Internal Revenue
bulletin

Bulletin No. 2001–16
April 16, 2001

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. 8944, page 1067.
Final regulations and amendments to temporary regulations under section 925 of the Code provide guidance to taxpayers that have made an election to be treated as a foreign sales corporation (FSC). These regulations permit the grouping of transactions for purposes of applying the administrative pricing (including marginal costing) rules to determine FSC transfer prices and provide a time for filing for the election to group transactions.

REG–105946–00, page 1069.
Proposed regulations under section 460 of the Code provide guidance regarding changes in the taxpayer accounting for a long-term contract that has been accounted for under a long-term contract method. A public hearing is scheduled for June 13, 2001.

REG–106513–00, page 1076.
Proposed regulations under section 643 of the Code and related sections relate to the definition of income for trust purposes. A public hearing is scheduled for June 8, 2001.

REG–107101–00, page 1083.
Proposed regulations under section 894 of the Code relate to the eligibility for treaty benefits of items of income paid by domestic entities that are not fiscally transparent under U.S. law but are fiscally transparent under the laws of the jurisdiction of the person claiming treaty benefits (a domestic reverse hybrid entity). This is the corrected version of what was published in the Federal Register on February 27, 2001. A public hearing is scheduled for June 26, 2001.

EMPLOYEE PLANS

Announcement 2001–37, page 1090.
These regulations delay the effective date, by 60 days, of regulations previously published in T.D. 8931, 2001-7 I.R.B. 542, providing guidance on the HIPAA requirements for group health plans not to establish any rule of eligibility based on a health factor of any individual and not to charge any individual a greater premium or contribution based on a health factor than any similarly situated individual.

EXEMPT ORGANIZATIONS

Announcement 2001–35, page 1087.
A list is provided of organizations now classified as private foundations.

Announcement 2001–36, page 1089.
A list is provided of organizations that no longer qualify as organizations to which contributions are deductible under section 170 of the Code.

ESTATE TAX

REG–106513–00, page 1076.
Proposed regulations under section 643 of the Code and related sections relate to the definition of income for trust purposes. A public hearing is scheduled for June 8, 2001.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

GIFT TAX

REG–106513–00, page 1076.
Proposed regulations under section 643 of the Code and related sections relate to the definition of income for trust purposes. A public hearing is scheduled for June 8, 2001.

ADMINISTRATIVE

Announcement 2001-34, page 1087.
This announcement sets forth the mutual agreement pursuant to Article 27 of the U.S.—Republic of Korea Income Tax Convention regarding gains from the disposition of shares of certain Korean real property corporations by U.S. persons.

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.

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

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

Section 925.—Transfer Pricing Rules

26 CFR 1.925(a)-1: Transfer pricing rules for FSCs.

T.D. 8944

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Grouping Rules for Foreign Sales Corporation Transfer Pricing

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations and amendments to temporary regulations that provide guidance to taxpayers that have made an election to be treated as a foreign sales corporation (FSC). These regulations permit the grouping of transactions for purposes of applying the administrative pricing (including marginal costing) rules to determine FSC transfer prices and provide a time for filing for the election to group transactions.

DATES: *Effective date*: These regulations are effective March 2, 2001.

Applicability: For dates of applicability, see §1.925(a)–1(c)(8)(i).

FOR FURTHER INFORMATION CONTACT: Christopher J. Bello (202) 874–1490 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On March 3, 1987, the IRS and Treasury published temporary regulations (T.D. 8126, 1987–1 C.B. 184) in the **Federal Register** (52 FR 6428) to provide (among other things) rules for grouping transactions for purposes of applying the FSC transfer pricing rules. A notice of proposed rulemaking (INTL–153–86, 1987–1 C.B. 799) cross-referencing the temporary regulations and inviting comments and requests for a public hearing was published on the same day in the **Federal Register** (52 FR 6467). Written comments concerning the proposed regulations were received and a public hearing was held.

On March 3, 1998, the IRS and Treasury amended the above temporary regulations by publishing temporary regulations (T.D. 8764, 1998–1 C.B. 844) in the **Federal Register** (63 FR 10305) that (among other things) modified the time for filing the election to group transactions for purposes of applying the administrative pricing (including marginal costing) rules to determine FSC transfer prices. A notice of proposed rulemaking (REG–102144–98, 1998–1 C.B. 860) cross-referencing the temporary regulations and notice of public hearing was published on the same day in the **Federal Register** (63 FR 10351). Written comments concerning the proposed regulations were received and, on June 24, 1998, a public hearing was held.

After consideration of all the comments, certain proposed regulations relating to grouping of transactions for FSC transfer pricing are adopted as revised by this Treasury decision.

Explanation of Provisions

Section 927(d)(2)(B) of the Internal Revenue Code provides generally that FSCs and their related suppliers may, to the extent provided in regulations, elect to apply the FSC transfer pricing provisions under section 925 on the basis of groups of transactions based on product lines or recognized industry or trade usage, rather than on a transaction-by-transaction basis. Sections 1.925(a)–1T(c)(8)(i) and 1.925(b)–1T(b)(3)(i) of the temporary regulations permit taxpayers, at their annual choice, to group transactions in applying the administrative pricing (including marginal costing) rules to determine FSC transfer prices. Such grouping elections must be evidenced on a Schedule P of the FSC's timely filed (including extensions) U.S. income tax return for the taxable year. No untimely or amended returns are allowed to make a grouping election, change a grouping basis, or change from a grouping basis to a transaction-by-transaction basis (collectively "grouping redeterminations").

Section 1.925(a)–1T(c)(8)(i) of the temporary regulations also contains a transition rule that requires grouping redeterminations for any taxable year beginning before January 1, 1998, to be made no later than the due date of the FSC's timely filed (including extensions) U.S. income tax return for the FSC's first taxable year beginning after December 31, 1997 (transition rule).

Conforming changes are reflected in §§1.925(a)–1T(e)(4) and 1.925(b)–1T(b)(3)(i) of the temporary regulations.

Commentators requested that the rule limiting grouping elections to timely filed returns be removed to allow taxpayers to maximize FSC benefits and correct grouping errors. Other commentators requested that the time limit for grouping elections be replaced by a case-by-case analysis that would disallow only those grouping redeterminations that are abusive. Commentators also suggested alternative time limits that would allow taxpayers to file amended returns to reflect grouping redeterminations within a specified time limit (for example, one year from the extended due date of the original return). In response to these comments, the Treasury and the IRS have revised the time limits for filing grouping elections under §1.925(a)–1T(c)(8)(i). Accordingly, these regulations permit grouping redeterminations no later than one year after the due date of the FSC's timely filed (including extensions) U.S. income tax return for taxable years beginning after December 31, 1999. For any taxable year beginning before January 1, 2000, a grouping redetermination may be made no later than the due date of the FSC's timely filed (including extensions) U.S. income tax return for the FSC's first taxable year beginning on or after January 1, 2000.

Commentators also suggested that the transition rule be extended by two or more years to enable taxpayers to assemble data and determine the most advantageous groupings for taxable years beginning before January 1, 1998. In response, the IRS on May 17, 1999, published Notice 99–24 (1999–1 C.B. 1069). Notice 99–24 notified taxpayers that the IRS and Treasury intended to extend by one year the transition rule for such years. These regulations provide a further extension of the transition rule time limit.

These regulations also provide an additional time period for certain taxpayers to make grouping redeterminations notwithstanding the time limits for filing grouping redeterminations otherwise specified in these regulations. In particular, a grouping redetermination may be made at any time during the one-year period commencing upon notification of the related supplier by the Internal Revenue Service of an examination, provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for assessment by one year. The IRS and Treasury anticipate the IRS and taxpayers to plan and conduct examinations in a manner consistent with the foregoing provision so as to facilitate efficient and fair administration of the FSC grouping rules for transfer pricing.

Finally, these regulations provide that the requirements under §1.925(a)–1T(e)(4) with respect to redeterminations other than grouping also apply to grouping redeterminations.

Special Analyses

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

Drafting Information

The principal author of these regulations is Christopher J. Bello of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and Treasury Department also participated in the development of these regulations.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order for section 1.925(a)–1 to read as follows:

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

Section 1.925(a)–1 also issued under 26 U.S.C. 925(b)(1) and (2) and 927(d)(2)(B). * * *

Par. 2. Section 1.925(a)–1 is added to read as follows:

§1.925(a)–1 Transfer pricing rules for FSCs.

(a) through (c)(7) [Reserved] For further guidance, see §1.925(a)–1T(a) through (c)(7).

(c)(8) *Grouping transactions*. (i) The determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice made by the related supplier if the administrative pricing methods are used, some or all of these determinations may be made on the basis of groups consisting of products or product lines. The election to group transactions shall be evidenced on Schedule P of the FSC's U.S. income tax return for the taxable year. No untimely or amended returns filed later than one year after the due date of the FSC's timely filed (including extensions) U.S. income tax return will be allowed to elect to group, to change a grouping basis, or to change from a grouping basis to a transaction-by-transaction basis (collectively "grouping redeterminations"). The rule of the previous sentence is applicable to taxable years beginning after December 31, 1999. For any taxable year beginning before January 1, 2000, a grouping redetermination may be made no later than the due date of the FSC's timely filed (including extensions) U.S. income tax return for the FSC's first taxable year beginning on or after January 1, 2000. Notwithstanding the time limits for filing grouping redeterminations otherwise specified in the previous three sentences, a grouping redetermination may be made at any time during the one-year period commencing upon notification of the related supplier by the Internal Revenue Service of an examination, provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for assessment by one year. In addition, any grouping redeterminations made under this paragraph must meet the requirements under §1.925(a)–1T(e)(4) with respect to redeterminations other than grouping. The language "or grouping of transactions" is removed from the fourth sentence of §1.925(a)–1T(e)(4), applicable to taxable years beginning after December 31, 1997. See also §1.925(b)–1T(b)(3)(i).

(c)(8)(ii) through (f) [Reserved] For further guidance, see §1.925(a)–1T(c)(8)(ii) through (f).

(g) *Effective date*. The provisions of this section apply on or after March 2, 2001.

Par. 3. Section 1.925(a)–1T is amended as follows:

1. Paragraph (c)(8)(i) is revised.

2. The last sentence of paragraph (e)(4) is removed.

The revision reads as follows:

§1.925(a)–1T Temporary regulations; transfer pricing rules for FSCs.

* * * * *

(c) * * *

(8) * * * (i) * * * [Reserved] For further guidance, see §1.925(a)–1(c)(8)(i).

§1.925(b)–1T [Amended]

Par. 4. Section 1.925(b)–1T is amended by removing the last sentence of paragraph (b)(3)(i).

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

Approved February 28, 2001.

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

(Filed by the Office of the Federal Register on March 2, 2001, 8:45 a.m., and published in the issue of the Federal Register for March 6, 2001, 66 F.R. 13427)

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Mid-Contract Change in Taxpayer

REG–105946–00

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations concerning a mid-contract change in taxpayer of a contract that has been accounted for under a long-term contract method of accounting. A taxpayer that is a party to such a contract will be affected by these proposed regulations. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by May 17, 2001. Outlines of oral comments to be presented at the public hearing scheduled for June 13, 2001, at 10 a.m. must be received by May 30, 2001.

ADDRESSES: Send submissions to CC:M&SP:RU (REG–105946–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–105946–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at *http://www.irs.gov/prod/tax_regs/regslist.html*. The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John Aramburu or Leo F. Nolan II at (202) 622-4960; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor of the Regulations Unit at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224. Comments on the collections of information should be received by April 16, 2001. Comments are specifically requested concerning:

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

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

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

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

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

The collection of information in this proposed regulation is in §1.460–6(g)(3)(ii)(C). The information collected in §1.460–6(g)(3)(ii)(C) is required to provide certain recipients of long-term contracts with the information needed to make look-back calculations. This collection of information is mandatory. The likely respondents are for-profit entities.

Estimated total reporting burden: 10,000 hours.

Estimated average burden per respondent: 2 hours.

Estimated number of respondents: 5000.

Estimated annual frequency of responses: On occasion.

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

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

Background

Section 460 of the Internal Revenue Code was enacted by section 804 of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085, 2358–2361). Section 460 was amended by section 10203 of the Omnibus Budget Reconciliation Act of 1987, Public Law 100–203 (101 Stat. 1330, 1330–394); by sections 1008(c) and 5041 of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100–647 (102 Stat. 3342, 3438–3439 and 3673–3676); by sections 7621 and 7811(e) of the Omnibus Budget Reconciliation Act of 1989, Public Law 101–239 (103 Stat. 2106, 2375–2377 and 2408–2409); by section 11812 of the Omnibus Budget Reconciliation Act of 1990, Public Law 101–508 (104 Stat. 1388, 1388–534 to 1388–536); by sections 1702(h)(15) and 1704(t)(28) of the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755, 1874, 1888); and by section 1211 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 998–1000).

Section 460(h) directs the Secretary to prescribe regulations to the extent necessary or appropriate to carry out the purpose of section 460, including regulations to prevent a taxpayer from avoiding section 460 by using related parties, pass-through entities, intermediaries, options, and other similar arrangements.

Explanation of Provisions

Overview

Generally, manufacturing and construction contracts not completed within the taxable year they are entered into are long-term contracts. A manufacturing contract, however, is not a long-term contract unless it requires the manufacture of a unique item or an item normally requiring more than 12 months to complete. Section 460 generally requires that long-term contracts be accounted for under the percentage-of-completion method (PCM) and that taxpayers make a look-back computation of interest to compensate the government (or the taxpayer) for any underestimation (overestimation) of income from the contract. However, home construction contracts and certain contracts of smaller construction contractors are exempt from these requirements. Moreover, residential builders are entitled to use the 70/30 percentage-of-completion/capitalized cost method (PCCM), and certain shipbuilders are entitled to use the 40/60 PCCM. A long-term contract or a portion of a long-term contract that is exempt from the PCM may be accounted for under any permissible method, including the completed contract method (CCM) or the exempt percentage-of-completion method (EPCM). These long-term contract methods of accounting (i.e., the PCM, PCCM, CCM and EPCM) are described in proposed §1.460–4. These proposed regulations address the Federal income tax treatment of a change in taxpayer prior to completion of a long-term contract accounted for under a long-term contract method of accounting.

Existing Guidance on Transfers of Long-term Contracts

In the case of transactions not governed by section 381, such as those occurring prior to its effective date, numerous cases have required a taxpayer to take into income items that under its method of accounting would be deferred past the date of the transaction. These cases have involved both taxable and nontaxable transactions, e.g., liquidations and reorganizations. For example, in the case of a disposition of a long-term contract accounted for under the CCM, the transferor was required to recognize income earned on the contract prior to its transfer, with the amount earned determined under some variant of the PCM. These cases generally relied on section 446(b), section 482 and/or the assignment of income doctrine to allocate income to the transferor. See e.g., *Jud Plumbing and Heating, Inc. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946); *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2nd Cir.), *cert. denied*, 344 U.S. 874 (1952); *Dillard-Waltermire, Inc. v. Campbell*, 255 F.2d 433 (5th Cir. 1958); and *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973). In addition, §1.451–5(f) of the regulations has been cited as support for taxing a transferor who has deferred advance payments under its long-term contract method of accounting. See *Rotolo v. Commissioner*, 88 T.C. 1500 (1987).

Under section 381(c)(4), in the case of a section 381 transaction, an acquiring corporation generally must use the method of accounting used by the transferor. Further, regulations under §1.381(c)(4)–1 require the acquiring corporation to take into account the transferor's items of income or deduction which, because of its method of accounting, were not required or permitted to be included or deducted by the transferor in computing taxable income prior to the date of the transfer. Consistent with section 381, the IRS has held that section 381 generally requires a transferee to account for a long-term contract transferred pursuant to a section 381 transaction using the CCM used by the transferor and, thus, to report the entire gain or loss from the contract. Accordingly, the decisions in the *Standard Paving* line of cases are generally not applicable to transactions to which section 381 applies. Rev. Rul. 70–83 (1970–1 C.B. 85). In addition, section 351 generally has been interpreted to prevent recognition of gain or loss by a transferor from a section 351 transfer of partially completed long-term contracts accounted for by the transferor using the CCM. See GCM 39258 (July 13, 1984) applying Rev. Rul. 80–198 (1980–2 C.B. 113) (no gain or loss is recognized to a cash basis transferor with respect to unrealized accounts receivable and unrecognized accounts payable transferred in a section 351 transaction).

In 1990, the IRS issued proposed regulations (REG–20930–86) (55 FR 23755) that addressed the treatment of a mid-contract change in taxpayer of a contract accounted for using PCM for purposes of applying the look-back method. Generally, these proposed regulations provided that the successor to the contract "stepped into the shoes" of the predecessor with respect to the PCM. Thus, the successor was to continue to use the same PCM used by the predecessor both for purposes of reporting income under the contract and recomputing income under the look-back method. No look-back calculation was to be made until the successor completed the contract, and the successor was liable for look-back interest attributable to both pre- and post-transaction years. On the other hand, except in the case of taxable dispositions to unrelated parties, the successor could not recover look-back interest owed by the government that was attributable to pre-transaction years. These proposed regulations were withdrawn. One criticism of the regulations was that step-in-the-shoes treatment was inappropriate in the case of taxable dispositions.

Proposed Provisions

Consistent with the existing guidance described above and in response to comments received on the 1990 proposed regulations, these proposed regulations divide the rules regarding a mid-contract change in taxpayer of a long-term contract accounted for under a long-term contract method into two categories — constructive completion transactions and step-in-the-shoes transactions. For this purpose, the step-in-the-shoes rules apply to the following transactions —

(1) Transactions described in section 381 (i.e., liquidations under section 332 and reorganizations described in section 368(a)(1)(A), (C), (D), (F), or (G));

(2) Transactions described in section 351;

(3) Transactions described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met (divisive "D" reorganization);

(4) Transfers (e.g. sales) of S corporation stock;

(5) Conversion to or from an S corporation;
(6) Members joining or leaving a consolidated group; and
(7) Any other transaction designated in the Internal Revenue Bulletin by the Internal Revenue Service. See 26 CFR 601.601(d)(2)(ii).

The constructive completion rules apply to all other transactions.

A constructive completion transaction results in the taxpayer originally reporting income under the long-term contract (old taxpayer) recognizing income from the contract based on a contract price that takes into account any amounts realized from the transaction or paid by the old taxpayer to the taxpayer subsequently reporting income under the long-term contract (new taxpayer) that are allocable to the contract. Similarly, the new taxpayer in a constructive completion transaction is treated as though it entered into a new contract as of the date of the transaction, with the contract price taking into account the purchase price and any amount paid by the old taxpayer that is allocable to the contract.

In the case of a step-in-the-shoes transaction, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. The new taxpayer must assume the old taxpayer's methods of accounting for the contract, with both the contract price and allocable contract costs based on amounts taken into account by both parties. However, in the case of a tax avoidance transaction, the IRS may allocate income with respect to a transferred long-term contract between the old and new taxpayers. Section §1.451–5(f) will not be applied to a mid-contract change in taxpayer of a contract accounted for under a long-term contract method.

In the case of a step-in-the-shoes transaction in which the transferor's basis in the stock of the transferee is determined by reference to its basis of the property transferred, the basis in the stock of the transferee attributable to the transfer of a long-term contract will not be appropriate unless the amount previously received by the transferor under the long-term contract equates to the amount previously recognized as gross receipts by the transferor. Under both the PCM and the CCM, however, it is common for the amount received with respect to a long-term contract to differ from the amount recognized because the receipt of progress payments does not affect the recognition of income. To address this situation, the proposed regulations provide that, in the case of a section 351 transaction or a divisive "D" reorganization, the old taxpayer must adjust its basis in the stock of the new taxpayer by the difference between the amount the old taxpayer has recognized with respect to the contract and the amount the old taxpayer has received or reasonably expects to receive under the contract. The IRS and Treasury Department specifically request comments with respect to this rule.

The proposed regulations also provide rules for applying the look-back method in the case of a mid-contract change in taxpayer. For constructive completion transactions, the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the transaction date and, if applicable, by the new taxpayer with respect to post-transaction years upon contract completion. For step-in-the-shoes transactions, the look-back method is applied only by the new taxpayer upon contract completion. The new taxpayer must account for pre- and post-transaction years, with special rules governing the calculation of look-back interest in the case of pre-transaction years. The proposed regulations also require the old taxpayer in such cases to provide certain information to the new taxpayer in order to enable the new taxpayer to make the necessary look-back calculations.

The proposed regulations reserve on whether a mid-contract change in taxpayer that results from a partnership transaction, including a transaction described in section 721, a transaction described in section 731, and a transfer (e.g., sale) of a partnership interest, should be treated as a constructive completion, or a step-in-the-shoes, transaction. Although these transactions are similar to other step-in-the-shoes transactions, such as nonrecognition transactions (e.g., sections 351 and 332) and transactions where the party responsible for performing the contract has not changed (e.g., sales of S corporation stock and members joining or leaving consolidated groups), the IRS and Treasury Department are concerned that step-in-the-shoes treatment for these partnership transactions could more readily facilitate the shifting of income to tax indifferent parties than in other situations and thus are concerned about monitoring such activities solely through an anti-abuse rule. In addition, other issues, such as the treatment of long-term contracts under section 704(c), 751, and 752, significantly complicate, and could thwart, the application of the step-in-the-shoes rule with respect to mid-contract changes involving partnership transactions. The IRS and Treasury Department request comments on the appropriate treatment for mid-contract changes in taxpayer resulting from these partnership transactions.

Proposed Effective Date

These regulations are proposed to be applicable for transactions on or after the date they are published in the Federal Register as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It 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. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the relevant information is already maintained by taxpayers. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Comments and Public Hearing

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

A public hearing has been scheduled for June 13, 2001, at 10 a.m. in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenue, NW, In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by May 30, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is John Aramburu, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. In §1.381(c)(4)–1, a sentence is added at the end of paragraph (a)(2) to read as follows:

§1.381(c)(4)–1 Method of accounting.

(a) * * *

(2) * * *See §1.460–4(k) for rules relating to transfers of contracts accounted for using a long-term contract method of accounting in a transaction to which section 381 applies.

* * * * *

Par. 3. Section 1.460–0 is amended by:

1. Revising the entry for paragraph (k) of §1.460–4.

2. Adding entries for paragraphs (k)(1) through (k)(6) of §1.460–4.

3. Revising the entry for paragraph (g) of §1.460–6.

4. Adding entries for paragraphs (g) through (g)(3) of §1.460–6.

The revisions and additions read as follows:

§1.460–0 Outline of regulations under section 460.

* * * * *

§1.460–4 Methods of accounting for long-term contracts.

* * * * *

(k) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(i) Scope.
(ii) Old taxpayer.
(iii) New taxpayer.
(3) Step-in-the-shoes transactions.
(i) Scope.
(ii) Old taxpayer.
(iii) New taxpayer.
(A) Method of accounting.
(B) Contract price.
(C) Contract costs.
(4) Anti-abuse rule.
(5) Examples.
(6) Effective date.

* * * * *

§1.460–6 Look-back method.

* * * * *

(g) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(3) Step-in-the-shoes transactions.
(i) General rules.
(ii) Application of look-back method to pre-transaction period.
(A) Method.
(B) Interest accrual period.
(C) Information old taxpayer must provide.
(iii) Application of look-back method to post-transaction years.

* * * * *

Par. 4. Section 1.460–4 is amended by:

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

2. Revising paragraph (k).

The revision and addition read as follows:

§1.460–4 Methods of accounting for long-term contracts.

(a) * * * Finally, paragraph (k) of this section provides rules relating to a mid-contract change in taxpayer of a contract accounted for using a long-term contract method of accounting.

* * * * *

(k) *Mid-contract change in taxpayer* — (1) *In general*. The rules in this paragraph (k) apply if prior to the completion of a long-term contract accounted for using a long-term contract method by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for reporting income from the same contract. For purposes of this paragraph (k) and §1.460–6(g), an old taxpayer also includes any old taxpayer(s) (e.g., predecessors) of the old taxpayer. In addition, a change in status from taxable to tax exempt or from domestic to foreign, and *vice versa*, will be considered a change in taxpayer. Finally, a contract will be treated as the same contract if the terms of the contract are not substantially changed in connection with the transaction, whether or not the customer agrees to release the old taxpayer from any or all of its obligations under the contract. The rules governing constructive completion transactions are provided in paragraph (k)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (k)(3) of this section. For application of the look-back method to mid-contract changes in taxpayers for contracts accounted for using the PCM, see §1.460–6(g).

(2) *Constructive completion transactions* — (i) *Scope*. The constructive com-

pletion rules in this paragraph (k)(2) apply to transactions that result in a change in the taxpayer responsible for reporting income from a contract and that are not described in paragraph (k)(3)(i) of this section (constructive completion transactions). Constructive completion transactions generally include, for example, taxable sales under section 1001 and deemed asset sales under section 338.

(ii) *Old taxpayer*. The old taxpayer is treated as completing the contract on the date of the transaction. The total contract price (or, gross contract price in the case of a long-term contract accounted for under the CCM) for the old taxpayer is the sum of any amounts realized from the transaction that are allocable to the contract and any amounts the old taxpayer has received or reasonably expects to receive under the contract after the transaction. Total contract price (gross contract price) is reduced by any amount paid by the old taxpayer to the new taxpayer, and by any transaction costs, that are allocable to the contract. Thus, the old taxpayer's allocable contract costs do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount realized from the transaction allocable to the contract is determined by using the residual method under §§1.338–6T and 1.338–7T.

(iii) *New taxpayer*. The new taxpayer is treated as entering into a new contract on the date of the transaction. The new taxpayer must evaluate whether the new contract should be classified as a long-term contract within the meaning of §1.460–1(b) and account for the contract under a permissible method of accounting. For a new taxpayer who accounts for a contract using the PCM, the total contract price is any amount the new taxpayer reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Total contract price is reduced in the amount of any consideration paid as a result of the transaction, and by any transaction costs, that are allocable to the contract and is increased in the amount of any consideration received as a result of the transaction that is allocable to the contract. Similarly, the gross contract price for a contract accounted for using the CCM is all amounts the new taxpayer is entitled by law or contract to receive consistent with paragraph (d)(3) of this section, adjusted for any consideration paid (or received) as a result of the transaction that is allocable to the contract. Thus, the new taxpayer's allocable contract costs do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount of consideration paid that is allocable to the contract is determined by using the residual method under §§1.338–6T and 1.338–7T.

(3) *Step-in-the-shoes transactions* — (i) *Scope*. The step-in-the-shoes rules in this paragraph (k)(3) apply to the following transactions that result in a change in the taxpayer responsible for reporting income from a contract (step-in-the-shoes transactions) —

(A) Transactions described in section 381 (i.e., liquidations under section 332 and reorganizations described in section 368(a)(1)(A), (C), (D), (F), or (G));

(B) Transactions described in section 351;

(C) Transactions described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met;

(D) Transfers (e.g., sales) of S corporation stock;

(E) Conversion to or from an S corporation;

(F) Members joining or leaving a consolidated group; and

(G) Any other transaction designated in the Internal Revenue Bulletin by the Internal Revenue Service. See §601.601(d)(2)(ii) of this chapter.

(ii) *Old taxpayer* – (A) *In general*. The new taxpayer will "step into the shoes" of the old taxpayer with respect to the contract. Thus, consistent with §1.381(c)(4)–1(a)(1)(ii), the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer, as set forth in paragraph (k)(3)(iii) of this section. As a result, an old taxpayer using the PCM is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. Similarly, an old taxpayer using the CCM is not required to recognize any revenue and may not deduct allocable contract costs incurred with respect to the contract.

(B) *Basis adjustment*. In the case of transactions described in paragraph (k)(3)(i)(B) or (C) of this section, the old taxpayer must adjust its basis in the stock of the new taxpayer by reducing such basis to the extent the amount the old taxpayer has received or reasonably expects to receive under the contract exceeds the amount recognized by the old taxpayer with respect to the contract or by increasing such basis to the extent the amount the old taxpayer has recognized with respect to the contract exceeds the amount the old taxpayer has received or reasonably expects to receive under the contract. However, the old taxpayer may not reduce its basis in the stock of the new taxpayer below zero. If the old and new taxpayer do not join in the filing of a consolidated Federal income tax return, the old taxpayer must recognize income to the extent the basis in the stock of the new taxpayer otherwise would be reduced below zero. If the old and new taxpayer join in the filing of a consolidated Federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be reduced below zero. See §§1.1502–19 and 1.1502–32(a)(3)(ii).

(iii) *New taxpayer* — (A) *Method of accounting*. Beginning on the date of the transaction, the new taxpayer must account for the long-term contract by using the same method of accounting used by the old taxpayer prior to the transaction consistent with §1.381(c)(4)–1(b)(4). The same method of accounting must be used for such contract regardless of whether the old taxpayer's method is the new taxpayer's principal method of accounting under §1.381(c)(4)–1(b)(3) or whether the new taxpayer is otherwise eligible to use the old taxpayer's method. Thus, if the old taxpayer uses the PCM to account for the contract, the new taxpayer steps into the shoes of the old taxpayer with respect to its completion factor and percentage of completion methods (such as the 10-percent method), even if the new taxpayer has not elected such methods for similarly classified contracts. Similarly, if the old taxpayer uses the CCM, the new taxpayer steps into the shoes of the old taxpayer with respect to the CCM, even if the new taxpayer is not otherwise eligible to use the CCM. However, the new taxpayer is not necessarily bound by the old taxpayer's method for similarly classified contracts entered into by the new taxpayer subsequent to the transaction and must apply general tax principles, including section 381, to determine the appropriate method to account for these subsequent contracts. To the extent that general tax principles allow the taxpayer to account for similarly classified contracts using a method other than the old taxpayer's method, the taxpayer is not required to obtain the consent of the Commissioner to begin using such other method.

(B) *Contract price*. The total contract price for the new taxpayer is the sum of any amounts the old taxpayer or new taxpayer have received or reasonably expect to receive under the contract consistent with paragraph (b)(4) of this section. Similarly, the gross contract price in the case of a long-term contract accounted for under the CCM includes all amounts the old taxpayer or new taxpayer are entitled by law or by contract to receive consistent with paragraph (d)(3) of this section.

(C) *Contract costs*. Total allocable contract costs for the new taxpayer are the allocable contract costs as defined under paragraph (b)(5) of this section incurred by either the old taxpayer prior to or the new taxpayer after the transaction. Thus, any payments between the old taxpayer and the new taxpayer with respect to the contract are not treated as part of contract price or an allocable contract cost.

(4) *Anti-abuse rule*. Notwithstanding this paragraph (k), in tax avoidance cases, the Commissioner may allocate to the old (or new) taxpayer the income from a long-term contract properly allocable to the old (or new) taxpayer. For example, the Commissioner may scrutinize a transaction in which a long-term contract accounted for using the CCM, or using the PCM where the old taxpayer has received advance payments in excess of its contribution to the contract, is transferred to a tax indifferent party.

(5) *Examples*. The following examples illustrate the rules of this paragraph (k). For purposes of these examples, it is assumed that the contracts are long-term construction contracts accounted for using the PCM prior to the transaction unless stated otherwise and the contracts are not transferred in tax avoidance cases. The examples are as follows:

Example 1. Constructive completion — PCM. (i) *Facts*. In Year 1, X enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $200,000. In Year 2, X incurs additional costs of $400,000 before selling the contract as part of the sale of its business in Year 2 to Y, an unrelated party. At the time of sale, X has received $650,000 in progress payments under the contract. The consideration allocable to the contract under section 1060 is $150,000. Pursuant to the sale, the new taxpayer Y immediately assumes X's contract obligations and rights. Y is required to account for the contract using the PCM. In Year 2, Y incurs additional allocable contract costs of $50,000. Y correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract.

(ii) *Old taxpayer*. For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 x $1,000,000)) and costs of $200,000, for a profit of $50,000. X is treated as completing the contract in Year 2 because it sold the contract. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and the total allocable contract costs are $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)). Thus, in Year 2, X reports receipts of $550,000 (total contract price minus receipts already reported ($800,000 - $250,000)) and costs incurred in year 2 of $400,000, for a profit of $150,000.

(iii) *New taxpayer*. Y is treated as entering into a new contract in Year 2. The total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 - $650,000 - $150,000)). The estimated total allocable contract costs at the end of Year 2 are $125,000 (the allocable contract costs that Y reasonably expects to incur to complete the contract ($50,000 + $75,000)). In Year 2, Y reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) x $200,000] and costs of $50,000 (the costs incurred after the purchase), for a profit of $30,000. For Year 3, Y reports receipts of $120,000 (total contract price minus receipts already reported ($200,000 - $80,000)) and costs of $75,000, for a profit of $45,000.

Example 2. Constructive completion — CCM. (i) *Facts*. The facts are the same as in *Example 1*, except that X and Y properly account for the contract under the CCM.

(ii) *Old taxpayer*. X does not report any income or costs from the contract in Year 1. In Year 2, the contract is deemed complete for X, and X reports its gross contract price of $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and its total allocable contract costs of $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)) in that year.

(iii) *New taxpayer*. Y is treated as entering into a new contract in Year 2. Under the CCM, Y reports no gross receipts or costs in Year 2. Y reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 - $650,000 - $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that Y incurred to complete the contract ($50,000 + $75,000)) in Year 3, the completion year, for a profit of $75,000.

Example 3. Step-in-the-shoes — PCM. (i) *Facts*. The facts are the same as in *Example 1*, except that X transfers the contract to Y in exchange for stock of Y in a transaction that qualifies as a statutory merger described in section 368(a)(1)(A) and does not result in gain or loss to X under section 361(a).

(ii) *Old taxpayer*. For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 x $1,000,000)) and costs of $200,000, for a profit of $50,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i) of this section, X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (the completion factor multiplied by the total contract price and minus the Year 1 gross receipts [($600,000/$800,000 x $1,000,000) - $250,000]) and costs of $400,000, for a profit of $100,000.

(iii) *New taxpayer*. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Total contract price is the sum of any amounts that X and Y have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and Y. Thus, the estimated total allocable contract costs at the end of Year 2 are $725,000 (the cumulative allocable contract costs of X and the estimated total allocable contract costs of Y ($200,000 + $400,000 + $50,000 + $75,000)). In Year 2, Y reports receipts of $146,552 (the completion factor multiplied by the total contract price minus receipts reported by the old taxpayer ([($650,000/$725,000) x $1,000,000] - $750,000) and costs of $50,000, or a profit of $96,552. For Year 3, Y reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 - $896,552)) and costs of $75,000, for a profit of $28,448.

Example 4. Step-in-the-shoes — CCM. (i) *Facts*. The facts are the same as in *Example 3*, except that X properly accounts for the contract under the CCM.

(ii) *Old taxpayer*. X reports no income or costs from the contract in Years 1, 2 or 3.

(iii) *New taxpayer*. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Thus, in Year 3, the completion year, Y reports receipts of $1,000,000 and total contract costs of $725,000, for a profit of $275,000.

Example 5. Step-in-the-shoes — Basis adjustment. The facts are the same as in *Example 1*, except that X transfers the contract (including the uncompleted property with a basis of $0) and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in Z is $125,000. X must increase its basis in Z by $100,000 pursuant to paragraph (k)(3)(ii)(B) of this section because the amount X recognized with respect to the contract, $750,000 ($250,000 receipts in Year 1 + $500,000 receipts in Year 2), exceeds the amount X received under the contract, the $650,000 in progress payments, by $100,000.

Example 6. Step-in-the-shoes — Basis adjustment. The facts are the same as in *Example 2*, except that X receives progress payments of $800,000 (rather than $650,000) and transfers the contract (including the uncompleted property with a basis of $600,000) and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in Z is $725,000. X and Z do not join in filing a consolidated Federal income tax return. X must reduce its basis in the stock of Z by $725,000 to zero pursuant to paragraph (k)(3)(ii)(B) of this section because the amount X received under the contract, $800,000 in progress payments, exceeds the amount recognized by X with respect to the contract, $0. In addition, X must recognize income of $75,000 because X's basis in the stock of Z otherwise would have been reduced below zero by $75,000 (800,000 unrecognized progress payments - 725,000 basis).

(6) *Effective date*. This paragraph (k) is applicable for transactions on or after the date they are published in the **Federal Register** as final regulations.

Par. 5. In §1.460–6, paragraph (g) is revised to read as follows:

§1.460–6 Look-back method.

* * * * *

(g) *Mid-contract change in taxpayer* — (1) *In general.* The rules in this paragraph (g) apply if, as described in §1.460–4(k), prior to the completion of a long-term contract accounted for using the PCM or the PCCM by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for reporting income from the same contract. The rules governing constructive completion transactions are provided in paragraph (g)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (g)(3) of this section. For purposes of this paragraph, pre-transaction years are all taxable years of the old taxpayer in which the old taxpayer reported (or should have reported) gross receipts from the contract, and post-transaction years are all taxable years of the new taxpayer in which the new taxpayer reported (or should have reported) gross receipts from the contract.

(2) *Constructive completion transactions*. In the case of a transaction described in §1.460–4(k)(2)(i) (constructive completion transaction), the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the date of the transaction and, if the new taxpayer uses the PCM or the PCCM to account for the contract, by the new taxpayer with respect to post-transaction years upon completion of the contract. The contract price and allocable contract costs to be taken into account by the old taxpayer or the new taxpayer in applying the look-back method are described in §1.460–4(k)(2).

(3) *Step-in-the-shoes transactions* — (i) *General rules*. In the case of a transaction described in §1.460–4(k)(3)(i) (step-in-the-shoes transaction), the look-back method is not applied at the time of the transaction, but is instead applied for the first time when the contract is completed by the new taxpayer. Upon completion of the contract, the look-back method is applied by the new taxpayer with respect to both pre-transaction years and post-transaction years, taking into account all amounts reasonably expected to be received by either the old or new taxpayer and all allocable contract costs incurred during both periods as described in §1.460–4(k)(3). The new taxpayer is liable for filing the Form 8697 and for interest computed on hypothetical underpayments of tax, and is entitled to receive interest with respect to hypothetical overpayments of tax, for both pre- and post-transaction years. Pursuant to section 6901, the old taxpayer will be secondarily liable for any interest required to be paid with respect to pre-transaction years reduced by any interest on pre-transaction overpayments.

(ii) *Application of look-back method to pre-transaction period* — (A) *Method*. The new taxpayer must apply the look-back method to each pre-transaction year that is a redetermination year using the simplified marginal impact method described in paragraph (d) of this section (regardless of whether or not the old taxpayer would have actually used that method and without regard to the tax liability ceiling).

(B) *Interest accrual period*. With respect to any hypothetical underpayment or overpayment of tax for a pre-transaction year, interest accrues from the due date of the old taxpayer's tax return (not including extensions) for the taxable year of the underpayment or overpayment until the due date of the new taxpayer's return (not including extensions) for the completion year or the year of a post-completion adjustment, whichever is applicable.

(C) *Information old taxpayer must provide*. In order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that reported income from a long-term contract under the PCM or PCCM for either regular or alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the taxable year ending with, or the first taxable year ending after, a step-in-the-shoes transaction described in §1.460–4(k)(3)(i). The required information is as follows - -

(*1*) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (i.e., whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

(*2*) The submethod used to apply PCM (e.g., the simplified cost-to-cost method or the 10-percent method);

(*3*) The amount of total contract price reported by year;

(*4*) The numerator and the denominator of the completion factor by year;

(*5*) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

(*6*) Whether the old taxpayer was a corporate or a noncorporate taxpayer by year; and

(*7*) Any other information required by the Commissioner by administrative pronouncement.

(iii) *Application of look-back method to post-transaction years*. With respect to post-transaction taxable years, the new taxpayer must use the same look-back method it uses for other contracts (i.e., the simplified marginal impact method or the actual method) to determine the amount of any hypothetical overpayment or underpayment of tax and the time period for computing interest on these amounts.

* * * * *

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

(Filed by the Office of the Federal Register on February 15, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 16, 2001, 66 FR 10643)

Notice of Proposed Rulemaking and Notice of Public Hearing

Definition of Income for Trust Purposes

REG–106513–00

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations revising the definition of income under section 643(b) of the Internal Revenue Code to take into account changes in the definition of trust accounting income under state laws. The proposed regulations also clarify the situations in which capital gains are included in distributable net income under section 643(a)(3). Conforming amendments are made to regulations affecting ordinary trusts, pooled income funds, charitable remainder trusts, trusts that qualify for the gift and estate tax marital deduction, and trusts that are exempt from generation-skipping transfer taxes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by May 18, 2001. Outlines of topics to be discussed at the public hearing scheduled for June 8, 2001 must be received by May 18, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–106513–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–106513–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at: *http://www.irs.ustreas.gov/tax_regs/regslist.html*. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Bradford Poston at (202) 622–3060 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy R. Traynor, 202-622-8452 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 643(b) provides a definition of the term income for purposes of subparts A through D of part I of subchapter J of the Internal Revenue Code (Code) . The term *income*, when not modified by any other term, means the amount of income of the trust or estate determined under the terms of the governing instrument and applicable local law. Section 1.643(b)–1 further provides that trust provisions that depart fundamentally from the concepts of local law in determining what constitutes income will not be recognized.

These statutory and regulatory provisions date back to a time when, under state statutes, dividends and interest were considered income and were allocated to the income beneficiary while capital gains were allocated to the principal of the trust. Changes in the types of available investments and in investment philosophies have caused states to revise, or to consider revising, these traditional concepts of income and principal.

The prudent investor standard for managing trust assets has been enacted by many states and encourages fiduciaries to adopt an investment strategy designed to maximize the total return on trust assets. Under this investment strategy, trust assets should be invested for total positive return, that is, ordinary income plus appreciation, in order to maximize the value of the trust. Thus, under certain economic circumstances, equities, rather than bonds, would constitute a greater portion of the trust assets than they would under traditional investment standards.

One of the concerns with shifting trust investments toward equities and away from bonds is the potential adverse impact on the income beneficiary. Based on the traditional concepts of income and principal, the income beneficiary is entitled only to the dividends and interest earned by the trust assets. The dividend return on equities as a percentage of their value traditionally has been substantially less than the interest return on bonds.

To ensure that the income beneficiary is not penalized if a trustee adopts a total return investment strategy, many states have made, or are considering making, revisions to the definitions of income and principal. Some state statutes permit the trustee to make an equitable adjustment between income and principal if necessary to ensure that both the income beneficiary and the remainder beneficiary are treated impartially, based on what is fair and reasonable to all of the beneficiaries. Thus, a receipt of capital gains that previously would have been allocated to principal may be allocated by the trustee to income if necessary to treat both parties impartially. Conversely, a receipt of dividends or interest that previously would have been allocated to income may be allocated by the trustee to principal if necessary to treat both parties impartially.

Other states are proposing legislation that would allow the trustee to pay a unitrust amount to the income beneficiary in satisfaction of that beneficiary's right to the income from the trust. This unitrust amount will be a fixed percentage, sometimes required to be within a range set by state statute, of the fair market value of the trust assets determined annually.

Questions have arisen concerning how these state statutory changes affect the definition of income provided in section 643(b) and the other Code provisions that rely on the section 643(b) definition of income. This definition of income affects trusts including, but not limited to, ordinary trusts, charitable remainder trusts, pooled income funds, and qualified subchapter S trusts.

In addition, trusts that qualify for the gift or estate tax marital deduction must pay to the spouse all the income from the property. All the income is considered paid to the spouse if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property that the principles of trust law accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Section 25.2523(e)–1(f) of the Gift Tax Regulations and §20.2056(b)–5(f) of the Estate Tax Regulations. Questions have arisen whether the spouse is entitled to all the income from the property in a state that permits equitable adjustments or unitrust payments.

Similarly, questions have arisen as to whether an otherwise exempt trust which uses equitable adjustments or unitrust payments will be subject to the generation-skipping transfer tax provisions of chapter 13 of the Code.

Explanation of provisions

Definition of Income

The proposed regulations will amend the definition of income under §1.643(b)–1 to take into account certain state statutory changes to the concepts of income and principal. Under the proposed regulations, trust provisions that depart fundamentally from traditional concepts of income and principal (that is, allocating ordinary income to income and capital gains to principal) will generally continue to be disregarded, as they are under the current regulations. However, amounts allocated between income and principal pursuant to applicable state law will be respected if state law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, taking into account ordinary income, capital gains, and, in some situations, unrealized appreciation. For example, a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust. Similarly, a state law that permits the trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is a reasonable apportionment of the total return of the trust.

In addition, an allocation of capital gains to income will be respected under certain circumstances. Such an allocation will be respected if directed by the terms of the governing instrument and applicable local law. Similarly, if a trustee, pursuant to a discretionary power granted to the trustee by local law or by the governing instrument (if not inconsistent with local law), allocates capital gains to income, the allocation will be respected, provided the power is exercised in a reasonable and consistent manner.

The proposed changes to the regulations will permit trustees to implement a total return investment strategy and to follow the applicable state statutes designed to treat the income and remainder beneficiaries impartially. At the same time, the limitations imposed by the proposed regulations ensure that the Code provisions relying on the definition of income under section 643(b) are not undermined by an unlimited ability of the trustee to allocate between income and principal.

Pooled Income Funds

A special rule is proposed to be added to the regulations covering pooled income funds to address the problems arising from the potential application of the new state statutes to these funds. A pooled income fund as defined in section 642(c)(5) is a split-interest trust created and maintained by certain types of charitable organizations. Noncharitable beneficiaries receive the income from the commingled fund during their lives and the charitable organization receives the remainder interests. The income that is to be paid to the noncharitable beneficiaries is income as defined in section 643(b). §1.642(c)–5(i).

A pooled income fund is a trust subject to taxation under section 641. It is entitled to a distribution deduction under section 661 for income distributed to the noncharitable beneficiaries. In addition, it receives a charitable deduction under section 642(c)(3) for any amount of net long-term capital gain which pursuant to the terms of the governing instrument is permanently set aside for charitable purposes. A pooled income fund is taxed on any net short-term capital gain that is not required to be distributed to the income beneficiaries pursuant to the terms of the governing instrument and applicable local law.

Under traditional principles of income and principal, ordinary income would be paid to the income beneficiaries. Any net long-term capital gain would be allocated to principal to be held for the ultimate benefit of the charitable remainderman and therefore would qualify for the charitable deduction under section 642(c)(3).

If a pooled income fund were to pay the income beneficiaries a unitrust amount in satisfaction of their right to income, as provided by proposed state statutes, long-term capital gains would no longer qualify for the charitable deduction. Any net long-term capital gain not required to be distributed during the current year would be added to principal. However, the amount of the gain would not be permanently set aside for charitable purposes because this amount may be used in the future to make the unitrust payment to the income beneficiaries. A similar situation arises if the trustee is permitted under state law to make equitable adjustments with respect to unrealized appreciation in the value of the trust assets. A portion of any subsequently realized capital gain may already have been treated as distributed to the income beneficiaries in accordance with an equitable adjustment distribution.

The proposed regulations will amend §1.642(c)–2(c) to address these issues for pooled income funds. Thus, no net long-term capital gain qualifies for the charitable deduction if, under the terms of the governing instrument and applicable state law, income may be a unitrust amount or may include an equitable adjustment with respect to unrealized appreciation in the value of the trust assets.

Charitable Remainder Unitrusts

A charitable remainder unitrust is a split-interest trust that provides for a specified distribution to one or more noncharitable beneficiaries for life or a term of years, with an irrevocable remainder interest held for the benefit of a charitable organization. Under section 664(d)(2), the amount distributed to the noncharitable beneficiaries is a fixed percentage (not less than 5% and not more than 50%) of the annual fair market value of the trust assets. Alternatively, under section 664(d)(3), the unitrust amount may be the lesser of this fixed percentage amount or trust income (with or without a make-up amount). For this purpose, trust income means income as defined under section 643(b) and the applicable regulations. §1.664–3(a)(1)(i)(b).

Under proposed state statutes, trust income could be a fixed percentage of the annual fair market value of the trust assets, and the fixed percentage may be less than 5%. A net income charitable remainder unitrust using such a state statutory definition of income would in substance be a fixed percentage unitrust with a percentage less than the 5% required by section 664(d)(2). Therefore, the proposed regulations will amend §1.664–3(a)(1)(i)(b) to provide that income under the terms of the governing instrument and applicable local law may not be determined by reference to a fixed percentage of the annual fair market value of the trust property. If the applicable state law defines income as a unitrust amount, the governing instrument of a net income charitable remainder unitrust must provide its own definition of trust income. In addition, the proposed regulations will provide that capital gains attributable to appreciation in the value of assets after the date contributed to the trust or purchased by the trust may be allocated to income under the terms of the governing instrument and applicable local law. Such an allocation, however, may not be discretionary with the trustee. The section 664 regulations already prohibit the allocation of pre-contribution gains to income.

Capital Gains and Distributable Net Income

Section 643(a)(3) provides that gains from the sale or exchange of capital assets are excluded from distributable net income to the extent that these gains are allocated to corpus and they are not either paid, credited, or required to be distributed, to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. The circumstances in which capital gains are considered paid or credited to a beneficiary during the year, and therefore included in distributable net income, are not entirely clear. In addition, the revisions to state law definitions of income have precipitated additional questions in this area. The question arises, for example, whether realized capital gains are included in the unitrust amount distributed to the income beneficiary under local law, if the unitrust amount exceeds the trust's ordinary income.

The proposed regulations will amend §1.643(a)–3(a) to clarify the circumstances in which capital gains are includible in distributable net income for the year. In general, capital gains are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument or local law, or pursuant to a reasonable and consistent exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by the governing instrument or local law): allocated to income; allocated to corpus but treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or allocated to corpus but utilized by the fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary. As is the case under the current regulations, capital gains that are paid, permanently set aside, or to be used for the purposes specified in section 642(c) are included in the distributable net income. Capital losses are netted at the trust level against any capital gains, except for a capital gain that is utilized in determining the amount that is distributed or required to be distributed to a particular beneficiary.

Under the proposed regulations, capital gains will be included in distributable net income under certain circumstances that are directed by the terms of the governing instrument and applicable local law. Thus, any capital gain that is included in the section 643(b) definition of income is included in distributable net income. Similarly, any capital gain that is used to determine the amount or the timing of a distribution to a beneficiary is included in distributable net income.

Capital gains are also included in distributable net income if the fiduciary, pursuant to a discretionary power granted by local law or by the governing instrument (if not inconsistent with local law), treats the capital gains as distributed to a beneficiary, provided the power is exercised in a reasonable and consistent manner. Thus, if a trustee exercises a discretionary power by consistently treating any distribution in excess of ordinary income as being made from realized capital gains, any capital gain so distributed is included in distributable net income.

The provisions of sections 643(b) and 643(a)(3) are further intertwined when consideration is given to the new state statutory provisions defining income. If, under the terms of the governing instrument or applicable local law, realized capital gains are treated as income to the extent the unitrust amount or the equitable adjustment amount exceeds ordinary income, capital gains so treated are included in distributable net income. A similar result is achieved for capital gains consistently allocated to income by the fiduciary pursuant to a discretionary power. In any other situation, capital gains will be excluded from distributable net income and will be taxed to the trust.

Distributions in Kind

The proposed regulations will clarify the consequences of certain distributions of property in kind for purposes of the distribution deductions under sections 651 and 661. Thus, if property is distributed to a beneficiary in satisfaction of the beneficiary's right to income, the trust will be treated as having sold the property for its fair market value on the date of distribution.

Trusts Qualifying for Gift and Estate Tax Marital Deduction

Certain transfers of property in trust for the benefit of the spouse qualify for the marital deduction for gift and estate tax purposes. These transfers include a life estate with a general power of appointment described in sections 2523(e) and 2056(b)(5) and qualified terminal interest property described in sections 2523(f) and 2056(b)(7). One of the requirements of these provisions is that the spouse must be entitled for life to all the income from the trust property. The rules for determining whether the spouse is entitled to all the income from either a life estate with a general power of appointment trust or a qualified terminable interest trust are set forth in §20.2056(b)–5(f) of the Estate Tax Regulations and §25.2523(e)–1(f) of the Gift Tax Regulations. These rules provide that if an interest is transferred in trust, the spouse is entitled for life to all the income from the entire interest or a specific portion of the entire interest if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property during the spouse's life which the principles of the law of trusts accord a person who is unqualifiedly designated as the life beneficiary of a trust.

The proposed regulations will provide that a spouse's interest satisfies the income standard set forth in §§20.2056(b)–5(f) and 25.2523(e)–1(f) if the spouse is entitled to income as defined under a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)–1(a). As the examples under §1.643(b)–1(a) make clear, reasonable apportionment can be accomplished through a unitrust definition of income or by giving the trustee the power to make equitable adjustments between income and principal. In addition, a conforming amendment is made to §20.2056A–5(c)(2) providing rules regarding distributions of income from a qualified domestic trust.

Trusts Exempt From Generation-Skipping Transfer Tax

In general, under the effective date rules accompanying the generation-skipping transfer (GST) tax statutory provisions, a trust that was irrevocable on September 25, 1985, is not subject to the GST tax provisions, unless a GST transfer is made out of corpus added to the trust after that date. Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (TRA), Public Law 99–514 (100 Stat. 2085, 2731), 1986–3 (Vol. 1) C.B. 1, 634. The regulations provide guidance on when certain changes made to the terms of an exempt trust will not be treated as causing the trust to lose its exempt or grandfathered status. One safe-harbor in §26.2601–1(b)(4)(i)(D) is for modifications that will not shift a beneficial interest in the trust to a lower generation beneficiary or increase the amount of a GST transfer.

Under the proposed regulations, the administration of a pre-September 25, 1985, trust in conformance with a state law that defines income as a unitrust amount, or permits equitable adjustments between income and principal to ensure impartiality, and that meets the requirements of §1.643(b)–1(a) will not be treated as a modification that shifts a beneficial interest to a lower generation beneficiary, or increases the amount of a generation-skipping transfer.

Proposed Effective Date

The regulations are proposed to apply to trusts and estates for taxable years that begin on or after the date that final regulations are published in the **Federal Register**.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) and comments sent via the Internet that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing has been scheduled for June 8, 2001, in the IRS Auditorium, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Owing to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by May 18, 2001. A period of 10 minutes will be allotted to each person making comments.

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

Drafting Information

Various personnel from offices of the IRS and the Treasury Department participated in the development of these proposed regulations.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1, 20, 25, and 26 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In §1.642(c)–2, paragraph (c) is amended by adding a sentence after the first sentence to read as follows:

§1.642(c)–2 Unlimited deduction for amounts permanently set aside for a charitable purpose.

* * * * *

(c) * * * No amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if it is possible, under the terms of the fund’s governing instrument or applicable local law, that the income beneficiaries’ right to income may, at any time, be satisfied by the payment of either an amount equal to a fixed percentage of the annual fair market value of the trust property or any amount based on unrealized appreciation in the value of the trust property. * * *

* * * * *

Par. 3. Section 1.643(a)–3 is revised to read as follows:

§1.643(a)–3 Capital gains and losses.

(a) *In general*. Except as provided in §1.643(a)–6 and in paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and consistent exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law)—

(1) Allocated to income;

(2) Allocated to corpus but treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but utilized by the fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary.

(c) *Charitable contributions included in distributable net income*. If capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(d) *Capital losses*. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See §1.642(h)–1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

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

Example 1. Under the terms of Trust's governing instrument, all income is to be paid to *A* for life. Trustee is given discretionary powers to invade principal for *A*'s benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to *A* $5,000, representing *A*'s right to trust income. In addition, Trustee distributes to *A* $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust.

Example 2. The facts are the same as in *Example 1*, except that Trustee intends to follow a regular practice of treating discretionary distributions as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to *A*. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example 3. The facts are the same as in *Example 1*, except that pursuant to the terms of the governing instrument (in a provision not inconsistent with applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 4. The facts are the same as in *Example 1*, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to *A* is $10,000, rather than $12,000. Because Trustee will consistently use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 5. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to *A*. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to *A*, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Example 6. Under the terms of Trust's governing instrument, all income is to be paid to *A* during the Trust's term. When *A* reaches 35, Trust is to terminate and all the principal is to be distributed to *A*. All capital gains realized in the year of termination are included in distributable net income. See §1.641(b)–3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

Example 7. The facts are the same as *Example 6*, except Trustee is directed to distribute only one-half of the principal to *A* when *A* reaches 35. Trust assets consist entirely of stock in corporation M. If Trustee sells one-half of the stock and distributes the sales proceeds to *A*, all the capital gain attributable to that sale is included in distributable net income. If Trustee sells all the stock and distributes one-half of the sales proceeds to *A*, one-half of the capital gain attributable to that sale is included in distributable net income.

Example 8. The facts are the same as *Example 6*, except Trustee is directed to pay *B* $10,000 before distributing the remainder of Trust assets to *A*. No portion of the capital gains is allocable to *B* because the distribution to *B* is a gift of a specific sum of money within the meaning of section 663(a)(1).

Example 9. State law provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. State law provides that this unitrust amount shall be considered paid first from ordinary income, then from net short–term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that *A* is to receive each year income as defined under State law. Trustee makes the unitrust election under State law. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to *A* $20,000 (4% of $500,000) in satisfaction of *A*'s right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the State law ordering rule and is included in distributable net income for the taxable year.

Example 10. The facts are the same as in *Example 9*, except that neither State law nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment with respect to all realized capital gains.

Example 11. The facts are the same as in Example 9, except that neither State law nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary income.

Par. 4. Section 1.643(b)–1 is revised to read as follows:

§1.643(b)–1 Definition of income.

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, *income*, when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal, that is, allocating ordinary income to income and capital gains to principal, will generally not be recognized. However, amounts allocated between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary income, capital gains, and appreciation. For example, a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust. Similarly, a state law that permits the trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. These adjustments are permitted when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of income and principal is unable to administer the trust impartially. In addition, an allocation of capital gains to income will be respected if the allocation is made either pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law.

Par. 5. In §1.651(a)–2, paragraph (d) is added to read as follows:

§1.651(a)–2 Income required to be distributed currently.

* * * * *

(d) If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income.

Par. 6. In §1.661(a)–2, paragraph (f) is revised to read as follows:

§1.661(a)–2 Deduction for distributions to beneficiaries.

* * * * *

(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

Par. 7. In §1.664–3, paragraph (a)(1)(i)(*b*)(*3*) is revised to read as follows:

§1.664–3 Charitable remainder unitrust.

(a) * * *

(1) * * *

(i) * * *

(*b*) * * *

(*3*) For purposes of this paragraph (a)(1)(i)(*b*), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property. If applicable state law provides that income is a unitrust amount, the trust's governing instrument must contain its own definition of trust income. In addition, capital gain attributable to appreciation in the value of a trust asset after the date it was contributed to the trust or purchased by the trust may be allocated to income pursuant to applicable local law and the terms of the governing instrument but not pursuant to a discretionary power granted the trustee.

* * * * *

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 8. The authority citation for part 20 continues to read in part as follows:

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

Par. 9. Section 20.2056(b)–5 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

§20.2056(b)–5 Marital deduction; life estate with power of appointment in surviving spouse.

* * * * *

(f) * * * (1) * * * In addition, the surviving spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section, if the spouse is entitled to income as defined by a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)–1 of the this chapter.

* * * * *

Par. 10. Section 20.2056(b)–7 is amended by adding a new sentence to the end of paragraph (d)(1) to read as follows:

§20.2056(b)–7 Election with respect to life estate for surviving spouse.

* * * * *

(d) * * * (1) * * * A power under applicable state law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)–1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

* * * * *

Par. 11. Section 20.2056(b)–10 is amended by adding a new sentence at the end of the section to read as follows:

§20.2056(b)–10 Effective dates.

* * * In addition, the rule in the last sentence of §20.2056(b)–5(f)(1) and the rule in the last sentence of §20.2056(b)–7(d)(1) regarding the spouse's right to income if the state statute provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of the trust are applicable with respect to trusts for taxable years that begin on or after the date that final regulations are published in the **Federal Register**.

Par. 12. Section 20.2056A–5 is amended by adding a new sentence in paragraph (c)(2) after the third sentence to read as follows:

§20.2056A–5 Imposition of section 2056A estate tax.

* * * * *

(c) * * *

(2) * * * However, distributions made to the surviving spouse as the income beneficiary in conformance with applicable state law that defines the term income as a unitrust amount, or permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will be considered distributions of trust income, if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)–1 of this chapter. *** * ***

* * * * *

Par. 13. Section 20.2056A–13 is revised to read as follows:

§20.2056A–13 Effective dates.

Except as provided in this section, the provisions of §§20.2056A–1 through 20.2056A–12 are applicable with respect to estates of decedents dying after August 22, 1995. The rule in the fourth sentence of §20.2056A–5(c) regarding unitrusts and distributions of income to the surviving spouse in conformance with applicable state law that provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts for taxable years that begin on or after the date that final regulations are published in the **Federal Register.**

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 14. The authority citation for part 25 continues to read in part as follows:

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

Par. 15. Section 25.2523(e)–1 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

§25.2523(e)–1 Marital deduction; life estate with power of appointment in donee spouse.

* * * * *

(f) * * * (1) * * * In addition, the spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section, if the spouse is entitled to income as defined by a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)–1(a) of this chapter.

* * * * *

Par. 16. Section 25.2523(h)–2 is amended by adding a new sentence to the end of the section to read as follows:

§25.2523(h)–2 Effective dates.

* * * In addition, the rule in the fourth sentence of §25.2523(e)–1(f)(1) regarding the spouse's right to income if the state statute provides for reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts and estates for taxable years that begin on or after the date the final regulations are published in the **Federal Register**.

PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Par. 17. The authority citation for part 26 continues to read in part as follows:

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

Par. 18. Section 26.2601–1 is amended as follows:

1. Paragraph (b)(4)(i)(D)(*2*) is amended by adding a new sentence to the end of the paragraph.

2. Paragraph (b)(4)(i)(E) is amended by adding *Examples 11* and *12.*

3. Paragraph (b)(4)(ii) is revised to read as follows.

The additions and revisions read as follows:

§26.2601–1 Effective dates.

* * * * *

(b) * * *

(4) * * *

(i) * * *

(D) * * *

(*2*) * * * In addition, administration of a trust in conformance with applicable state law that defines the term income as a unitrust amount, or permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will not be considered to shift a beneficial interest in the trust, if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)–1 of this chapter.

(E) * * *

Example 11. Conversion of income interest to unitrust interest under state statute. In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, *A*, and *A*'s issue. The trust provides that trust income is payable to *A* for life and upon *A*'s death the remainder is to pass to *A*'s issue, per stirpes. In 2002, State X amends its income and principal statute to define "income" as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. *A* and *A*'s issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 12. Equitable adjustments under state statute. The facts are the same as in *Example 11*, except that in 2002, State X amends its income and principal statute to permit the trustee to make equitable adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these equitable adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

(ii) *Effective dates*. The rules in this paragraph (b)(4) are applicable on and after December 20, 2000. However, the rule in the last sentence of paragraph (b)(4)(i)(D)(*2*) of this section regarding the administration of a trust in conformance with applicable state law providing for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts for taxable years that begin on or after the date that final regulations are published in the **Federal Register**.

* * * * *

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on February 14, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 15, 2001, 66 F.R. 10396)

Notice of Proposed Rulemaking and Notice of Public Hearing

Treaty Guidance Regarding Payments With Respect to Domestic Reverse Hybrid Entities

REG–107101–00

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 894 of the Internal Revenue Code relating to the eligibility for treaty benefits of items of income paid by domestic entities that are not fiscally transparent under U.S. law but are fiscally transparent under the laws of the jurisdiction of the person claiming treaty benefits (a domestic reverse hybrid entity). The proposed regulations affect the determination of tax treaty benefits with respect to U.S. source income of foreign persons. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by May 28, 2001. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for June 26, 2001, at 10 a.m., must be submitted by June 5, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–107101–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–107101–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at *http://www.irs.gov/tax_regs/regslist.html*. The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Elizabeth U. Karzon or Karen Rennie-Quarrie at (202) 622-3880; concerning submissions and the hearing, Guy R. Traynor at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On June 30, 1997, the IRS and Treasury issued temporary regulations (T.D. 8722, 1997–2 C.B. 81) in the **Federal Register** (62 FR 35673, as corrected at 62 FR 46876, 46877) under section 894 of the Internal Revenue Code relating to eligibility for benefits under income tax treaties for payments to certain entities. These regulations addressed, among other matters, the eligibility for treaty benefits of U.S. source payments made to domestic reverse hybrid entities, concluding that treaty benefits were not available for such payments. 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 FR 35755). On July 3, 2000, the IRS and Treasury issued final regulations (T.D. 8889, 2000–30 I.R.B. 124), reaffirming the position taken in the temporary regulations with respect to payments made to domestic reverse hybrid entities. The final regulations, however, did not address the question of whether payments made by domestic reverse hybrid entities to their interest holders are eligible for treaty benefits. Section 1.894–1(d)(2)(ii) was reserved for further guidance on that issue.

Explanation of Provisions

These proposed regulations provide guidance with respect to the previously reserved paragraph. They provide rules on the character of such payments for treaty purposes and the extent to which such payments are eligible for a reduced rate of U.S. tax under a U.S. income tax treaty. The use of domestic reverse hybrid entities may give rise to inappropriate and unintended results under income tax treaties, such as double non-taxation or double taxation, unless the income tax treaties are interpreted to resolve the conflict of laws. These regulations provide guidance regarding how to apply U.S. income tax treaties under these circumstances.

Section 1.894–1T(d)(3) provided guidance on the appropriate treatment of items of income paid to 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. Thus, neither the domestic reverse hybrid entity nor its interest holders could claim a reduction under an income tax treaty with respect to a payment to a domestic reverse hybrid entity, notwithstanding that the interest holder might otherwise derive the income as a resident of a treaty jurisdiction under §1.894–1T(d)(1). The rationale for the rule was the U.S. tax treaty principle that the United States retains taxing jurisdiction over items of U.S. source income paid to its residents. The final regulations published in the **Federal Register** on July 3, 2000, retain the rule that a domestic reverse hybrid entity remains subject to the taxing jurisdiction of the United States on U.S. source payments, but reserve with respect to the treatment of payments made by domestic reverse hybrid entities.

Commentators on the previously issued temporary and proposed regulations noted that it was unclear how items of income paid by a domestic reverse hybrid entity to its interest holders should be treated. In particular, the general rule contained in §1.894–1T(d)(1) required the item of income to be "received by" a person resident in a treaty jurisdiction and for that item of income to be "subject to tax" in the hands of the person deriving the item of income. Commentators expressed concern 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 treats the domestic reverse hybrid entity as fiscally transparent. The interest holder's jurisdiction views 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. The interest holder's jurisdiction does not recognize the items of income paid by the domestic reverse hybrid entity to the interest holder. Based on this analysis, commentators questioned whether the items of income paid by the domestic reverse hybrid entity to an interest holder in that entity would be subject to a 30-percent tax under the Code. The IRS and Treasury believe similar questions may also arise under the recently issued final regulations.

Accordingly, these proposed regulations provide rules on the treatment of payments made by domestic reverse hybrid entities. Paragraph (d)(2)(ii) of this section provides a general rule that an item of income paid by a domestic reverse hybrid entity to an interest holder shall be characterized under U.S. tax law. This means that U.S. tax principles are first applied to characterize the item of income paid by the domestic reverse hybrid entity to the interest holder for purposes of applying an applicable income tax treaty provision. Once the item of income is so characterized, it is necessary to determine if the interest holder derives the item of income. In determining whether the interest holder derives the item of income, paragraph (d)(2)(ii)(A) of this section provides a special rule for determining whether the interest holder is fiscally transparent with respect to the item of income. Under that rule, whether the interest holder is fiscally transparent with respect to the item of income for purposes of §1.894–1(d)(3)(ii) is made based on the treatment that would have resulted had the item of income been paid by an entity that was not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income. Accordingly, if the interest holder is not fiscally transparent, then it will be considered to have derived the item of income, even if, for example, the item of income were characterized differently or treated as received at an earlier date under the laws of the interest holder's jurisdiction than the item of income paid by the domestic reverse hybrid entity.

The IRS and Treasury have learned, however, that domestic reverse hybrid entities are being established by related parties to manipulate differences in U.S. and foreign entity classification rules to reduce inappropriately the amount of tax imposed on items of income paid from the United States to related foreign interest holders. In a typical scenario, a foreign investor, resident in a treaty jurisdiction, establishes a domestic reverse hybrid holding company with a combination of debt and equity contributions. The domestic reverse hybrid entity holds the stock of a wholly-owned U.S. operating company. The operating company pays a dividend to the domestic reverse hybrid entity, but the domestic reverse hybrid entity primarily pays interest to its foreign owner within the earning stripping limits of section 163(j). The foreign jurisdiction views the foreign owner as receiving dividends, but the United States views the domestic reverse hybrid entity as receiving the dividends and making deductible interest payments. In circumstances when the income tax treaty between the United States and the applicable foreign jurisdiction applies a zero withholding rate on interest and a 5-percent rate on related party dividends, the domestic reverse hybrid entity treats its payment to the foreign owner as an interest payment and the foreign owner avoids the withholding tax on the dividends that its jurisdiction treats it as receiving. In addition, the domestic reverse hybrid entity receives the benefit of an interest deduction in the United States while the foreign interest holder receives either a tax credit or exclusion on the dividend amount in its jurisdiction.

The IRS and Treasury believe that it is inappropriate for related parties to use domestic reverse hybrid entities for the purpose of converting higher taxed U.S. source items of income to lower taxed, or untaxed, U.S. source items of income. To do so defeats the expectation of the United States and its treaty partners that treaties should be used to reduce or eliminate double taxation for legitimate transactions, not to reward the manipulation of inconsistencies in the laws of the treaty partners. The legislative history of section 894(c) supports this analysis. Congress specifically expressed its concern about the potential tax avoidance opportunities available for foreign persons that invest in the United States through hybrid entities that are designed to avoid both U.S. and foreign income taxes. See H.R. Conf. Rep. No 220, 105th Cong, 1st Sess. 573 (1997); Joint Committee on Taxation, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997 (JCS–23–97), at 249 (December 17, 1997). The approach contained in §1.894–1(d)(2), as revised, is also consistent with the general tax treaty principle that contracting states may adopt provisions in their domestic laws to counter structures and transactions intended to take advantage of the differences in the tax laws of the contracting states. See Commentaries to Article 1 of The 1998 OECD Model Tax Convention on Income and Capital; S. Rep. No. 445, 100th Cong. 2d Sess. 322–23 (1988)

The IRS and Treasury are further concerned by the ability of foreign acquiring entities to obtain tax advantaged financing through domestic reverse hybrid entities by exploiting differences between U.S. and foreign law. Such financing unfairly disadvantages similarly situated U.S. domestic acquiring entities. Congress has expressed concern about the use of analogous hybridized structures that were effected to provide foreign acquiring entities with tax advantaged acquisition financing not available to similarly situated domestic companies. See Joint Committee on Taxation, 100th Congress, 1st Sess., General Explanation of the Tax Reform Act of 1986 (JCS–10–87), at 1064, 1065 (May 4, 1987).

For these reasons, the proposed regulations provide a special rule in paragraph (d)(2)(ii)(B) of the regulations, such that if: (1) a domestic entity makes a payment to a related domestic reverse hybrid entity that is considered to be a dividend either under the laws of the United States or under the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and the related foreign interest holder is treated as deriving its proportionate share of the payment to the domestic reverse hybrid entity under the laws of the related foreign interest holder's jurisdiction; and (2) the domestic reverse hybrid entity makes a payment to the related foreign interest holder of a type that is deductible for U.S. tax purposes and for which a reduction in the U.S. withholding tax rate would be allowed under the general rule, but for this exception, then to the extent the amount of the payment by the domestic reverse hybrid entity to the related foreign interest holder does not exceed the total amount of the interest holder's proportionate share of any payments by the domestic entity to the domestic reverse hybrid entity treated as dividends under either jurisdiction's laws, the payment by the domestic reverse hybrid entity shall be treated as a dividend for all purposes of the Code and the applicable income tax treaty.

For purposes of determining the amount of the payment from the domestic reverse hybrid entity to the related foreign interest holder to be recharacterized as a dividend, the portion of the payments treated as derived by the related foreign interest holder shall be reduced by the amount of any prior actual dividend payments, under U.S. law, made by the domestic reverse hybrid entity to the related foreign interest holder and by the amount of any payments from the domestic reverse hybrid entity to the related foreign interest holder previously recharacterized under this special rule. The tax withheld from the payment from the domestic reverse hybrid entity to the related foreign interest holder shall be determined based on the appropriate rate of withholding that would be applicable to dividends paid by the domestic reverse hybrid entity to the related foreign interest holder under the U.S. treaty with the related foreign interest holder's jurisdiction had that jurisdiction viewed the domestic reverse hybrid entity as not fiscally transparent. Because any payment subject to the provisions of this special rule is treated as a dividend for all purposes of the Code and the applicable treaty, the domestic reverse hybrid entity will not be able to claim a deduction on the payment to the related foreign interest holder.

The regulations provide an 80% ownership test to determine if the parties are related to one another and a special rule that treats accommodation parties as related foreign interest holders. The foregoing rules also apply to recharacterize payments when more than one domestic reverse hybrid entity or other fiscally transparent entity is involved.

The proposed regulations further provide that a taxpayer may not affirmatively use the rules of paragraph (d)(2) of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Code. Thus, with respect to such a taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Code) the arrangement in accordance with its form or its economic substance. The regulations further provide that, if a taxpayer enters into an arrangement the effect of which is to circumvent the principles of this paragraph (d)(2), the Commissioner may recharacterize (for all purposes of the Code) the arrangement in accordance with the principles of this paragraph (d)(2).

Comments are requested on potential rules with respect to transaction when the domestic reverse hybrid entity is sold to unrelated parties who later receive distributions.

Proposed Effective Dates

These proposed regulations apply to items of income paid by a domestic reverse hybrid entity on or after the date these regulations are published as final regulations in the **Federal Register** with respect to amounts received by the domestic reverse hybrid entity on or after the date these regulations are published as final regulations in the **Federal Register**. No inference is intended as to the treatment of transactions entered into prior to the date of applicability of the final regulations.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It 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. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for June 26, 2001, at 10 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restriction, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by May 28, 2001, and submit an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by June 5, 2001.

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

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

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.894–1(d)(2) also issued under 26 U.S.C. 894 and 7701(l).* * *

Par. 2. In §1.894–1, paragraph (d)(2)(ii) is revised and paragraphs (d)(2)(iii) and (d)(2)(iv) are added to read as follows:

§1.894–1 Income affected by treaty.

* * * * *

(d) * * *

(2) * * *

(ii) *Payments by domestic reverse hybrid entities*—(A) *General rule*. Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, an item of income paid by a domestic reverse hybrid entity to an interest holder in such entity shall have the character of such item of income under U.S. law and shall be considered to be derived by the interest holder, provided the interest holder is not fiscally transparent in its jurisdiction, as defined in paragraph (d)(3)(iii) of this section, with respect to the item of income. In determining whether the interest holder is fiscally transparent with respect to the item of income under this paragraph (d)(2)(ii)(A), the determination under paragraph (d)(3)(ii) of this section shall be made based on the treatment that would have resulted had the item of income been paid by an entity that is not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income.

(B) *Payment made to related foreign interest holder*—(*1*) *General rule*. If—

(*i*) A domestic entity makes a payment to a related domestic reverse hybrid entity that is treated as a dividend under either the laws of the United States or the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and under the laws of the jurisdiction of the related foreign interest holder in the domestic reverse hybrid entity, the related foreign interest holder is treated as deriving its proportionate share of the payment under the principles of paragraph (d)(1) of this section; and

(*ii*) The domestic reverse hybrid entity makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder and for which a reduction in the U.S. withholding tax rate would be allowed under paragraph (d)(2)(ii)(A) of this section but for this paragraph (d)(2)(ii)(B), then

(*iii*) To the extent the amount of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section does not exceed the sum of the portion of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder and the portion of any other prior payments described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder, the amount of the payment described in (d)(2)(ii)(B)(*1*)(*ii*) of this section will be treated for all purposes of the Internal Revenue Code and the applicable income tax treaty as a dividend, and the tax to be withheld from the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section shall be determined based on the appropriate rate of withholding that would be applicable to dividends paid from the domestic reverse hybrid entity to the related foreign interest holder under the U.S. treaty with the related foreign interest holder's jurisdiction had that jurisdiction viewed the domestic reverse hybrid entity as not fiscally transparent; and

(*iv*) For purposes of determining the amount to be recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section, the portion of the payments described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder shall be reduced by the amount of any prior actual dividend payments made by the domestic reverse hybrid entity to the related foreign interest holder and by the amount of any payments from the domestic reverse hybrid entity to the related foreign interest holder previously rechacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section.

(*2*) *Tiered entities*. The principles of this paragraph (d)(2)(ii)(B) shall also apply to payments referred to in this paragraph (d)(2)(ii)(B) made among related entities when there is more than one domestic reverse hybrid entity or other fiscally transparent entities involved.

(*3*) *Definition of related*. Related shall mean any entity satisfying the ownership requirements of section 267(b) or 707(b)(1), except that 80 percent shall be substituted for 50 percent. For purposes of determining whether a person is related to another person, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership. If a person enters into a transaction (or series of transactions) with the domestic reverse hybrid entity, its related interest holders, or its related entities, and the effect of the transaction (or series of transaction) is to avoid the principles of this paragraph (d)(2)(ii)(B), then that person shall be treated as related to the domestic reverse hybrid entity for purposes of this section.

(C) *Commissioner's discretion*. The Commissioner may, as the Commissioner determines to be appropriate, recharacterize for all purposes of the Internal Revenue Code all or part of any transaction (or series of transactions) between related parties if the effect of the transaction (or series of transactions) is to avoid the principles of this paragraph (d)(2).

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

Example 1. Treatment of payment by unrelated entity to domestic reverse hybrid entity. (i) *Facts*. Entity A is a domestic reverse hybrid entity, as defined in paragraph (d)(2)(i) of this section, with respect to the U.S. source dividends it receives from B, a domestic corporation to which A is not related, within the meaning of paragraph (d)(2)(ii)(B)(*3*) of this section. A's 85-percent shareholder FC is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. Under Country X law, FC is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. In year 1, A receives a $100 of dividend income from B. Under Country X law, FC is treated as deriving $85 of the $100 dividend payment received by A. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5 percent with respect to a 10-percent or more corporate shareholder.

(ii) *Analysis*. Under paragraph (d)(2)(i) of this section, the U.S.-Country X income tax treaty does not apply to the dividend income received by A because the income is paid by B, a domestic corporation, to A, another domestic corporation. A remains fully taxable under the U.S. tax laws as a domestic corporation with regard to that item of income. Further, pursuant to paragraph (d)(2)(i) of this section, notwithstanding the fact that under the laws of Country X A is treated as fiscally transparent with respect to the dividend income, FC may not claim a reduced rate of taxation on its share of the U.S. source dividend income received by A.

Example 2. Treatment of payment by domestic reverse hybrid entity to related foreign interest holder involving unrelated party. (i) *Facts*. The facts are the same as in *Example 1*. Both the United States and Country X characterize the payment by B in year 1 as a dividend. In addition, in year 2, A makes a payment of $25 to FC that is characterized under U.S. tax laws as an interest payment to FC on a loan from FC to A. Under the U.S.-Country X income tax treaty, the rate of tax on interest is zero. Under Country X laws, had the interest been paid by an entity that is not fiscally transparent under Country X's laws with respect to any item of income, FC would not be fiscally transparent as defined in paragraph (d)(2)(ii) of this section with respect to the interest.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 payment from B to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(ii)(B) of this section will not apply because, although FC is related to A, A is not related to the payor of the dividend income it received. Under paragraph (d)(2)(ii)(A) of this section, the $25 interest income paid from A to FC in year 2 will be characterized under U.S. law as interest . Accordingly, in year 2, FC may obtain the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

Example 3. Treatment of payment by domestic reverse hybrid entity to related foreign interest holder. (i) *Facts*. The facts are the same as in *Example 2*, except the $100 dividend income received by A in year 1 is from A's wholly owned subsidiary S.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. However, the $25 interest payment in year 2 by A to FC will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because $25 does not exceed FC's share of the $100 dividend payment made by S to A ($85). Since FC is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FC will be entitled to obtain the reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A would not be entitled to an interest deduction with respect to that payment and FC would not be entitled to claim the reduced rate of withholding applicable to interest.

(iv) *Effective date*. This paragraph (d)(2) applies to items of income paid by a domestic reverse hybrid entity on or after the date these regulations are published as final regulations in the **Federal Register** with respect to amounts received by the domestic reverse hybrid entity on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 26, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 27, 2001, 66 FR 12445)

U.S.— Korean Agreement

Announcement 2001–34

On June 23, 1999, the Internal Revenue Service and the Korean Ministry of Finance and Economy entered into a mutual agreement pursuant to Article 27 of the U.S. – Republic of Korea Income Tax Convention regarding gains from the disposition of shares of certain Korean real property corporations by U.S. persons.

Under the Individual Income Tax Act and Corporate Income Tax Act of Korea, the income from the disposition of shares of a corporation are treated as derived from the transfer of real property if three conditions are met. The three conditions that must exist are: (1) that the value of the real property held by the corporation in the country equals or exceeds 50 percent of the value of all the property held by the corporation; (2) that the shareholder (and related parties) hold at least 50 percent of the shares of the corporation; and (3) that the shareholder transfers at least 50 percent of the corporation. Korea treats the income attributable to the gain on such transfers of a Korean corporation as Korean source, for both nonresident aliens and foreign corporations.

The U.S. and Korea have agreed that gains derived from the disposition of shares of such a Korean corporation would be sourced in the *situs* country of the real property in order to prevent double taxation for purposes of Article 6(9) and Article 27(2)(9)(c) of the Convention.

Foundations Status of Certain Organizations

Announcement 2001–35

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:

Acceptance Communications Network, Edgewood, NM
Adams-Johnson Community Outreach, Inc., Fayetteville, NC
Adopt A Horse Program, Inc., Palermo, ME
Afterschool Publishing Company, Inc., Detroit, MI
Agape Youth Homeless Ministry Circuit, Decatur, GA
Alleghany Foundation, Covington, VA
Allman, Inc., Fresno, CA
Almobarak Cultural Center, Hot Springs, AR
American Elite Runners, Inc., Alamogordo, NM
American Friends of the Institute of Advocacy Training, Inc., New York, NY
American Opera Company, Inc., Centerville, UT
American Sign Language Resource Corp., Marietta, GA
Animal Aid Association, Inc., Springfield, VA
Animal League of Nevada, Las Vegas, NV
Another Level, Montclair, CA
Arizona Equal Justice Foundation, Phoenix, AZ
Army Retirement Residence Foundation Potomac, Fort Belvoir, VA
As He Is Ministries, Inc., Knoxville, TN
Association for the Historic Restoration and Preservation of Lives, Jamaica, NY
Atlantic Health Services, Inc., Lynwood, CA
Attica Housing Development Fund Company, Inc., Buffalo, NY
Avec Amis With Friends, Inc., Orlando, FL
Babycare, Inc., Colorado Springs, CO

Baltimore Senior Care, Inc., Baltimore, MD
Barkley Art Center, Inc., Annandale, MN
BECU Foundation, Tukwila, WA
Bolshoi Ballet and Opera Foundation, Inc., New York, NY
Bright Path, Inc., West Newbury, MA
Calls for Help Foundation, Fullerton, CA
Caloptima Health Partnership, Orange, CA
Cameron Cunningham Foundation, Oakwood, IL
Carmel Health Network, Mobile, AL
Carol and Arnold Wolowitz Foundation, Inc., Hauppauge, NY
Casa de Milagro, Inc., McKinney, TX
Central Oregon District Hospital Foundation, Inc., Redmond, OR
Changing Perspectives, Inc., Mount Kisco, NY
Charles E. Peterson Institute for Preservation of French Heritage, Ste Genevieve, MO
Cherith Ministries, Inc., Fayetteville, GA
Children's Enrichment Program, Los Angeles, CA
Christ House, Inc., Chi, Temple Hills, MD
Citizens for Humane Animal Treatment, Inc., Ellicott, NY
Cleveland Forum for the Arts, Inc., Cleveland, OH
Cochise Center for the Blind and Visually Impaired, Hereford, AZ
Cohasset Conservation Trust, Inc., Cohasset, MA
Community Revitalization Foundation, Inc., Baltimore, MD
Community Threads, Columbus, OH
Concerned Coaches & Athletes Against Drugs, Sedona, AZ
Connecticut Professional Society on the Abuse of Children, Inc., New Haven, CT
Contemporary Dance Company of Boca Raton, Inc., Boca Raton, FL
Copper Communities Housing Corporation, Kearney, AZ
Creative Resources Network, Inc., Bonner Springs, KS
Dance Et Vous, Mesquite, TX
David J. Patterson Institute for the Advancement of Ethics, Inc., Missoula, MT
Deacon & Brothers Foundation, Bryan, TX
Delavan Historic Foundation, Inc., Delavan, WI
Detriot Three Dimensional Community Development Corporation, Detroit, MI
Donna P. Jackson Ministries, Inc., Tulsa, OK
Dr. Grover C. Hunter University of North Carolina Dental Trust Fund, Atlanta, GA
Educational Association for Family Child Care, Inc., Lodi, NJ
Edutech Fideiicomiso Educativo P T, Bayamon, PR
Electronic Alexandria Community Forum, Alexandria, VA
Elishama Imbi Timbwa Memorial Merit Scholarship Award, Inc., New York, NY
Emerald Eyes Children's Foundation, Sherman Oaks, CA
Encore Chamber Music Society, Ltd., Jersey City, NJ
FAHD Foundation, Monroe, MI
Families United of Iowa, Ames, IA
Far and Away Missions, Inc., Florence, KY
Farm Relief Fund, Inc., of Wisconsin, Marshfield, WI
Father Paul Wolf Foundation, Winsted, MN
First African Housing Development Corporation at Darby Township, Sharon Hill, PA
Fishers of Men Ministries, Fairfield, OH
Food Closet of the Isaiah 58, Modesto, CA
Fort Hill Housing Development Fund Company, Inc., Rochester, NY
Foundation for Musculoskeletal Research and Education, Little Rock, AR
Foundation for O.C. Private School Opportunities, Inc., Anaheim, CA
Four H International Ministries, Corp., Hayden, ID
Friends of Hill-Stead, Inc., Farmington, CT
Friends of Son Shine Ministries Foundation, Corpus Christi, TX
Gerald Hanus Share the Spirit Scholarship, Omaha, NE
Gift of Green, Branson, MO
Gods Temple, St. Louis, MO
Grace Harbour Ministries, Inc., Bois Darc, MO
Grace HOPE Development Corporation, Baltimore, MD
Grand Valley Beautification Council, Grand Junction, CO
Great American Flag Association, Inc., Largo, FL
Gulf Marine Institute of Technology, Gulf Breeze, FL
Hands Extended Ministries, Inc., Maple Grove, MN
Happy Voice, Inc., Medford, OR
Hasbrouck Family Association, Inc., New Paltz, NY
Hawaii Society for Prevention of Cruelty to Children & Animals, Pahoa, HI
Henry E. Hardin Education Fund, Inc., South Plainfield, NJ
Hidden Ponds Foundation, Inc., Larchmont, NY
Hire a Teen for a Brighter Tomorrow, Park Forest, IL
Homeland of the Heart School, Olivia, MN
Institute for Health Care Research, Inc., Hialeah, FL
Institute for Health Improvement in Southeast Michigan, Southfield, MI
International Foundation for the Conservation of Natural Resources, Vienna, VA
Irish and American Repertory Theatre, Inc., Columbus, OH
Jeff Colby Charitable Foundation, Long Beach, IN
Keren Tefert Yaacov, Monsey, NY
Kids With Special Needs Day Care Center, Buffalo, NY
King of Glory Ministries, Inc., Avondale, AZ
L.A.M.B., Inc., Baltimore, MD
Lancaster Love, Inc., Lititz, PA
Legacy Ministries, Inc., California, MO
Liaison of Arkansas, Inc., Nashville, TN
Liechty-Windows Family Organization, Provo, UT
Life Care Management Services, Inc., St. Petersburg, FL
Light Years, LTD., Bayfield, CO
Lindstrom Foundation for Archaeological Research & Development, San Leandro, CA
Lov A Second Chance Foundation, Bois Darc, MO
Luci Di Speranza A New Jersey Non-Profit Corporation, West Long Branch, NJ
MARIA Multi-Behavioral Autism Rehabilitation & Intervention Assn., Eugene, OR
McMastersville Village Volunteer Fire Department, Ann Arbor, MI
Medical Research Scholarship Foundation, St. Louis, MO
Memphis Rock-N-Soul, Inc., Memphis, TN

Men Against Breast Cancer, Inc., Hollywood, FL
Menemsha Pond Preservation Trust, Inc., Boston, MA
Mentor and Associated Services, Robbinsdale, MN
Ministry of Love, Sterling Heights, MI
Mount Zion Non-Profit Housing Corporation, Detroit, MI
Native Fish Society, Inc., Portland, OR
Ndigbo Development Foundation, Inc., New Orleans, LA
Neighborhood Rehabilitation Center, Inc., Arlington, TX
Net Ministries, Inc., Carrollton, TX
Newcorp, Inc., New Orleans, LA
New Pisgah Haven Homes, Ltd., Chicago, IL
Noble African American Boys, Inc., Atlanta, GA
North American Community Health Foundation, Inc., Jackson, MS
North Las Vegas Chamber of Commerce Foundation, N. Las Vegas, NV
Northeast Commonworks, Inc., Newbury, MA
Northside Plaza, Inc., Houston, TX
Northwest Endurance Center, Bend, OR
Nutrition Art Music and Technology Therapy, Inc., Washington, DC
Oh-Za-H-Dah-Zay-Lee, Inc., Lapwai, ID
Omaha Volunteers for Handicapped Children, Omaha, NE
Omega Point Foundation, Portland, OR
Omega Psi Phi Development Corp., Decatur, GA
Oregonians for Environmental Rights, Sisters, OR
Out Reach Ministries Community Street Ministries, Ft. Lauderdale Lakes, FL
Oz Nidberu Trust, Brooklyn, NY
Phoenix Development, Inc., Memphis, TN
Pikes Peak Minority Business Foundation, Colorado Springs, CO
Pioneering Partners Foundation, Inc., Noblesville, IN
PLAY, Grass Valley, CA
Positive People, Inc., Chicago, IL
Pride Foundation, Inc., Banks, AL
Pride of the Carolina's, Incorporated, Manchester, NH
Raksha, Inc., Atlanta, GA
Ralph and Billie Howard Foundation for Scholarship and Technology, Tyler, TX
Red Arce Farm, Inc., Stow, MA
Reflections A True Gospel Ministry, Stockton, CA
Richland Affordable Housing Corporation, Sidney, MT
Roanoke Chowan Foundation, Inc., Ahoskie, NC
Rogue Wave Foundation, Boulder, CO
Ronald McDonald House Charities of South Dakota, Inc., Sioux Falls, SD
Rowlett Animal Adoption Center, Fort Worth, TX
Rural School and Community Trust, Washington, DC
Safety & Firearms Education, Inc., Westbury, NY
Saint Martin's Place, Hazelton, PA
Seek & Save Ministries, Inc., Thurmont, MD
Shade for the Children, Black Hawk, SD
Shiloh Development for Community Home Care, Inc., Fayetteville, NC
Solutions An Education and Mediation Project, Laguna Niguel, CA
South Central Pennsylvania Sickle Cell Council, Harrisburg, PA
Southwest Academy for Conservation and Ecology, Forest Falls, CA
Spectrum Delta, Inc., Tinley Park, IL
Spirit of Truth Ministry, Columbus, OH
Sport Education and Values Foundation, Salt Lake City, UT
Springhill Community Childcare Center, Inc., Gainesville, FL
St. Francis County Family Resources, Inc., Forrest City, AZ
Steps, Inc., Winchester, IN
Syracuse Rescue Mission Foundation, Inc., Syracuse, NY
Tewksbury Ice Arena Authority, Inc., Tewskbury, MA
Thorntown Businessmen's Educational Foundation, Inc., Lebanon, IN
Tjo Fowroe-Haven Homes, Escondido, CA
To Life Foundation, Woodcliff Lakes, NJ
Toledo Homes, Inc., Toledo, OH
Townsmen Jazz Orchestra, Bedford Hts., OH
Treme Community Education Program, Inc., New Orleans, LA
Tri-Counties Special Services, Inc., Hopkinsville, KY
Trulove Charities for the Promotion of Family Literacy, Champaign, IL
Union Street Foundation, Decatur, IL
United Communal Services Foundation, Los Angeles, CA
United Debt Counseling, Inc., Wilmington, DE
Uplift Foundation, New York, NY
US Friends of English National Opera, Inc., Minneapolis, MN
Vallecito Schools Foundation, Avery, CA
Viarts, Providence, RI
Victory Lakes Village, Waukegan, IL
Voice of Youth, Seattle, WA
Washington Metropolitan Area Affiliate of the American Geriatrics Society, Takoma Park, MD
Wilson-Fleetwood Development Foundation, Alton, IL
Womanhood, Inc., Detroit, MI
Women in Need of Growth Services, Inc., Naples, FL
World Against Racism Foundation, Washington, DC
World Dance Day Foundation, Monterey Park, CA
Worldpeace Communities, St. Paul, MN

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 2001–36

The name of an organization that no longer qualifies as an organization described in section 170(c)(2) of the Internal Revenue Code of 1986 is 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 April 16, 2001, 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.

Friends of High Point Drug Action
Council, Inc., High Point, NC

Interim Final Rules for Nondiscrimination in Health Coverage in the Group Market; Technical Amendment

Announcement 2001-37

AGENCIES: Internal Revenue Service, Department of the Treasury; Pension and Welfare Benefits Administration, Department of Labor; Health Care Financing Administration, Department of Health and Human Services.

ACTION: Interim final rules; delay of effective date and conforming amendments.

SUMMARY: Consistent with the memorandum of January 20, 2001, from the Assistant to the President and Chief of Staff, entitled "Regulatory Review Plan," published in the **Federal Register** on January 24, 2001 (66 FR 7702), this action delays for 60 days the effective date for the rules entitled "Interim Final Rules for Nondiscrimination in Health Coverage in the Group Market," published in the **Federal Register** on January 8, 2001 (66 FR 1378 [T.D. 8931, 2001–7 I.R.B. 542]). This document also makes conforming amendments to reflect the delay in effective date.

DATES: The effective date of the Interim Final Rules amending 26 CFR Part 54, 29 CFR Part 2590, and 45 CFR Part 146, published in the **Federal Register** on January 8, 2001, at 66 FR 1378, is delayed for 60 days, from March 9, 2001, until May 8, 2001. The conforming amendments in this document are effective May 8, 2001.

FOR FURTHER INFORMATION CONTACT: Russ Weinheimer, Internal Revenue Service, Department of the Treasury, at (202) 622-6080; Amy J. Turner, Pension and Welfare Benefits Administration, Department of Labor, at (202) 219-7006; or Ruth A. Bradford, Health Care Financing Administration, Department of Health and Human Services, at (410) 786-1565.

SUPPLEMENTARY INFORMATION:

Consistent with the memorandum of January 20, 2001, from the Assistant to the President and Chief of Staff, entitled "Regulatory Review Plan," published in the **Federal Register** on January 24, 2001 (66 FR 7702), this action delays for 60 days the effective date and, for consistency, certain applicability dates for the rules entitled "Interim Final Rules for Nondiscrimination in Health Coverage in the Group Market," published in the **Federal Register** on January 8, 2001 (66 FR 1378). These rules implement statutory provisions prohibiting discrimination based on a health factor by group health plans and issuers offering health insurance coverage in connection with a group health plan. The rules implement changes made to the Internal Revenue Code of 1986, the Employee Retirement Income Security Act of 1974, and the Public Health Service Act, enacted as part of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), and most of the guidance contained in these rules remains applicable for plan years beginning on or after July 1, 2001. This document also makes conforming amendments to reflect the delay in effective date.

To the extent that 5 U.S.C. 553 applies to this action, it is exempt from notice and comment because it constitutes a rule of procedure under 5 U.S.C. 553(b)(3)(A). Alternatively, the Departments' implementation of this rule without opportunity for public comment, effective immediately upon publication today (March 9, 2001) in the **Federal Register**, is based on the good cause exceptions in 5 U.S.C. 553(b)(3)(B) and 553(d)(3), in that seeking public comment is impracticable, unnecessary, and contrary to the public interest. The 60-day delay in effective date is necessary to give Department officials the opportunity for further review and consideration of new regulations, consistent with the Assistant to the President's memorandum of January 20, 2001. Given the imminence of the effective date, seeking prior public comment on this delay would have been impractical, unnecessary, and contrary to the public interest in the orderly promulgation and implementation of regulations. Because the delay is only for 60 days, a 30-day comment period before the delay could be effective would exhaust a substantial amount of time that group health plans, health insurance issuers, and State insurance commissioner's offices could otherwise use to review their plan documents, insurance policies, and State laws for purposes of the orderly implementation of the interim regulations. In addition, it would create confusion among State agencies, employers, plan administrators, issuers, and third party administrators as to the effective date of certain provisions, impeding their compliance and enforcement efforts

List of Subjects

26 CFR Part 54

Excise taxes, Health care, Health insurance, Pensions, Reporting and recordkeeping requirements.

29 CFR Part 2590

Employee benefit plans, Employee Retirement Income Security Act, Health care, Health insurance, Reporting and recordkeeping requirements.

45 CFR Part 146

Health care, Health insurance, Reporting and recordkeeping requirements, and State regulation of health insurance.

Conforming Amendments to the Regulations

Internal Revenue Service

26 CFR Chapter I

Accordingly, the publication on January 8, 2001, of the temporary and final rules, 26 CFR Part 54, is amended as follows:

PART 54 — PENSION EXCISE TAXES

Paragraph 1. The authority citation for part 54 continues to read in part as follows:

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

§54.9802–1 [Amended]

Par. 2. Section 54.9802–1 is amended by removing the date "March 9, 2001" in each place it appears in paragraph (i)(1) and adding in its place "May 8, 2001".

§54.9802–1T [Amended]

Par. 3. Section 54.9802–1T is amended by:

1. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(1).
2. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(3)(ii)(A) introductory text.
3. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(3)(ii)(C) *Example 2* (ii).

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved March 2, 2001.

Pamela F. Olsen,
Deputy Assistant Secretary of the Treasury.

Pension and Welfare Benefits Administration

29 CFR Chapter XXV

For the reasons set forth above, the publication on January 8, 2001, of the interim final rule, 29 CFR Part 2590, is amended as follows:

PART 2590 – RULES AND REGULATIONS FOR HEALTH INSURANCE PORTABILITY AND RENEWABILITY FOR GROUP HEALTH PLANS

Paragraph 1. The authority citation for Part 2590 continues to read as follows:

Authority: Secs. 107, 209, 505, 701–703, 711–713, and 731–734 of ERISA (29 U.S.C. 1027, 1059, 1135, 1171–1173, 1181–1183, and 1191–1194), as amended by HIPAA (Public Law 104–191, 110 Stat. 1936), MHPA and NMHPA (Public Law 104–204, 110 Stat. 2935), and WHCRA (Public Law 105–277, 112 Stat. 2681–436), section 101(g)(4) of HIPAA, and Secretary of Labor's Order No. 1–87, 52 FR 13139, April 21, 1987.

§ 2590.702 [Amended]

Par. 2. Section 2590.702 is amended by:

1. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in the heading to paragraph (i)(1).
2. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(1).
3. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(3)(ii)(A) introductory text.
4. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(3)(ii)(C) *Example 2* (ii).

Signed at Washington, DC, this 16th day of February 2001.

Alan D. Lebowitz,
Acting Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor.

Health Care Financing Administration

45 CFR Subtitle A

For the reasons set forth above, the publication on January 8, 2001, of the interim final rule, 45 CFR Part 146, is amended as follows:

PART 146 – RULES AND REGULATIONS FOR HEALTH INSURANCE PORTABILITY AND RENEWABILITY FOR GROUP HEALTH PLANS

Paragraph 1. The authority citation for Part 146 continues to read as follows:

Authority: Secs. 2701 through 2763, 2791 and 2792 of the Public Health Service Act, 42 U.S.C. 300gg through 300gg–63, 300gg–91, 300gg–92 as amended by HIPAA (Public Law 104–191, 110 Stat. 1936), MHPA and NMHPA (Public Law 104–204, 110 Stat. 2935), and WHCRA (Public Law 105–277, 112 Stat. 2681–436), and section 102(c)(4) of HIPAA.

§ 146.121 [Amended]

Par. 2. Section 146.121 is amended by:

1. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in the heading to paragraph (i)(1).
2. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(1).
3. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(3)(ii)(A) introductory text.
4. Removing the date "March 9, 2001" and adding in its place "May 8, 2001" in paragraph (i)(3)(ii)(C) *Example 2* (ii).

Dated February 20, 2001.

Michael McMullan,
Acting Deputy Administrator, Health Care Financing Administration.

Approved March 5, 2001.

Tommy G. Thompson,
Secretary, Health and Human Services.

(Filed by the Office of the Federal Register on March 8, 2001, 8:45 a.m., and published in the issue of the Federal Register for March 9, 2001, 66 F.R. 14076)

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 Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—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.

Numerical Finding List[1]

Bulletins 2001–1 through 2001–15

Announcements:

2001–1, 2001–2 I.R.B. *277*
2001–2, 2001–2 I.R.B. *277*
2001–3, 2001–2 I.R.B. *278*
2001–4, 2001–2 I.R.B. *286*
2001–5, 2001–2 I.R.B. *286*
2001–6, 2001–3 I.R.B. *357*
2001–7, 2001–3 I.R.B. *357*
2001–8, 2001–3 I.R.B. *357*
2001–9, 2001–3 I.R.B. *357*
2001–10, 2001–4 I.R.B. *431*
2001–11, 2001–4 I.R.B. *432*
2001–12, 2001–6 I.R.B. *526*
2001–13, 2001–96 I.R.B. *752*
2001–14, 2001–7 I.R.B. *648*
2001–15, 2001–8 I.R.B. *715*
2001–16, 2001–8 I.R.B. *715*
2001–17, 2001–8 I.R.B. *716*
2001–18, 2001–10 I.R.B. *791*
2001–19, 2001–10 I.R.B. *791*
2001–20, 2001–8 I.R.B. *716*
2001–21, 2001–9 I.R.B. *752*
2001–22, 2001–11 I.R.B. *895*
2001–23, 2001–10 I.R.B. *791*
2001–24, 2001–10 I.R.B. *793*
2001–25, 2001–11 I.R.B. *895*
2001–26, 2001–11 I.R.B. *896*
2001–27, 2001–11 I.R.B. *897*
2001–28, 2001–13 I.R.B. *975*
2001–29, 2001–14 I.R.B. *1014*
2001–30, 2001–15 I.R.B. *1065*

Notices:

2001–1, 2001–2 I.R.B. *261*
2001–2, 2001–2 I.R.B. *265*
2001–3, 2001–2 I.R.B. *267*
2001–4, 2001–2 I.R.B. *267*
2001–5, 2001–3 I.R.B. *327*
2001–6, 2001–3 I.R.B. *327*
2001–7, 2001–4 I.R.B. *374*
2001–8, 2001–4 I.R.B. *374*
2001–9, 2001–4 I.R.B. *375*
2001–10, 2001–5 I.R.B. *459*
2001–11, 2001–5 I.R.B. *464*
2001–12, 2001–3 I.R.B. *328*
2001–13, 2001–6 I.R.B. *514*
2001–14, 2001–6 I.R.B. *516*
2001–15, 2001–7 I.R.B. *589*
2001–16, 2001–9 I.R.B. *730*
2001–17, 2001–9 I.R.B. *730*
2001–18, 2001–9 I.R.B. *731*
2001–19, 2001–10 I.R.B. *784*
2001–20, 2001–11 I.R.B. *818*
2001–21, 2001–11 I.R.B. *818*
2001–22, 2001–12 I.R.B. *911*
2001–23, 2001–12 I.R.B. *911*
2001–24, 2001–12 I.R.B. *912*
2001–25, 2001–13 I.R.B. *941*
2001–26, 2001–13 I.R.B. *942*
2001–27, 2001–13 I.R.B. *942*
2001–28, 2001–13 I.R.B. *944*
2001–29, 2001–14 I.R.B. *989*
2001–30, 2001–14 I.R.B. *989*

Proposed Regulations:

LR–230–76, 2001–13 I.R.B. *945*
REG–209461–79, 2001–8 I.R.B. *712*
REG–246256–96, 2001–8 I.R.B. *713*
REG–251701–96, 2001–4 I.R.B. *396*
REG–101520–97, 2001–15 I.R.B. *1057*
REG–106030–98, 2001–11 I.R.B. *820*
REG–106446–98, 2001–13 I.R.B. *945*
REG–106542–98, 2001–5 I.R.B. *473*
REG–121928–98, 2001–6 I.R.B. *520*
REG–109481–99, 2001–13 I.R.B. *961*
REG–111835–99, 2001–11 I.R.B. *834*
REG–114998–99, 2001–14 I.R.B. *992*
REG–115560–99, 2001–14 I.R.B. *993*
REG–101739–00, 2001–14 I.R.B. *996*
REG–103320–00, 2001–8 I.R.B. *714*
REG–104683–00, 2001–4 I.R.B. *407*
REG–104876–00, 2001–14 I.R.B. *998*
REG–105801–00, 2001–13 I.R.B. *965*
REG–106702–00, 2001–4 I.R.B. *424*
REG–106791–00, 2001–6 I.R.B. *521*
REG–106892–00, 2001–15 I.R.B. *1060*
REG–107047–00, 2001–14 I.R.B. *1002*
REG–107175–00, 2001–13 I.R.B. *971*
REG–107176–00, 2001–4 I.R.B. *428*
REG–107186–00, 2001–13 I.R.B. *973*
REG–107566–00, 2001–3 I.R.B. *346*
REG–110374–00, 2001–12 I.R.B. *915*
REG–110659–00, 2001–12 I.R.B. *917*
REG–114082–00, 2001–7 I.R.B. *629*
REG–114083–00, 2001–7 I.R.B. *630*
REG–114084–00, 2001–7 I.R.B. *633*
REG–116468–00, 2001–6 I.R.B. *522*
REG–119352–00, 2001–6 I.R.B. *525*
REG–121109–00, 2001–15 I.R.B. *1064*
REG–125237–00, 2001–12 I.R.B. *919*
REG–126100–00, 2001–11 I.R.B. *862*
REG–129608–00, 2001–14 I.R.B. *1011*
REG–130477–00, 2001–11 I.R.B. *865*
REG–130481–00, 2001–11 I.R.B. *865*

Railroad Retirement Quarterly Rates:

2001–2, I.R.B. *258*
2001–15, I.R.B. *1054*

Revenue Procedures:

2001–1, 2001–1 I.R.B. *1*
2001–2, 2001–1 I.R.B. *79*
2001–3, 2001–1 I.R.B. *111*
2001–4, 2001–1 I.R.B. *121*
2001–5, 2001–1 I.R.B. *164*
2001–6, 2001–1 I.R.B. *194*
2001–7, 2001–1 I.R.B. *236*
2001–8, 2001–1 I.R.B. *239*
2001–9, 2001–3 I.R.B. *328*
2001–10, 2001–2 I.R.B. *272*
2001–11, 2001–2 I.R.B. *275*
2001–12, 2001–3 I.R.B. *335*
2001–13, 2001–3 I.R.B. *337*
2001–14, 2001–3 I.R.B. *343*
2001–15, 2001–5 I.R.B. *465*
2001–16, 2001–4 I.R.B. *376*
2001–17, 2001–7 I.R.B. *589*
2001–18, 2001–8 I.R.B. *708*
2001–19, 2001–9 I.R.B. *732*
2001–20, 2001–9 I.R.B. *738*
2001–21, 2001–9 I.R.B. *742*

Revenue Procedures—Continued:

2001–22, 2001–9 I.R.B. *745*
2001–23, 2001–10 I.R.B. *784*
2001–24, 2001–10 I.R.B. *788*
2001–25, 2001–12 I.R.B. *913*

Revenue Rulings:

2001–1, 2001–9 I.R.B. *726*
2001–2, 2001–2 I.R.B. *255*
2001–3, 2001–3 I.R.B. *319*
2001–4, 2001–3 I.R.B. *295*
2001–5, 2001–5 I.R.B. *451*
2001–6, 2001–6 I.R.B. *491*
2001–7, 2001–7 I.R.B. *541*
2001–8, 2001–9 I.R.B. *726*
2001–9, 2001–8 I.R.B. *652*
2001–10, 2001–10 I.R.B. *755*
2001–11, 2001–10 I.R.B. *780*
2001–12, 2001–11 I.R.B. *811*
2001–13, 2001–12 I.R.B. *898*
2001–14, 2001–12 I.R.B. *898*
2001–15, 2001–13 I.R.B. *922*
2001–16, 2001–13 I.R.B. *936*
2001–17, 2001–15 I.R.B. *1052*

Treasury Decisions:

8910, 2001–2 I.R.B. *258*
8911, 2001–3 I.R.B. *321*
8912, 2001–5 I.R.B. *452*
8913, 2001–3 I.R.B. *300*
8914, 2001–8 I.R.B. *653*
8915, 2001–4 I.R.B. *359*
8916, 2001–4 I.R.B. *360*
8917, 2001–7 I.R.B. *538*
8918, 2001–4 I.R.B. *372*
8919, 2001–6 I.R.B. *505*
8920, 2001–8 I.R.B. *654*
8921, 2001–7 I.R.B. *532*
8922, 2001–6 I.R.B. *508*
8923, 2001–6 I.R.B. *485*
8924, 2001–6 I.R.B. *489*
8925, 2001–6 I.R.B. *496*
8926, 2001–6 I.R.B. *492*
8927, 2001–11 I.R.B. *807*
8928, 2001–8 I.R.B. *685*
8929, 2001–10 I.R.B. *756*
8930, 2001–5 I.R.B. *433*
8931, 2001–7 I.R.B. *542*
8932, 2001–11 I.R.B. *813*
8933, 2001–11 I.R.B. *794*
8934, 2001–12 I.R.B. *904*
8935, 2001–8 I.R.B. *702*
8937, 2001–11 I.R.B. *806*
8938, 2001–13 I.R.B. *929*
8939, 2001–12 I.R.B. *899*
8940, 2001–15 I.R.B. *1016*
8941, 2001–14 I.R.B. *977*
8942, 2001–13 I.R.B. *929*
8943, 2001–15 I.R.B. *1054*

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2000–27 through 2000–52 is in Internal Revenue Bulletin 2001–1, dated January 2, 2001.

Finding List of Current Actions on Previously Published Items[1]

Bulletins 2001–1 through 2001–15

Announcement:

98–99
Modified by
Ann. 2001–9, 2001–3 I.R.B. *357*

99–79
Superseded by
Ann. 2001–3, 2001–2 I.R.B. *278*

2000–78
Obsoleted by
T.D. 8933, 2001–11 I.R.B. *794*

2000–97
Corrected by
Ann. 2001–7, 2001–3 I.R.B. *357*

Cumulative Bulletin:

1998–2
Corrected by
Ann. 2001–5, 2001–2 I.R.B. *286*

Notices:

94–3
Modified by
T.D. 8933, 2001–11 I.R.B. *794*

98–39
Modified by
Notice 2001–9, 2001–4 I.R.B. *375*

98–40
Modified by
Notice 2001–9, 2001–4 I.R.B. *375*

99–53
Modified and superseded by
Notice 2001–7, 2001–4 I.R.B. *374*

2000–21
Superseded by
Notice 2001–1, 2001–2 I.R.B. *261*

2000–22
Modified and superseded by
Notice 2001–8, 2001–4 I.R.B. *374*

2000–26
Modified by
Notice 2001–22, 2001–12 I.R.B. *911*

2000–43
Extended by
Notice 2001–13, 2001–6 I.R.B. *514*

Proposed Regulations:

EE–130–86
Partially withdrawn by
REG–209461–79, 2001–8 I.R.B. *712*

REG–106030–98
Corrected by
Ann. 2001–30, 2001–15 I.R.B. *1065*

REG–106542–98
Corrected by
Ann. 2001–24, 2001–13 I.R.B. *793*

Proposed Regulations—Continued:

REG–116733–98
Withdrawn by
Ann. 2001–11, 2001–4 I.R.B. *432*

REG–116048–99
Withdrawn by
Ann. 2001–27, 2001–11 I.R.B. *897*

REG–106702–00
Corrected by
Ann. 2001–28, 2001–13 I.R.B. *975*

Revenue Procedures:

83–87
Superseded by
Rev. Proc. 2001–15, 2001–5 I.R.B. *465*

90–18
Amplified and superseded by
Rev. Proc. 2001–18, 2001–8 I.R.B. *708*

92–19
Superseded by
Rev. Proc. 2001–15, 2001–5 I.R.B. *465*

96–15
Modified by
Ann. 2001–22, 2001–11 I.R.B. *895*

96–17
Modified by
Rev. Proc. 2001–9, 2001–3 I.R.B. *328*

99–18
Modified and superseded by
Rev. Proc. 2001–21, 2001–9 I.R.B. *742*

99–47
Superseded by
Rev. Proc. 2001–16, 2001–4 I.R.B. *376*

99–49
Modified and amplified by
Notice 2001–23, 2001–12 I.R.B. *911*
Rev. Proc. 2001–10, 2001–2 I.R.B. *272*
Rev. Proc. 2001–23, 2001–10 I.R.B. *784*
Rev. Proc. 2001–24, 2001–10 I.R.B. *788*
Rev. Proc. 2001–25, 2001–12 I.R.B. *913*
Rev. Rul. 2001–8, 2001–9 I.R.B. *762*

2000–1
Superseded by
Rev. Proc. 2001–1, 2001–1 I.R.B. *1*

2000–2
Superseded by
Rev. Proc. 2001–2, 2001–1 I.R.B. *79*

2000–3
Superseded by
Rev. Proc. 2001–3, 2001–1 I.R.B. *111*

2000–4
Superseded by
Rev. Proc. 2001–4, 2001–1 I.R.B. *121*

2000–5
Superseded by
Rev. Proc. 2001–5, 2001–1 I.R.B. *164*

2000–6
Superseded by
Rev. Proc. 2001–6, 2001–1 I.R.B. *194*

Revenue Procedures—Continued:

2000–7
Superseded by
Rev. Proc. 2001–7, 2001–1 I.R.B. *236*

2000–8
Superseded by
Rev. Proc. 2001–8, 2001–1 I.R.B. *239*

2000–16
Modified and superseded by
Rev. Proc. 2001–17, 2001–7 I.R.B. *589*

2000–22
Modified and superseded by
Rev. Proc. 2001–10, 2001–2 I.R.B. *272*

2001–3
Corrected by
Ann. 2001–25, 2001–11 I.R.B. *895*

2001–13
Clarified by
Notice 2001–12, 2001–3 I.R.B. *328*

Revenue Rulings:

64–328
Modified by
Notice 2001–10, 2001–5 I.R.B. *459*

66–110
Modified by
Notice 2001–10, 2001–5 I.R.B. *459*

85–30
Clarified by
Rev. Rul. 2001–8, 2001–9 I.R.B. *762*

88–95
Clarified by
Rev. Rul. 2001–8, 2001–9 I.R.B. *762*

92–19
Supplemented in part by
Rev. Rul. 2001–11, 2001–10 I.R.B. *780*

2000–56
Corrected by
Ann. 2001–19, 2001–10 I.R.B. *791*

2001–4
Modified by
Notice 2001–23, 2001–12 I.R.B. *911*

Treasury Decisions:

7530
Removed by
T.D. 8938, 2001–13 I.R.B. *929*

8757
Revised by
T.D. 8941, 2001–14 I.R.B. *977*

8889
Corrected by
Ann. 2001–14, 2001–2 I.R.B. *286*

8913
Corrected by
Ann. 2001–26, 2001–11 I.R.B. *896*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2000–27 through 2000–52 is in Internal Revenue Bulletin 2001–1, dated January 2, 2001.

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	048–004–02366–1	Cum. Bulletin 1996-1 (Jan-June)	77	
	048–004–02376–8	Cum. Bulletin 1996-2 (July-Dec)	57	
	048–004–02384–9	Cum. Bulletin 1996-3 (1996 Tax Legislation)	84	
	048–004–02385–7	Cum. Bulletin 1997-1 (Jan-June)	75	
	048–004–02397–1	Cum. Bulletin 1997-2 (July-Dec)	68	
	048–004–02424–1	Cum. Bulletin 1997-3	62	
	048–004–02425–0	Cum. Bulletin 1997-4 Vol. 1	74	
	048–004–02430–6	Cum. Bulletin 1997-4 Vol. 2	76	
	048–004–02405–5	Cum. Bulletin 1998-1 (Jan-June)	86	
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