Bulletin No. 1997–3
January 21, 1997

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 97–4, page 6.
Low-income housing tax credit. This ruling clarifies that section 502(e)(3) of the Tax Reform Act of 1986 does not prevent a taxpayer from claiming a low-income housing tax credit under section 42 of the Code for a building's credit period beginning after 1995.

T.D. 8688, page 7.
Final regulations under section 108 of the Code relate to the time and manner of making certain elections under the Omnibus Budget Reconciliation Act of 1993.

T.D. 8689, page 9.
Final and temporary regulations under section 6695 of the Code relate to the methods of signing returns, statements, or other documents.

T.D. 8692, page 4.
Final and temporary regulations under section 25 of the Code relate to the reissuance of mortgage credit certificates.

REG–209762–95, page 12.
Proposed regulations under section 1245 of the Code relate to the allocation of depreciation recapture among partners in a partnership. A public hearing will be held on March 27, 1997.

Notice 97–12, page 11.
Electing Small Business Trust (ESBT) election. This notice provides the time and manner for the trustee to elect to be treated as an ESBT. This notice also provides that only the trustee need consent to the S corporation election on Form 2553.

Announcement 97–4, page 14.
Invalid and late S corporation elections. In order to obtain relief for invalid and late S corporation elections, taxpayers must generally request a private letter ruling. However, if an S corporation election is untimely made for the 1996 taxable year, there is a special transition rule for seeking late election relief.

ADMINISTRATIVE

Announcement 97–5, page 15.
New Form 8832, Entity Classification Election, is now available.

Finding Lists begin on page 17.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is ''protecting the revenue.'' The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

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 of a permanent nature 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.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

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

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

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

Section 25.—Interest on Certain Home Mortgages

26 CFR 1.25–3: Qualified mortgage credit certificate.

T.D. 8692

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Reissuance of Mortgage Credit Certificates

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the reissuance of mortgage credit certificates. Changes to the applicable law were made by the Tax Reform Act of 1984. The regulations provide guidance to issuers and holders of mortgage credit certificates.

EFFECTIVE DATE: These regulations are effective December 17, 1996.

FOR FURTHER INFORMATION CONTACT: L. Michael Wachtel, (202) 622–3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document adds final regulations to the Income Tax Regulations (26 CFR part 1) to provide guidance under section 25(e)(4) of the Internal Revenue Code (Code) with respect to the reissuance of mortgage credit certificates. Section 25(e)(4) was added to the Code by section 612 of the Tax Reform Act of 1984, 98 Stat. 494, 905.

On December 22, 1993, temporary regulations (TD 8502) relating to refinancing under section 25(e)(4) were published in the **Federal Register** (58 FR 67689). A notice of proposed rulemaking (REG–209574–92, previously FI–47–92) cross-referencing the temporary regulations was published in the **Federal Register** for the same day (58 FR 67744).

Written comments responding to these notices were received. There were no requests to appear in response to publication of a notice of a hearing in the **Federal Register** (61 FR 15204). Therefore, no public hearing was held. After consideration of all the comments, the proposed regulations under section 25(e)(4) are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed. The comments and revisions are discussed below.

Explanation of provisions and summary of comments

The temporary regulations permit the reissuance of a mortgage credit certificate on or after December 22, 1992, but no later than 1 year after the date of the refinancing. Commentators thought this unnecessarily limited eligibility for the reissuance of a certificate and limited the flexibility of State and local governments. The final regulations, reflecting the goal of giving State and local governments maximum flexibility to administer mortgage credit certificate programs, remove these limits. A State or local government may reissue a certificate to any person who refinanced a mortgage for which a mortgage credit certificate was issued and who meets the other requirements for a reissued certificate. The credit for prior years is available to the extent that the certificate holder may file a claim for refund.

The temporary regulations provide that the certified mortgage indebtedness amount on the reissued certificate cannot exceed the remaining balance of the certified mortgage indebtedness amount on the existing certificate. Commentators suggested that the final regulations permit the indebtedness amount on the reissued certificate to include costs such as closing costs of the refinancing loan. This recommendation was not implemented in the final regulations because section 25(e)(4) of the Code limits the amount of the reissued certificate to the outstanding balance of the existing certificate.

The temporary regulations provide that the reissued certificate may not result in an increase in the credit that would otherwise have been allowable to the holder under the existing certificate for any taxable year. In the case of a series of refinancings, the amount allowable on the refinanced loan would be the amount allowable on the original loan, rather than the immediately preceding refinanced loan.

A holder of a mortgage credit certificate who refinances a fixed rate loan can determine the amount of interest that would have been paid for any taxable year on the refinanced loan from an amortization schedule that projects interest and principal payments over the life of the loan. By applying the mortgage credit rate to the amount of interest, the holder can calculate the amount of tax credit that would have been allowable for the taxable year.

The amount of tax credit that would have been allowable for a taxable year is not as easily calculated by a holder of a mortgage credit certificate who refinances a variable rate loan because the holder cannot project an amortization schedule for the refinanced loan. Instead, each year the holder must calculate the amount of interest that would have been paid on the refinanced loan under the interest rate in effect for that year and then calculate the tax credit that would have been allowable. This procedure was described as burdensome by various commentators.

The final regulations continue to reflect the statutory requirement that the reissued certificate not result in an increase in the credit that would otherwise have been allowable to the certificate holder under the existing certificate for any taxable year. The final regulations, however, permit a certificate holder who refinances a variable rate loan with either a variable rate loan or a fixed rate loan to determine the amount of credit that would have been allowable by using an alternative method instead of calculating the amount based on the actual interest that would have been paid on the refinanced loan. Under the alternative method, the credit that would have been allowable is computed using an amortization schedule of a hypothetical self-amortizing loan with level payments projected to the final maturity date of the refinanced loan. The interest rate of the hypothetical loan is the annual percentage rate (APR) of the refinancing loan determined for purposes of the Federal Truth in Lending Act. The principal of the hypothetical loan is the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate.

A certificate holder who refinances a variable rate loan may use the alternative method or may compute the actual amount of credit that would have been allowable. However, the method chosen must be consistently applied by the holder beginning with the first taxable year for which the tax credit based upon the reissued certificate is claimed.

The temporary regulations do not address whether a refinancing loan is a financing that is subject to the recapture provisions of section 143(m) if the refinanced loan was not subject to recapture. The final regulations provide that the refinancing loan underlying a reissued mortgage credit certificate that replaces a mortgage credit certificate issued on or before December 31, 1990, is not a federally subsidized indebtedness that is subject to the recapture provisions of section 143(m) of the Code.

Commentators asked for clarification of whether additional volume cap was required in order to reissue a mortgage credit certificate and whether additional reporting was required by the issuer of a reissued mortgage certificate. Reissuance of a mortgage credit certificate relates to refinancing by a mortgage credit certificate holder of a mortgage loan on the holder's principal residence. Volume cap was required to be obtained in connection with the program under which the original certificate had been issued. Because the reissued certificate is replacing the existing certificate, it is treated as issued in connection with the original program, and additional volume cap is unnecessary for the reissuance. For similar reasons, no additional reporting is required by an issuer of a reissued mortgage credit certificate.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. It also has been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rule making preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is L. Michael Wachtel, Office of the Assistant Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry "1.25–1T–1.25–8T" and adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.25–1T also issued under 26 U.S.C. 25.
Section 1.25–2T also issued under 26 U.S.C. 25.
Section 1.25–3 also issued under 26 U.S.C. 25.
Section 1.25–3T also issued under 26 U.S.C. 25.
Section 1.25–4T also issued under 26 U.S.C. 25.
Section 1.25–5T also issued under 26 U.S.C. 25.
Section 1.25–6T also issued under 26 U.S.C. 25.
Section 1.25–7T also issued under 26 U.S.C. 25.
Section 1.25–8T also issued under 26 U.S.C. 25. * * *

Par. 2. Section 1.25–3 is added to read as follows:

§ 1.25–3 Qualified mortgage credit certificate.

(a) through (g)(1)(ii) [Reserved] For further guidance, see § 1.25–3T(a) through (g)(1)(ii).

(g)(1)(iii) *Reissued certificate exception.* See paragraph (p) of this section for rules regarding the exception in the case of refinancing existing mortgages.

(g)(2) through (o) [Reserved] For further guidance, see § 1.25–3T(g)(2) through (o).

(p) *Reissued certificates for certain refinancings*—(1) *In general.* If the issuer of a qualified mortgage credit certificate reissues a certificate in place of an existing mortgage credit certificate to the holder of that existing certificate, the reissued certificate is treated as satisfying the requirements of this section. The period for which the reissued certificate is in effect begins with the date of the refinancing (that is, the date on which interest begins accruing on the refinancing loan).

(2) *Meaning of existing certificate.* For purposes of this paragraph (p), a mortgage credit certificate is an existing certificate only if it satisfies the requirements of this section. An existing certificate may be the original certificate, a certificate issued to a transferee under § 1.25–3T(h)(2)(ii), or a certificate previously reissued under this paragraph (p).

(3) *Limitations on reissued certificate.* An issuer may reissue a mortgage credit certificate only if all of the following requirements are satisfied:

(i) The reissued certificate is issued to the holder of an existing certificate with respect to the same property to which the existing certificate relates.

(ii) The reissued certificate entirely replaces the existing certificate (that is, the holder cannot retain the existing certificate with respect to any portion of the outstanding balance of the certified mortgage indebtedness specified on the existing certificate).

(iii) The certified mortgage indebtedness specified on the reissued certificate does not exceed the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate.

(iv) The reissued certificate does not increase the certificate credit rate specified in the existing certificate.

(v) The reissued certificate does not result in an increase in the tax credit that would otherwise have been allowable to the holder under the existing certificate for any taxable year. The holder of a reissued certificate determines the amount of tax credit that would otherwise have been allowable by multiplying the interest that was scheduled to have been paid on the refinanced loan by the certificate rate of the existing certificate. In the case of a series of refinancings, the tax credit that would otherwise have been allowable is determined from the amount of interest that was scheduled to have been paid on the original loan and the certificate rate of the original certificate.

(A) In the case of a refinanced loan that is a fixed interest rate loan, the interest that was scheduled to be paid on the refinanced loan is determined using the scheduled interest method described in paragraph (p)(3)(v)(C) of this section.

(B) In the case of a refinanced loan that is not a fixed interest rate loan, the interest that was scheduled to be paid on the refinanced loan is determined using either the scheduled interest method described in paragraph (p)(3)(v)(C) of this section or the hypothetical interest method described in paragraph (p)(3)(v)(D) of this section.

(C) The scheduled interest method determines the amount of interest for

each taxable year that was scheduled to have been paid in the taxable year based on the terms of the refinanced loan including any changes in the interest rate that would have been required by the terms of the refinanced loan and any payments of principal that would have been required by the terms of the refinanced loan (other than repayments required as a result of any refinancing of the loan).

(D) The hypothetical interest method (which is available only for refinanced loans that are not fixed interest rate loans) determines the amount of interest treated as having been scheduled to be paid for a taxable year by constructing an amortization schedule for a hypothetical self-amortizing loan with level payments. The hypothetical loan must have a principal amount equal to the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate, a maturity equal to that of the refinanced loan, and interest equal to the annual percentage rate (APR) of the refinancing loan that is required to be calculated for the Federal Truth in Lending Act.

(E) A holder must consistently apply the scheduled interest method or the hypothetical interest method for all taxable years beginning with the first taxable year the tax credit is claimed by the holder based upon the reissued certificate.

(4) *Examples.* The following examples illustrate the application of paragraph (p)(3)(v) of this section:

Example 1. A holder of an existing certificate that meets the requirements of this section seeks to refinance the mortgage on the property to which the existing certificate relates. The final payment on the holder's existing mortgage is due on December 31, 2000; the final payment on the new mortgage would not be due until January 31, 2004. The holder requests that the issuer provide to the holder a reissued mortgage credit certificate in place of the existing certificate. The requested certificate would have the same certificate credit rate as the existing certificate. For each calendar year through the year 2000, the credit that would be allowable to the holder with respect to the new mortgage under the requested certificate would not exceed the credit allowable for that year under the existing certificate. The requested certificate, however, would allow the holder credits for the years 2001 through 2004, years for which, due to the earlier scheduled retirement of the existing mortgage, no credit would be allowable under the existing certificate. Under paragraph (p)(3)(v) of this section, the issuer may not reissue the certificate as requested because, under the existing certificate, no credit would be allowable for the years 2001 through 2004. The issuer may, however, provide a reissued certificate that limits the amount of the credit allowable in each year to the amount allowable under the existing certificate. Because the existing certificate would allow no credit after December 31, 2000, the reissued certificate could expire on December 31, 2000.

Example 2. (a) The facts are the same as *Example 1* except that the existing mortgage loan has a variable rate of interest and the refinancing loan will have a fixed rate of interest. To determine whether the limit under paragraph (p)(3)(v) of this section is met for any taxable year, the holder must calculate the amount of credit that otherwise would have been allowable absent the refinancing. This requires a determination of the amount of interest that would have been payable on the refinanced loan for the taxable year. The holder may determine this amount by—

(1) Applying the terms of the refinanced loan, including the variable interest rate or rates, for the taxable year as though the refinanced loan continued to exist; or

(2) Obtaining the amount of interest, and calculating the amount of credit that would have been available, from the schedule of equal payments that fully amortize a hypothetical loan with the principal amount equal to the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate, the interest equal to the annual percentage rate (APR) of the refinancing loan, and the maturity equal to that of the refinanced loan.

(b) The holder must apply the same method for each taxable year the tax credit is claimed based upon the reissued mortgage credit certificate.

(5) *Coordination with section 143(m)(3).* A refinancing loan underlying a reissued mortgage credit certificate that replaces a mortgage credit certificate issued on or before December 31, 1990, is not a federally subsidized indebtedness for the purposes of section 143(m)(3) of the Internal Revenue Code.

§ 1.25–3T [Amended}

Par. 3. Section 1.25–3T is amended by removing paragraphs (g)(1)(iii) and (p).

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 27, 1996.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 16, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 17, 1996, 61 F.R. 66212)

Section 42.—Low-Income Housing Credit

Low-income housing tax credit. This revenue ruling clarifies that section 502(e)(3) of the Tax Reform Act of 1986 does not prevent a taxpayer from claiming a low-income housing tax credit under section 42 of the Code for a building's credit period beginning after 1995.

Rev. Rul. 97–4

ISSUE

Does § 502(e)(3) of the Tax Reform Act of 1986 (Act) prevent a taxpayer from claiming a low-income housing tax credit under § 42 of the Internal Revenue Code for a building whose credit period begins after 1995?

FACTS

On January 1, 1995, taxpayer, *T*, purchased a residential rental building (Building) from seller, *S*. *S* was allowed the transition-rule benefits under Act § 502(a). *T* intends to substantially rehabilitate the Building and qualify the Building for a low-income housing tax credit under § 42. The credit period for the Building will begin in 1996.

LAW AND ANALYSIS

Act § 502 contains a transition rule for taxpayers investing in certain low-income housing properties that exempts them from the passive-loss rules under § 469. The rule applies for investments made after 1983 in housing property constructed or acquired pursuant to a binding written contract entered into by August 16, 1986. If a binding contract existed by that date, taxpayers who purchased an interest in the property by the close of 1986 (1988 if the interest was held through certain partnerships), and who had not contributed more than 50 percent of their capital obligation, could qualify for the transition rule. These taxpayers could claim passive losses on new low-income housing investments for a limited period of time if the properties were placed in service prior to January 1, 1989. After 1995, the transition-rule benefits of Act § 502 are no longer available to any taxpayer.

Section 42 provides a tax credit for investment in qualified low-income buildings placed in service after December 31, 1986.

A taxpayer may not claim a § 42 credit before the start of a building's 10-year credit period. Section 42(f) provides that the 10-year credit period for a building begins with the taxable year the building is placed in service, or, at the election of the taxpayer, the succeeding taxable year.

Act § 502 and § 42 can apply to the same type of property. To prevent a

taxpayer from obtaining a simultaneous tax benefit under both sections, Act § 502(e)(3) provides that no low-income housing credit under § 42 is available ''with respect to any project with respect to which any person has been allowed any benefit under [Act § 502].''

The transition-rule benefits under Act § 502 are not available to *S* in 1996 and future years. Thus, no simultaneous tax benefit under Act § 502 and § 42 is available after that date. Therefore, Act § 502(e)(3) does not prohibit *T* from claiming a § 42 low-income housing credit for the Building whose credit period begins after 1995.

HOLDING

Act § 502(e)(3) does not prevent a taxpayer from claiming a low-income housing tax credit under § 42 for a building whose credit period begins after 1995.

DRAFTING INFORMATION

The principal author of this revenue ruling is Christopher J. Wilson of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Mr. Wilson on (202) 622–3040 (not a toll-free call).

Section 108.—Income From Discharge of Indebtedness

26 CFR 1.108(c)–1: Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

T.D. 8688

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

Certain Elections Under the Omnibus Budget Reconciliation Act of 1993

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the time and manner of making certain elections under the Omnibus Budget Reconciliation Act of 1993. These regulations provide guidance to persons making the elections.

EFFECTIVE DATE: December 12, 1996.

FOR FURTHER INFORMATION CONTACT: George Bradley, 202–622–4920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1421. Responses to these collections of information are required to obtain the benefits of the particular election that is the subject of the collection.

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.

The estimated annual burden per respondent varies from 15 minutes to 45 minutes, depending on individual circumstances, with an estimated average of 30 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

This document contains final regulations relating to elections under the following sections of the Internal Revenue Code of 1986 (Code) and the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 312) (Act):

Act Section	Code Section
13114	1044(a)
13150	108(c)(3)(C)
13206(d)	163(d)(4)(B)(iii)
13225	6655(e)(2)(C)

On December 27, 1993, the **Federal Register** published temporary regulations (T.D. 8509 [1994–1 C.B. 24]) and a cross-reference notice of proposed rulemaking (IA–62–93 [1994–1 C.B. 803]), 58 FR 68300 and 58 FR 68336, respectively, relating to these elections. Three written comments responding to the regulations were submitted. Since none of the commentators requested a public hearing, one was not held. After consideration of the comments, the proposed regulations are adopted as final regulations subject to modifications to proposed § 1.108(c)–1, and the corresponding temporary regulations are removed. The comments and a description of the modifications to proposed § 1.108(c)–1 are discussed below.

Summary of Comments and Modifications

All three comments related to the election under section 163(d)(4)(B)(iii), which allows a taxpayer to take all or a portion of certain net capital gains, attributable to dispositions of property held for investment, into account as investment income. As a consequence, the capital gains affected by this election are not eligible for the maximum capital gain rate of 28 percent. The election must be made on Form 4952, Investment Interest Expense Deduction, on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized.

The commentators questioned the authority of the IRS to require a formal election, stated that a formal election will add to the complexity of filing individual income tax returns, and suggested that taxpayers be allowed to freely change the manner in which they treat long-term capital gains, as long as the taxable year is open. These comments were given careful consideration. However, they have not been incorporated into these final regulations. The IRS and the Treasury Department believe that the requirement of a formal election is supported by the language of section 163(d)(4)(B)(iii), is not unduly burdensome, and provides taxpayers with flexibility, since the election is revocable.

The final regulations modify the requirements for making the election for discharge of qualified real property business indebtedness under section 108(c). Under the previous temporary regulations a taxpayer was required to make

the election with the taxpayer's income tax return for the taxable year in which the discharge occurred, but was permitted to file an election with an amended return or claim for credit or refund if the taxpayer established reasonable cause for failure to file the election with the original return. The final regulations require the taxpayer to make the election on the timely-filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludible under section 108(a). Therefore, a taxpayer that fails to make the election on that return must request the Commissioner's consent to file a late election under § 301.9100–3T or any regulations that supersede § 301.9100–3T.

Special Analyses

It has been determined that these regulations are not significant rules as defined in Executive Order 12866. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is George Bradley, Office of Assistant Chief Counsel (Income Tax and Accounting), Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and the Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, parts 1 and 602 of title 26 of the Code of Federal Regulations are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for section 1.108(c)–1T and by adding an entry in numerical order to read as follows:

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

Section 1.108(c)–1 also issued under the authority of 26 U.S.C. 108(d)(9); * * *

§ 1.108(c)–1T [Removed]

Par. 2. Section 1.108(c)–1T is removed.

§ 1.163(d)–1T [Removed]

Par. 3. Section 1.163(d)–1T is removed.

§ 1.1044(a)–1T [Removed]

Par. 4. Section 1.1044(a)–1T is removed.

§ 1.6655(e)–1T [Removed]

Par. 5. Section 1.6655(e)–1T is removed.

Par. 6. Section 1.108(c)–1 is added to read as follows:

§ 1.108(c)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 108(c)(3)(C), as added by section 13150 of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103–66, 107 Stat. 446), allows certain noncorporate taxpayers to elect to treat certain indebtedness described in section 108(c)(3) that is discharged after December 31, 1992, as qualified real property business indebtedness. This discharged indebtedness is excluded from gross income to the extent allowed by section 108.

(b) *Time and manner for making election.* The election described in this section must be made on the timely-filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludible from gross income under section 108(a). The election is to be made on a completed Form 982, in accordance with that Form and its instructions.

(c) *Revocability of election.* The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date.* The rules set forth in this section are effective December 27, 1993.

Par. 7. Section 1.163(d)–1 is added to read as follows:

§ 1.163(d)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 163(d)(4)(B)-(iii), as added by section 13206(d) of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103–66, 107 Stat. 467), allows an electing taxpayer to take all or a portion of certain net capital gains, attributable to dispositions of property held for investment, into account as investment income. As a consequence, the capital gains affected by this election are not eligible for the maximum capital gain rate of 28 percent. The election may be made for net capital gains recognized by noncorporate taxpayers during any taxable year beginning after December 31, 1992.

(b) *Time and manner for making the election.* The election under section 163(d)(4)(B)(iii) must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized. The election is to be made on Form 4952, Investment Interest Expense Deduction, in accordance with the Form and its instructions.

(c) *Revocability of election.* The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date.* The rules set forth in this section are effective December 12, 1996.

Par. 8. Section 1.1044(a)–1 is added to read as follows:

§ 1.1044(a)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 1044(a), as added by section 13114 of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103–66, 107 Stat. 430), generally allows individuals and C corporations that sell publicly traded securities after August 9, 1993, to elect not to recognize certain gain from the sale if the taxpayer purchases common stock or a partnership interest in a specialized small business investment company (SSBIC) within the 60-day period beginning on the date the publicly traded securities are sold.

(b) *Time and manner for making the election.* The election under section 1044(a) must be made on or before the due date (including extensions) for the income tax return for the year in which the publicly traded securities are sold. The election is to be made by reporting the entire gain from the sale of publicly traded securities on Schedule D of the

income tax return in accordance with instructions for Schedule D, and by attaching a statement to Schedule D showing —

(1) How the nonrecognized gain was calculated;

(2) The SSBIC in which common stock or a partnership interest was purchased;

(3) The date the SSBIC stock or partnership interest was purchased; and

(4) The basis of the SSBIC stock or partnership interest.

(c) *Revocability of election.* The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date.* The rules set forth in this section are effective December 12, 1996.

Par. 9. Section 1.6655(e)–1 is added to read as follows.

§ 1.6655(e)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 6655(e)(2)-(C), as added by section 13225 of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103–66, 107 Stat. 486), allows a corporate taxpayer to make an annual election to use a different annualization period to determine annualized income for purposes of paying any required installment of estimated income tax for a taxable year beginning after December 31, 1993.

(b) *Time and manner for making the election.* An election under section 6655(e)(2)(C) must be made on or before the date required for the payment of the first required installment for the taxable year. For a calendar or fiscal year corporation, Form 8842, Election to Use Different Annualization Periods for Corporate Estimated Tax, must be filed by the 15th day of the 4th month of the taxable year for which the election is to apply. Form 8842 must be filed with the Internal Revenue Service Center where the corporation files its income tax return.

(c) *Revocability of election.* The election described in this section is irrevocable.

(d) *Effective date.* The rules set forth in this section are effective December 12, 1996.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 10. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 11. In § 602.101, paragraph (c) is amended as follows:

1. The following entries are removed from the table:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control no.
* * * * *	
1.108(c)–1T.	1545–1421
* * * * *	
1.163(d)–1T	1545–1421
* * * * *	
1.1044(a)–1T.	1545–1421
* * * * *	
1.6655(e)–1T.	1545–1421
* * * * *	

2. The following entries are added in numerical order to the table:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control no.
* * * * *	
1.108(c)–1.	1545–1421
* * * * *	
1.163(d)–1.	1545–1421
* * * * *	
1.1044(a)–1.	1545–1421
* * * * *	
1.6655(e)–1.	1545–1421
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 1, 1996.

Donald C. Lubick,
Acting, Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 11, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 12, 1996, 61 F.R. 65321)

Section 6695.—Other Assessable Penalties With Respect To the Preparation of Income Tax Returns for Other Persons

26 CFR 1.6695–1: Other assessable penalties with respect to the preparation of income tax returns for other persons.
(Also Sec. 6061; 301.6061–1)

T.D. 8689

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

Methods of Signing

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the methods of signing returns, statements, or other documents. The final regulations clarify that the IRS may prescribe a method other than pen and ink for signing any return, statement, or other document. This clarification will facilitate the IRS' implementation of paperless filings.

EFFECTIVE DATE: These regulations are effective on December 12, 1996.

FOR FURTHER INFORMATION CONTACT: Celia Gabrysh (202) 622–4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) and the Procedure and Administration Regulations (26 CFR part 301) that relate to signing returns, statements, and other documents. Section 6061 provides in part that ''. . . any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall be signed in accordance with forms or regulations prescribed by the Secretary.'' Traditionally, the IRS has accepted pen-to-paper signatures. The IRS will prescribe additional methods of signing to be used for electronically filed returns and other documents.

The final regulations clarify that the IRS may prescribe the specific method of signing any return, statement, or other document. The final regulations also provide that the IRS may require a return preparer to use a method of signing other than a pen-to-paper signa-

ture or a facsimile signature stamp when signing a return, statement, or other document.

On July 21, 1995, temporary regulations (T.D. 8603 [1995–2 C.B. 281]) relating to the signing of returns, statements, and other documents were published in the **Federal Register** (60 FR 37589). A notice of proposed rulemaking (IA–10–95 [1995–2 C.B. 478]) cross-referencing the temporary regulations was published in the **Federal Register** for the same day (60 FR 37621).

One comment responding to this notice was received. A public hearing was held on November 2, 1995. After consideration of the comment, the proposed regulations under sections 6061 and 6695 are adopted without change by this Treasury decision, and the corresponding temporary regulations are removed. The comment is discussed below.

Summary of Comments

The commentator suggested that the IRS prescribe by regulation any new method of signing any return, statement, or other document to allow the public to comment on the method's feasibility. Also, the commentator suggested that a regulation would constitute substantial authority and would provide broader public exposure.

The final regulations did not adopt the commentator's suggestion. The final regulations retain the full range of options for prescribing new methods of signing: forms, instructions, or other appropriate guidance. The final regulations provide the IRS with the flexibility to address the particular circumstances of any method of signing. The IRS will continue to inform the public about methods of signing.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Celia Gabrysh, Office of Assistant Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6695–1 is amended by revising the first sentence of paragraph (b)(1) to read as follows:

§ 1.6695–1 Other assessable penalties with respect to the preparation of income tax returns for other persons.

* * * * *

(b) * * * (1) Unless the Secretary has prescribed another method of signing pursuant to § 301.6061–1(b) on or after July 21, 1995, an individual who is an income tax return preparer with respect to a return of tax under subtitle A of the Internal Revenue Code (Code) or claim for refund of tax under subtitle A of the Code shall manually sign the return or claim for refund (which may be a photocopy) in the appropriate space provided on the return or claim for refund after it is completed and before it is presented to the taxpayer (or nontaxable entity) for signature. * * *

* * * * *

§ 1.6695–1T [Removed]

Par. 3. Section 1.6695–1T is removed.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 is amended by removing the entry for § 301.6061–1T and adding an entry in numerical order to read as follows:

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

Section 301.6061–1 also issued under 26 U.S.C. 6061; * * *

Par. 5. Section 301.6061–1 is revised to read as follows:

§ 301.6061–1 Signing of returns and other documents.

(a) *In general.* For provisions concerning the signing of returns and other documents, see the regulations relating to the particular tax.

(b) *Method of signing.* The Secretary may prescribe in forms, instructions, or other appropriate guidance the method of signing any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations.

(c) *Effective dates.* The rule in paragraph (a) is effective December 12, 1996. The rule in paragraph (b) is effective on July 21, 1995.

§ 301.6061–1T [Removed]

Par. 6. Section 301.6061–1T is removed.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 1, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 11, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 12, 1996, 61 F.R. 65319)

Part III. Administrative, Procedural, and Miscellaneous

Electing Small Business Trusts

Notice 97–12

PURPOSE

Section 1302 of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188, 110 Stat. 1755 (1996) (the Act) amended § 1361 of the Internal Revenue Code to permit an Electing Small Business Trust (ESBT) to be a shareholder of an S corporation. The Department of Treasury and the Internal Revenue Service intend to issue regulations to provide guidance on the application of § 1302 of the Act. This notice provides guidance in advance of the issuance of regulations regarding the ESBT election and the ESBT's consent to the S corporation election.

ESBT ELECTION

The trustee of the ESBT must make the ESBT election pursuant to § 1361(e)(3) by signing and filing with the service center with which the corporation files its income tax return a statement that—

(1) Contains the name, address, and taxpayer identification number of all potential current beneficiaries, the trust, and the corporation;

(2) Identifies the election as an election made under section 1361(e)(3);

(3) Specifies the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed);

(4) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and

(5) Provides all information and representations necessary to show that:

(A) All potential current beneficiaries meet the shareholder requirements of section 1361(b)(1); and

(B) The trust meets the definitional requirements of an ESBT under section 1361(e).

The trustee of the ESBT must file the ESBT election within the time requirements prescribed in regulation section 1.1361–1(j)(6)(iii) for filing Qualified Subchapter S Trust (QSST) elections (generally within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust). The trustee may attach the ESBT election to the Form 2553 in the case of newly electing S corporations.

ESBT CONSENT TO S CORPORATION ELECTION

Section 1362(a) provides that all shareholders must consent to the S corporation election. Section 1361(c)(2)(B) generally provides that all potential current beneficiaries of the ESBT are treated as shareholders for purposes of determining whether the corporation has eligible shareholders and whether the number of shareholders does not exceed 75, as provided by § 1361(b)(1). For purposes of the ESBT's consent to the S corporation election under § 1362(a), however, because the ESBT is taxed on the S corporation's income and the trustee makes the ESBT election, only the trustee need consent to the S corporation election.

PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1523.

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.

The collections of information in this notice are in the section headed *ESBT Election.* This information is required by the IRS to assure compliance with the new provisions of the Small Business Job Protection Act of 1996. The likely respondents are business or other for-profit institutions.

The estimated total reporting burden is 5,000 hours.

The estimated average burden per respondent is one hour. The estimated number of respondents is 5,000.

The estimated frequency of responses is once.

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.

DRAFTING INFORMATION

The principal author of this notice is Steven R. Schneider of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Steven R. Schneider at (202) 622–3060 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Allocations of Depreciation Recapture Among Partners in a Partnership

REG–209762–95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the allocation of depreciation recapture among partners in a partnership. The proposed regulations amend existing regulations to require that any gain characterized as depreciation recapture must be allocated to each partner in an amount equal to the lesser of the partner's share of total gain from the sale of the property or the partner's share of depreciation from the property. The proposed regulations affect partnerships and their partners. This document also contains a notice of public hearing on the proposed regulations.

DATES: Written comments must be received by March 6, 1997. Outlines of oral comments and requests to speak at the public hearing scheduled for March 27, 1997, at 10 a.m., must be received by March 6, 1997.

ADDRESSES: Send submissions to CC:DOM:CORP:R [REG–209762–95], 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:DOM:CORP:R [REG–209762–95], 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/prod/tax_regs/comments.html. The public hearing will be held in room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Daniel J. Coburn or Deborah Harrington, (202) 622–3050 (not a toll-free number); concerning submissions and the hearing, Evangelista Lee, (202) 622–7190 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document proposes to change the current Income Tax Regulations (26 CFR part 1) relating to the characterization and allocation of depreciation recapture among partners in a partnership.

Section 1245 of the Internal Revenue Code requires taxpayers to recharacterize as ordinary income some or all of the gain on the disposition of certain types of business properties. The amount recharacterized as ordinary income (recapture gain) is the lesser of: (a) the gain realized on disposition, or (b) the total deductions allowed or allowable for depreciation or amortization from the property. Section 1.1245–1(e)(2) of the Income Tax Regulations currently provides that each partner's share of recapture gain will generally be determined in accordance with the provisions of section 704. The regulations also provide that, if the partnership agreement provides for the allocation of total gain from the property but does not provide for the allocation of recapture gain, recapture gain is allocated in the same manner as total gain.

The current regulations create some uncertainty because it is unclear how recapture gain is allocated under section 704. The allocation of recapture gain cannot have substantial economic effect because classifying a portion of the gain as recapture gain merely changes the tax character of the gain. In addition, by allowing the partnership to allocate recapture gain in the same manner as total gain, the current regulations increase the possibility that a partner may receive an allocation of recapture gain in excess of the partner's share of depreciation from the property. For example, if a partner acquires an interest in a partnership that has fully depreciated the property and the property is subsequently sold at a gain, the partner may be allocated a portion of the total gain and a portion of the recapture gain, even though the partner did not receive any depreciation deductions from the property. This mismatch between depreciation allocations and recapture allocations should be minimized because recapture gain is intended to offset the earlier depreciation deductions taken from the property and should therefore be allocated to the extent possible to the partner that received those depreciation deductions. Finally, the current regulations do not provide guidance on the allocation of recapture gain from contributed property subject to section 704(c). In the legislative history of the 1984 amendment to section 704(c), Congress suggested that Treasury and the Service issue regulations governing the allocation of recapture gain inherent in property contributed to a partnership. *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 857 (1984); *see also* Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 214 (Comm. Print 1984). In the 1994 preamble to the section 704(c) final regulations, Treasury and the Service indicated that this issue would be considered in a separate regulations project. 59 Fed. Reg. 66,726 (1994).

Explanation of Provisions

The proposed regulations provide guidance on allocating recapture gain among partners, including recapture gain attributable to contributed property. The proposed regulations provide that a partner's share of recapture gain is equal to the lesser of (1) the partner's share of total gain arising from the disposition of the property, or (2) the partner's share of depreciation or amortization from the property. This rule seeks to insure, to the extent possible, that a partner recognizes recapture on the disposition of property in an amount equal to the depreciation or amortization deductions previously taken by the partner on the property. If recapture gain remains unallocated under the general rule, the remaining unallocated gain is allocated among those partners whose shares of total gain on the disposition of the property exceed their shares of depreciation or amortization with respect to the property. Recapture gain may be unallocated under the general rule if, for example, the total gain allocated to a partner on the sale of the property is less than the amount of depreciation previously allocated to that partner.

The proposed regulations provide special rules for determining a partner's share of depreciation or amortization from contributed property subject to section 704(c). The proposed regulations provide that a contributing partner's share of depreciation or amortization

includes depreciation or amortization allowed or allowable prior to contribution. In addition, the proposed regulations provide that curative and remedial allocations generally reduce the contributing partner's share of depreciation or amortization and increase the noncontributing partners' shares of depreciation or amortization.

Treasury and the Service request comments on whether these special rules can be incorporated into accounting systems that track section 704(c) allocations for partnerships with multiple section 704(c) properties.

Proposed Effective Date

These amendments are proposed to apply to properties acquired by a partnership on or after the date the regulations are published as final regulations 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 EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 27, 1997, at 10:00 a.m. in room 3313 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, 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 March 6, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 6, 1997.

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

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

Drafting Information

The principal authors of these regulations are Daniel J. Coburn and Deborah Harrington, Office of Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

PART 1 — INCOME TAXES

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

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

Par. 2. Section 1.704–3 is amended as follows:

1. Paragraphs (a)(9) and (a)(10) are redesignated as paragraphs (a)(10) and (a)(11), respectively.

2. New paragraph (a)(9) is added. The addition reads as follows:

§ 1.704–3 Contributed property.

(a) * * *

(9) *Contributing and noncontributing partners' recapture shares.* For special rules applicable to the allocation of recapture gain with respect to property contributed by a partner to a partnership, see § § 1.1245–1(e)(2) and 1.1250–1(f).

* * * * *

Par. 3. Section 1.1245–1 is amended by revising paragraph (e)(2) to read as follows:

§ 1.1245–1 General rule for treatment of gain from dispositions of certain depreciable property.

* * * * *

(e) * * *

(2)(i) Unless paragraph (e)(3) of this section applies, a partner's distributive share of gain recognized under section 1245(a)(1) by the partnership is equal to the lesser of the partner's share of the total gain from the disposition of the property or the partner's share of the depreciation or amortization with respect to the property. Any gain recognized under section 1245(a)(1) by the partnership that is not allocated under the first sentence of this paragraph is allocated among the partners whose shares of total gain exceed their shares of depreciation or amortization with respect to the property and is allocated to those partners in proportion to (but not in excess of) their shares of the total gain (including gain recognized under section 1245(a)(1)) from the disposition of the property.

(ii) A partner's share of depreciation or amortization with respect to property equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property. If a partner transfers a partnership interest, a share of depreciation or amortization must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the partner transfers a portion of the partnership interest, a share of depreciation or amortization proportionate to the interest transferred must be allocated to the transferee partner.

(iii)(A) A partner's share of depreciation or amortization with respect to property contributed by the partner includes the amount of depreciation or amortization allowed or allowable to the partner for the period prior to the property's contribution.

(B) The partners' shares of depreciation or amortization with respect to property contributed by a partner must be adjusted to account for any curative allocations. (See § 1.704–3(c) for a description of the curative allocation method). The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any curative allocation of ordinary income to the contributing partner with respect to the contributed property and by the amount of any curative allocation of deduction or loss (other than capital loss) allocated to the noncontributing partners with respect to the contributed property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the noncontributing partner's share of any curative allocation of ordinary income to the contributing partner with respect to the contributed property and by the amount

of any curative allocation of deduction or loss (other than capital loss) allocated to the noncontributing partner with respect to the contributed property. The partners' shares of depreciation or amortization with respect to property from which curative allocations of depreciation or amortization are taken is determined without regard to those curative allocations.

(C) The partners' shares of depreciation or amortization with respect to property contributed by a partner must be adjusted to account for any remedial allocations. (See § 1.704–3(d) for a description of the remedial allocation method). The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any remedial allocation of ordinary income to the contributing partner with respect to the contributed property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the amount of any remedial allocation of depreciation or amortization to the noncontributing partner with respect to the contributed property.

(D) The principles of this paragraph (e)(2)(iii) apply in determining the effect of remedial or curative allocations on a partner's share of depreciation or amortization with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704–1(b)(2)(iv)(f).

(iv) Examples. The application of this paragraph (e)(2) may be illustrated by the following examples:

Example 1. Recapture allocations. (i) *Facts.* A and B each contribute $5,000 cash to form AB, a general partnership. The partnership agreement provides that depreciation deductions will be allocated 90 percent to A and 10 percent to B, and, on the sale of depreciable property, A will first be allocated gain to the extent necessary to equalize A's and B's capital accounts. Any remaining gain will be allocated 50 percent to A and 50 percent to B. In its first year of operations, AB purchases depreciable equipment for $5,000. AB depreciates the equipment over its 5-year recovery period and elects to use the straight-line method. In its first year of operations, AB's operating income equals its expenses (other than depreciation).

(ii) *Year 1.* In its first year of operations, AB has $1,000 of depreciation from the partnership equipment. (To simplify this example, the partnership's depreciation deductions are determined without regard to any first-year depreciation conventions.) In accordance with the partnership agreement, AB allocates 90 percent ($900) of the depreciation to A and 10 percent ($100) of the depreciation to B. At the end of the year, AB sells the equipment for $5,200, recognizing $1,200 of gain ($5,200 amount realized less $4,000 adjusted tax basis). In accordance with the partnership agreement, the first $800 of gain is allocated to A to equalize the partners' capital accounts, and the remaining $400 of gain is allocated $200 to A and $200 to B.

(iii) *Recapture allocations.* $1,000 of the gain from the sale of the equipment is treated as gain recognized under section 1245(a)(1). Under paragraph (e)(2)(i) of this section, each partner's share of this section 1245 gain is the lesser of the partner's share of total gain recognized on the sale of the equipment or the partner's share of total depreciation with respect to the equipment. Thus, A's share of the section 1245 gain is $900 (the lesser of A's share of total gain ($1,000) and A's share of depreciation ($900)) and B's share of the section 1245 gain is $100 (the lesser of B's share of total gain ($200) and B's share of depreciation ($100)). Accordingly, $900 of the $1,000 of total gain allocated to A will be treated as ordinary income and $100 of the $200 of total gain allocated to B will be treated as ordinary income.

Example 2. Recapture allocation limited by gain share. Assume the same facts as in *Example 1*, except that the partnership agreement provides that gains and losses from the sale of depreciable property will be allocated equally between the partners. On the sale of the equipment, the partnership's total gain of $1,200 is allocated $600 to A and $600 to B. Under paragraph (e)(2)(i) of this section, A's share of the section 1245 gain is limited to $600 (the amount of total gain allocated to A) even though A's share of the total depreciation from the equipment was $900. The remaining $400 of section 1245 gain must be allocated to B. Accordingly, all $600 of total gain allocated to A is treated as ordinary income and $400 of the $600 of total gain allocated to B is treated as ordinary income.

Example 3. Determination of partners' shares of depreciation with respect to contributed property. (i) *Facts.* C and D form partnership CD as equal partners. C contributes depreciable personal property C1 with an adjusted tax basis of $800 and a fair market value of $2,800. D contributes $2,800 cash. Prior to contributing C1, C claimed $200 of depreciation from C1. At the time of contribution, C1 has four years remaining on its 5-year recovery period and is depreciable under the straight-line method. At the time CD is formed, it purchases depreciable personal property D1 for $2,800, which is depreciable over seven years under the straight-line method. (To simplify the example, all depreciation is determined without regard to any first-year depreciation conventions).

(ii) *Traditional method.* C and D will each be allocated $350 of the total of $700 of book depreciation from C1 in year 1. Under the traditional method of making section 704(c) allocations, C will not be allocated any tax depreciation from C1 and D will be allocated the entire $200 of tax depreciation from C1. C and D will each be allocated $200 of book and tax depreciation from D1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 is $200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 is $200 (the amount of tax depreciation allocated to D). C and D each have a $200 share of depreciation with respect to D1.

(iii) *Effect of curative allocations.* If the partnership elects to make curative allocations under § 1.704–3(c) using depreciation from D1, the results in year 1 will be the same as under the traditional method, except that $150 of the $200 of tax depreciation from D1 that would have been allocated to C under the traditional method will be allocated to D as additional depreciation with respect to C1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 will be reduced to $50 (the total depreciation taken by C prior to contribution ($200) decreased by the amount of the curative allocation to D ($150)). C's share of depreciation with respect to D1 will still be $200 and D's share of depreciation with respect to C1 will be $350 (the depreciation allocated to D under the traditional method ($200) increased by the amount of the curative allocation to D ($150)). D's share of depreciation with respect to D1 will still be $200.

(iv) *Effect of remedial allocations.* If the partnership elects the remedial allocation method for making section 704(c) allocations under § 1.704–3(d), there will be $600 of total book depreciation from C1 in year 1. (Under the remedial allocation method, the amount by which C1's book basis ($2,800) exceeds its tax basis ($800) is depreciated over a 5-year life, rather than a 4-year life). C and D will each be allocated one-half ($300) of the total book depreciation. As under the traditional method, C will be allocated $0 of tax depreciation from C1 and D will be allocated $200 of tax depreciation from C1. Because the ceiling rule would cause a disparity of $100 between D's book and tax allocations of depreciation, D will also receive a $100 remedial allocation of depreciation with respect to C1, and C will receive a $100 remedial allocation of income with respect to C1. As a result, after the first year of partnership operations, D's share of depreciation with respect to C1 is $300 (the depreciation allocated to D under the traditional method ($200) increased by the amount of the remedial allocation ($100)). C's share of depreciation with respect to C1 is $100 (the total depreciation taken by C prior to contribution ($200) decreased by the amount of the remedial allocation of income ($100)). As under the traditional method, C and D each have a $200 share of depreciation with respect to D1.

(v) *Effective date.* This paragraph (e)(2) is effective for properties acquired by the partnership on or after the date the regulations are published as final regulations in the **Federal Register**.

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 11, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 12, 1996, 61 F.R. 65371)

Inadvertent Invalid S Elections and Late S Elections

Announcement 97–4

This announcement informs taxpayers of a recently enacted Internal Revenue Code provision that allows the Internal Revenue Service (IRS) to treat a late subchapter S election as timely made and to waive the defects in an inadvertent invalid S election.

Section 1305 of the Small Business Job Protection Act, Pub. L. No. 104–188, 110 Stat. 1755, enacted August 20, 1996, amends §§ 1362(b) and (f) of the

Internal Revenue Code, effective for taxable years beginning after December 31, 1982.

I. LATE SUBCHAPTER S ELECTIONS

A small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. Under prior law, the IRS did not have the authority to validate a late election.

New § 1362(b)(5) of the Code allows the Secretary to treat an election to be an S corporation as timely filed if either the election is made after the date prescribed or no such election was made, provided the Secretary determines there was reasonable cause for the failure to timely file the S election.

Generally, in order to obtain relief under § 1362(b)(5) of the Code, a taxpayer must receive a private letter ruling from the IRS. The procedural requirements for requesting a ruling are described in Revenue Procedure 97–1, 1997–1 I.R.B.

However, a special transition rule for seeking relief under § 1362(b)(5) is provided for untimely S corporation elections made for a taxable year beginning in 1996. Under this rule, taxpayers who did not file an S corporation election in a timely fashion for the 1996 taxable year may seek relief under § 1362(b)(5) of the Code by submitting on or before February 15, 1997, an S corporation election to the applicable service center as well as a letter explaining the reasonable cause for the untimely S corporation election.

Any taxpayer who is not eligible for the relief under the special transition rule described above may request relief by applying for a private letter ruling.

II. INADVERTENT INVALID S CORPORATION ELECTIONS

Under prior law, if the IRS determined that a corporation's subchapter S election was inadvertently terminated, the IRS could waive the effect of the terminating event for any period if the corporation timely corrected the event and if the shareholders agreed to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Prior law did not grant the IRS the ability to waive the effect of an inadvertent invalid subchapter S election.

New § 1362(f) of the Code applies the inadvertent termination relief rules in situations where an election by a corporation to be treated as a small business corporation was invalid due to a failure to meet the requirements of an S corporation found in § 1361(b) or to obtain all of the shareholder consents.

Generally, in order to obtain relief for inadvertent invalid elections, the corporation must request a private letter ruling from the IRS. Sections 1.1362–4(c) through (f) of the Income Tax Regulations provide rules for corporations requesting inadvertent termination relief under § 1362(f). These rules will also apply to corporations requesting inadvertent invalid election relief.

In situations where taxpayers fail to obtain all of the necessary shareholder consents on Form 2553, section 1.1362–6(b)(3)(iii) provides rules for obtaining § 1362(f) relief from the district director or director of the service center with which the corporation files its income tax return.

III. PAPERWORK REDUCTION ACT

The collection of information contained in this announcement has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1524.

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.

The collection of information in this announcement is in part I. LATE SUBCHAPTER S ELECTIONS. This information is required to be submitted to the applicable service center in order to obtain late S corporation election relief. This information will be used to determine if the reasonable cause requirement in § 1362(b)(5) has been met. The collection of information is required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting burden is 800 hours.

The estimated annual burden per respondent is 1 hour. The estimated number of respondents is 800.

This announcement provides for a single response that must be completed by February 15, 1997.

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.

The principal author of this announcement is Mark D. Harris of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this announcement contact Mr. Harris at (202) 622–3050 (not a toll-free call).

New Form 8832, Entity Classification Election, Now Available

Announcement 97–5

Final regulations under section 7701 of the Internal Revenue Code became effective on January 1, 1997. The new regulations allow certain business entities to choose their classification for Federal tax purposes under an elective regime. Under the regulations, any business entity that is not required to be treated as a corporation is an ''eligible entity'' that may choose its classification. In order to provide most eligible entities with the classification they would choose without requiring them to file an election, the regulations provide default classification rules. For example, under the default rules, a domestic eligible entity will be treated as a partnership if it has two or more members, and disregarded as an entity separate from its owner if it has a single owner.

Form 8832 was developed for eligible entities that choose **not** to be classified under the default rules or that wish to change their previous classification. The IRS will use the information entered on Form 8832 to establish the entity's filing and reporting requirements for Federal tax purposes.

Form 8832 is available electronically through the IRS Home Page on the World Wide Web (http://www.irs.ustreas.gov) or by modem directly to 703–321–8020 (not a toll-free number). You may also order Form 8832 by calling 1–800–TAX–FORM (1–800–829–3676).

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

A—Individual.

Acq.—Acquiescence.

B—Individual.

BE—Beneficiary.

BK—Bank.

B.T.A.—Board of Tax Appeals.

C.—Individual.

C.B.—Cumulative Bulletin.

CFR—Code of Federal Regulations.

CI—City.

COOP—Cooperative.

Ct.D.—Court Decision.

CY—County.

D—Decedent.

DC—Dummy Corporation.

DE—Donee.

Del. Order—Delegation Order.

DISC—Domestic International Sales Corporation.

DR—Donor.

E—Estate.

EE—Employee.

E.O.—Executive Order.

ER—Employer.

ERISA—Employee Retirement Income Security Act.

EX—Executor.

F—Fiduciary.

FC—Foreign Country.

FICA—Federal Insurance Contribution Act.

FISC—Foreign International Sales Company.

FPH—Foreign Personal Holding Company.

F.R.—Federal Register.

FUTA—Federal Unemployment Tax Act.

FX—Foreign Corporation.

G.C.M.—Chief Counsel's Memorandum.

GE—Grantee.

GP—General Partner.

GR—Grantor.

IC—Insurance Company.

I.R.B.—Internal Revenue Bulletin.

LE—Lessee.

LP—Limited Partner.

LR—Lessor.

M—Minor.

Nonacq.—Nonacquiescence.

O—Organization.

P—Parent Corporation.

PHC—Personal Holding Company.

PO—Possession of the U.S.

PR—Partner.

PRS—Partnership.

PTE—Prohibited Transaction Exemption.

Pub. L.—Public Law.

REIT—Real Estate Investment Trust.

Rev. Proc.—Revenue Procedure.

Rev. Rul.—Revenue Ruling.

S—Subsidiary.

S.P.R.—Statements of Procedural Rules.

Stat.—Statutes at Large.

T—Target Corporation.

T.C.—Tax Court.

T.D.—Treasury Decision.

TFE—Transferee.

TFR—Transferor.

T.I.R.—Technical Information Release.

TP—Taxpayer.

TR—Trust.

TT—Trustee.

U.S.C.—United States Code.

X—Corporation.

Y—Corporation.

Z—Corporation.

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[1]A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1996–27 through 1996–53 will be found in Internal Revenue Bulletin 1997–1, dated January 6, 1997.