the determination of that amount (or of the net income allocable thereto) is not affected by whether the recharacterization is accomplished by the transfer of shares of ABC Corp. or of shares of XYZ Corp.

V. REQUEST FOR COMMENTS

The Service and Treasury invite comments and suggestions concerning the new method described in this notice for calculating net income under §§ 408(d)(4) and 408A(d)(6) and also concerning the effective date for a rule that would establish the new method as the only method for calculating net income under §§ 408(d)(4) and 408A(d)(6). Any correspondence received will be evaluated, together with appropriate considerations relating to tax administration, to determine the scope of future guidance.

Comments can be submitted to CC:DOM:CORP:R (Notice 2000–39), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 2000–39), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Roger Kuehnle of Employee Plans (Tax Exempt and Government Entities Division). For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at (202) 622-6074/6075 (not toll-free numbers) between the hours of 1:30 and 3:30 p.m. Eastern Time, Monday through Thursday.

Weighted Average Interest Rate Update

Notice 2000–40

Notice 88–73 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 Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for June 2000 is 5.93 percent.

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

Month	Year	Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
July	2000	5.99	5.39 to 6.29	5.39 to 6.59

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, call the Employee Plans Actuarial hotline, (202) 622-6076 between 2:30 and 3:30 p.m. Eastern time (not a toll-free number). Mr. Newman's number is (202) 622-8458 (also not a toll-free number).

Part IV. Items of General Interest

Targeted Jobs Tax Credit Settlement

Announcement 2000–58

The Internal Revenue Service announces today a settlement initiative under which taxpayers may resolve an issue under the Targeted Jobs Tax Credit (the "TJTC"), formerly section 51 of the Internal Revenue Code of 1986, as in effect prior to January 1, 1995 ("section 51"). The issue relates to whether a taxpayer may claim the TJTC with respect to an employee for whom it has not received a certification or denial from a designated local agency that the employee is a member of a targeted group.

The purpose of the settlement initiative is to relieve both taxpayers and the Service from the burdens associated with further development or litigation, and to permit a quick resolution of this issue. See *Perdue Farms, Inc. v. United States of America*, No. Y–97–3571 (D.C. MD June 14, 1999), and *H.E. Butt Grocery Co. v. United States*, No. SA–98–CA–336– EP (W.D. Tex. July 30, 1999; February 9, 2000).

The settlement initiative is available only to taxpayers who have timely claimed (or may timely claim) the TJTC and can satisfy all of the section 51 requirements, other than the certification requirement (Noncertified Employee Claims). If a timely claim is not currently pending (and the statute of limitations within which to make the claim is open), the taxpayer should submit its claim with the Indication of Interest described below. Under the settlement initiative, taxpayers may take a credit for 50% of the Verified Noncertified Employee Claims, as described below.

Steps to Follow to Participate in the Settlement Program for Taxpayers whose Claims are Pending with the Internal Revenue Service (including Appeals and Tax Court)

Step 1: An eligible taxpayer, whether or not currently under examination, before Appeals, or in Tax Court litigation, must first indicate in writing its interest in accepting the offer under this settlement initiative by mailing the following Indication of Interest to the address listed below:

Indication of Interest in TJTC Settlement Program

Taxpayer's Name:___________________

Taxpayer's Address:__________________

____

Taxable Years Involved:_______________

Employer Identification Number: _______

Amount of Claim: $__________x 50% = Settlement: $_______________________

If Applicable:

Name, address and telephone number of I.R.S. employee responsible for claim year(s):

____

____

____

On behalf of the above-named taxpayer, I am interested in accepting the settlement offer described in Announcement 2000–58, 2000–30 I.R.B. (July 24, 2000), relating to the TJTC and Noncertified Employee Claims.

By ___________________Date_________

Title______________________________

Mailing Address of Signatory

____

The taxpayer should mail the completed Indication of Interest to the following address no later than 120 days after this Announcement appears in the Internal Revenue Bulletin to:

Internal Revenue Service
Kansas City, Missouri 64999
Attention: QMSS, Stop 4100, Annex 2.

If the taxpayer is under examination or before Appeals or in litigation before the Tax Court for the taxable year(s) listed in the Indication of Interest, the taxpayer should also provide a copy of their Indication of Interest to the IRS employee who is responsible for the examination or other consideration of the year(s). (The taxpayer should also state the name, address and telephone number of the I.R.S. employee responsible for the year(s) of the claim on the Indication of Interest.)

Step 2: Upon receiving the Indication of Interest, the IRS will send to the taxpayer instructions on how to accept the settlement offer.

These instructions will direct taxpayers to assemble the information that will be used to determine the Verified Noncertified Employee Claims. In order to accept the settlement offer, the taxpayer will be required to provide, and certify under penalties of perjury, the following information regarding the Noncertified Employee Claims for each taxable year: (1) the name and social security number of each employee included in the claim; (2) the targeted group in which it claims the employee belongs (e.g. economically disadvantaged youth, etc.); (3) the employee's start date; (4) the employee's end date, if any; (5) the amount of eligible wages; (6) the amount of the credit claimed for that employee; and (7) that the employer timely submitted a request for certification. Timely filing means: (a) a written request submitted to the designated local agency on or before the day the individual began work, or (b) if the individual presented the employer with a written preliminary determination from the designated local agency that the individual was a member of a targeted group, a written request submitted to the designated local agency no later than five days after the individual began work. The Service may also require the taxpayer to provide additional information to confirm the accuracy of any information submitted. Once the Service has confirmed to its satisfaction the accuracy of the information, that the statutory requirements for minimum hours are met, and that there are not duplicate claims, it will determine the amount of Verified Noncertified Employee Claims subject to the 50% settlement offer.

Step 3: The taxpayer will execute a closing agreement (Form 906) to document the resolution of this issue and appropriate adjustment of related matters (e.g., section 280C).

Steps to Follow to Participate in the Settlement Program For Taxpayers whose Claims are under the Jurisdiction of the Department of Justice

The settlement initiative does not apply to cases in litigation before the United States district courts or the United States court of appeals. Settlements of those cases should be discussed with the U.S. Department of Justice attorneys handling them.

No taxpayer, including one currently under examination, in Appeals, or in Tax Court litigation, is required to accept the terms of the settlement initiative. If a taxpayer does not believe that the offer is appropriate for its case, the taxpayer may decline to participate in the settlement initiative, and the case will be handled under normal procedures. If participation is declined, the final result in a case could be either more or less favorable than the settlement offer, depending on the merits of the taxpayer's position.

For cases that are not resolved through the settlement initiative, the Service will continue to advance the legal argument that a taxpayer may not claim the TJTC with respect to an employee for whom it has not received a certification from a designated local agency that the employee is a member of a targeted group. The Service will also consider whether, as a factual matter, an employee is a member of a targeted group and the other statutory requirements are met. In addition, the Service believes that the Work Opportunity Tax Credit (WOTC), section 51 of the Code as in effect after September 30, 1996, also requires that an employer receive a certification before it is entitled to this credit. Accordingly, the Service will rely on the certification process required by the WOTC before allowing this credit.

Please contact the Retail ISP Specialist at (763) 549–1020 x 328 (not a toll-free number) if there are any questions regarding the initiative. The settlement initiative is also described at the "Tax Professional's Corner" of the IRS Web site at http://www.irs.ustreas.gov.

The principal author of this announcement is Robert G. Wheeler. Mr. Wheeler can be reached at (202) 622-6060 (not a toll free number).

Foundations Status of Certain Organizations

Announcement 2000–61

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

AEONMS Health and Medical Research Foundation, Inc., Memphis, TN
Allen Outreach & Development Center, Inc., Orlando, FL
American Friends of Birkas Rifka, Inc., Lakewood, NJ
American Non-Profit Housing Corporation, Lake Oswego, OR
Assured Nonprofit Services, Inc., Sumner, WA
Athena Telematics Foundation, Inc., Hartsdale, NY
Austen Foundation, Inc., Ambridge, PA
Bread of Life Mission, Martinsville, VA
Brunettes Adult Residential Care Facility, Detroit, MI
Camp All American, Inc., Duluth, GA
Camptonville Education Fund, Camptonville, CA
Canon McMillan Baseball Association, Cannonsburg, PA
Caribbean Foundation, Hayes, VA
Center for the Development of Senior Horizons, Detroit, MI
Center for the Unfoldment of Heart, Mind, & Spirit, Freedom, CA
Charleston Council 22 056 Navy League of the United States, Charleston, SC
Child Development Center Parent Advisory Council, Ferguson, MO
Children's Homes Foundation, Oakley, CA
Children's Medical Research Foundation, Carlsbad, CA
Choreotectonics, Inc., New York, NY
Church Street Graveyard Preservation Foundation, Inc., Mobile, AL
City of Church Hill Community Chest, Church Hill, TN
Concerned Clergy Foundation, Inc., Indianapolis, IN
David Groves Ministries, Inc., Tulsa, OK
Deborah Salem Foundation, Brooklyn, NY
Edgartown Patrolmens Association, Inc., Edgartown, MA
Ezra Health Foundation, Beverly Hills, CA
Faith Human Services Ministry Incorporated, New Orleans, LA
Family Journey Center Foundation, Bluffdale, UT
Fort Bend Songwriters Association, Richmond, TX
Fortune Arms Corporation, Inc., Richmond, TX
Friends of the Holy Cross, Staunton, VA
Gang Outreach Covina, Covina, CA
GOYE Ministry, Chicago, IL
Helpline Soul Rescue Ministry, Inc., Baldwin, NY
Hope for Clevelands Children, Akron, OH
Joan Schuman Fund, Inc., New York, NY
John J. McMahon, Jr. Memorial Roller Hockey Club, Inc., Deer Park, NY
Los Islenos Heritage and Culture Society, Violet, LA
Love and Hope, Inc., Lynnwood, CA
Marietta Reading Center, Jackson, MS
Middlesex County Bar Foundation, Inc., Cambridge, MA
Minnesota Safety & Health Foundation, St. Paul, MN
National Learning Foundation, Las Vegas, NV
Nehemiah Ministries, Inc., Cleveland, OH
New Horizons Un-Limited, Inc., Wauwatosa, WI
Newport Volunteer Firefighters & Rescue Association, Newport, NC
New York Alliance of Black School Educators, Inc., Brooklyn, NY
Northern Lights Junior Drum & Bugle Corps Association, Longview, WA
Nurses Registry Care Center Foundations, Harahan, LA
Ocean Race Chesapeake, Inc., Baltimore, MD
Paradise Foundation, Ashford, CT
Peninsula Housing Development, Inc. IX, Miami, FL
Perfect Image Youth Center, Riverside, CA
Persian Community Center, Inc., Doraville, GA
Pious Propagating Islam over U.S., Fort Worth, TX
Pownal Education Foundation, Pownal, ME
Public Television Service, Inc., Columbia, MD

Rev. Willie Jordan Community Service Center, Harvey, IL
Russell House Association, Inc., Baltimore, MD
Sahmadan Foundation, Tempe, AZ
Shekinah Refuge, Inc., Sapulpa, OK
Skidrow Passion Outreach, Los Angeles, CA
Sonlight Ministries, Inc., Fort Collins, CO
Sub-Saharan Relief Fund, Inc., Washington, DC
Sullivan County Scenic Coalition, Inc., Livingston Manor, NY
Tennis in Motion, Chicago, IL
Tom Wick Agricultural Scholarship Fund, Brewster, WA
Trinity Adoption Services International, Inc., Houston, TX
Triple Cross Ranch, Inc., Okeechobee, FL
Truman High School Wrestling Team Parents Association, Bronx, NY
Two, Inc., Kingsport, TN
Urban Outpatient, Inc., Dorchester, MA
Urban Wall Street Community Development Corp., Kansas City, KS
Vintage War Birds, Louisville, KY
Woodburn, Inc., Cincinnati, OH
YBL Ohana Alliance, Pittsburgh, PA
YETA, Philadelphia, PA
Youth First Communications d/b/a Youth First Concerns, Englewood, CO
Youth Reach Out Program, Inc., Atlanta, GA
Youthventures, Inc., Miami, FL
Youth Your Opportunity Upward Through Hard Work, Lithonia, GA

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Deletions from Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2000–62

The names of organizations that no longer qualify as organizations described in section 170(c)(2) of the Internal Revenue Code of 1986 are listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on July 24, 2000, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Animal Right
Seattle, WA

Conservation Education
Seattle, WA

Enviro Hope
Seattle, WA

Great Will
Seattle, WA

Green Nature Service
Seattle, WA

Nature Care
Seattle, WA

Nature &Animal Circle
Seattle, WA

Nature Educator
Seattle, WA

Nature Preservation
Seattle, WA

Project Life Ministries
San Diego, CA

Wildlife Conservation
Seattle, WA

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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