Internal Revenue
bulletin

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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. 97–49, page 4.
1997 base period T-bill rate. The "base period T-bill rate" for the period ending September 30, 1997, is published, as required by section 995(f)(4) of the Code.

REG–105162–97, page 13.
Proposed regulations under section 7701 of the Code describe how elective changes in entity classification will be treated for Federal tax purposes. A public hearing will be held on February 24, 1998.

REG–251985–96, page 18.
Proposed regulations under section 863 of the Code relate to the source of income from sales of inventory produced in the United States and sold in a U.S. possession or produced in a U.S. possession and sold in the United States. A public hearing will be held on January 29, 1998.

Notice 97–66, page 8.
Securities lending transaction notice. Guidance is provided to payors of substitute interest payments made after November 13, 1997, and before January 1, 1999, to comply with the statement requirement of section 871(h)(5) of the Code in order to qualify the payments as portfolio interest payments for purposes of the tax imposed under sections 871 and 881 of the Code. Guidance is also provided to determine the amount of tax imposed and withheld on substitute dividend payments made by one foreign person to another foreign person.

Notice 97–68, page 11.
This notice informs taxpayers that the rules in sections 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i)(e) of the proposed Income Tax regulations, published in REG–209823–96, 1997–18 I.R.B. 47, will not be effective for certain charitable remainder trusts for the 1997 tax year.

EMPLOYEE PLANS

Notice 97–69, page 12.
Weighted average interest rate update. Guidelines are set forth for determining for November 1997 the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code as amended by the Omnibus Budget Reconciliation Act of 1987 and by the Uruguay Round Agreements Act (GATT).

EXEMPT ORGANIZATIONS

Announcement 97–116, page 25.
A list is provided of organizations now classified as private foundations.

ADMINISTRATIVE

Notice 97–61, page 8.
This notice informs the public of the Service's Year 2000 Date Standard Policy.

Notice 97–67, page 10.
Accounting method requests for grace period interest. This notice informs taxpayers that the Service will issue guidance that provides the procedures for a taxpayer to automatically change its method of accounting to comply with section 1004 of the Taxpayer Relief Act of 1997 for the taxpayer's first taxable year beginning after August 5, 1997. The notice provides that the Service will not grant any requests filed on or after August 5, 1997, to change to a method of accounting for grace period interest other than the method required by section 1004 of the Act.

Finding Lists begin on page 28.
Index for July–November begins on page 30.

Department of the Treasury
Internal Revenue Service

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

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

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 861.—Income From Sources Within the United States

26 CFR 1.861–2: Interest.

Guidance is provided to the payors of U.S. source substitute interest payments made after November 13, 1997, and before January 1, 1999, for complying with the statement requirement of § 871(h)(5) in order to qualify as portfolio interest. See Notice 97–66, page 8.

26 CFR 1.861–3: Dividends.

Guidance is provided on the determination of the amount of tax imposed under §§ 871 and 881 on U.S. source substitute dividend payments which are made by a foreign person to another foreign person (“foreign-to-foreign” payments).

Section 864.—Definitions and Special Rules

26 CFR 1.864–5: General provisions relating to withholding agent.

A general election to defer the effective date of final securities lending regulations (published October 14, 1997, TD 8735, 62 FR 53498) for substitute payments made after November 13, 1997, to January 1, 1999, does not apply for substitute interest and substitute dividend payments received that are foreign source effectively connected income under § 1.864–5(b)(2) of the final regulations. Notice 97–66, page 8.

Section 871.—Tax on Nonresident Alien Individuals

26 CFR 1.871–7: Taxation of nonresident alien individuals not engaged in U.S. business.

Guidance is provided as to the amount of tax to be imposed under § 1.871–7(b)(2) with respect to substitute interest or substitute dividend payments made by one foreign person to another foreign person. See Notice 97–66, page 8.

26 CFR 1.871–14: Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.

Guidance is provided to payors of substitute interest payments made after November 13, 1997, and before January 1, 1999, *i.e.*, prior to the effective date of §1.871–14, for complying with the statement requirement of § 871(h)(5) in order to qualify the payments as portfolio interest payments for purposes of the tax imposed under §§ 871 and 881. See Notice 97–66, page 8.

Section 881.—Tax on Income of Foreign Corporations Not Connected With United States Business

26 CFR 1.881–2: Income of foreign corporations treated as effectively connected with U.S. business.

Guidance is provided as to the amount of tax to be imposed under § 1.881–2(b)(2) with respect to substitute interest or substitute dividend payments made by one foreign person to another foreign person. See Notice 97–66, page 8.

Section 995.—Taxation of DISC Income to Shareholders

1997 base period T-bill rate. The “base period T-bill rate” for the period ending September 30, 1997, is published, as required by section 995(f)(4) of the Code.

Rev. Rul. 97–49

Section 995(f)(l) of the Internal Revenue Code provides that a shareholder of a DISC shall pay interest each taxable year in an amount equal to the product of the shareholder’s DISC-related deferred tax liability for the year and the “base period T-bill rate.” Under section 995(f)(4), the base period T-bill rate is the annual rate of interest determined by the Secretary to be equivalent to the average investment yield of United States Treasury bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with (or of the most recent calendar year ending before) the close of the taxable year of the shareholder. The base period T-bill rate for the period ending September 30, 1997, is 5.68 percent.

Pursuant to section 6622 of the Code, interest must be compounded daily. The table below provides factors for compounding the base period T-bill rate daily for any number of days in the shareholder’s taxable year (including a 52–53 week accounting period) for the 1997 base period T-bill rate. To compute the amount of the interest charge for the shareholder’s taxable year, multiply the amount of the shareholder’s DISC-related deferred tax liability (as defined in section 995(f)(2)) for that year by the base period T-bill rate factor corresponding to the number of days in the shareholder’s taxable year for which the interest charge is being computed. Generally, one would use the factor for 365 days. One would use a different factor only if the shareholder’s taxable year for which the interest charge being determined is a short taxable year, if the shareholder uses the 52-53 week taxable year, or if the shareholder’s taxable year is a leap year.

For the base period T-bill rates for the periods ending in prior years, *see*: Rev. Rul. 86–132, 1986–2 C.B. 137; Rev. Rul. 87–129, 1987–2 C.B. 196; Rev. Rul. 88–94, 1988–2 C.B. 301; Rev. Rul. 89–116, 1989–2 C.B. 197; Rev. Rul. 90–96, 1990–2 C.B. 188; Rev. Rul. 91–59, 1991–2 C.B. 347; Rev. Rul. 92–98, 1992–2 C.B. 201; Rev. Rul. 93–77, 1993–2 C.B. 253; Rev. Rul. 94–68, 1994–2 C.B. 177; Rev. Rul. 95–77, 1995–2 C.B. 122; and Rev. Rul. 96–55, 1996–2 C.B. 57.

DRAFTING INFORMATION

The principal author of this revenue ruling is David Bergkuist of the Office of the Associate Chief Counsel (International). For further information about this revenue ruling, contact Mr. Bergkuist on (202) 622-3850 (not a toll-free call).

1997 ANNUAL RATE, COMPOUNDED DAILY

DAYS	5.68 PERCENT FACTOR
1	.000155616
2	.000311257
3	.000466922
4	.000622611
5	.000778324
6	.000934062
7	.001089824
8	.001245610
9	.001401420
10	.001557255
11	.001713113
12	.001868996
13	.002024904
14	.002180835
15	.002336791
16	.002492771
17	.002648775
18	.002804804

1997 ANNUAL RATE, COMPOUNDED DAILY	
DAYS	5.68 PERCENT FACTOR
19	.002960857
20	.003116934
21	.003273036
22	.003429161
23	.003585312
24	.003741486
25	.003897685
26	.004053908
27	.004210155
28	.004366426
29	.004522722
30	.004679043
31	.004835387
32	.004991756
33	.005148149
34	.005304567
35	.005461009
36	.005617475
37	.005773966
38	.005930481
39	.006087020
40	.006243584
41	.006400172
42	.006556784
43	.006713421
44	.006870082
45	.007026768
46	.007183478
47	.007340212
48	.007496971
49	.007653754
50	.007810561
51	.007967393
52	.008124249
53	.008281130
54	.008438035
55	.008594965
56	.008751919
57	.008908897
58	.009065900
59	.009222927
60	.009379979
61	.009537055
62	.009694155
63	.009851280

1997 ANNUAL RATE, COMPOUNDED DAILY	
DAYS	5.68 PERCENT FACTOR
64	.010008430
65	.010165604
66	.010322802
67	.010480025
68	.010637272
69	.010794544
70	.010951840
71	.011109161
72	.011266506
73	.011423876
74	.011581270
75	.011738689
76	.011896132
77	.012053600
78	.012211092
79	.012368608
80	.012526150
81	.012683715
82	.012841306
83	.012998920
84	.013156560
85	.013314223
86	.013471912
87	.013629625
88	.013787362
89	.013945124
90	.014102911
91	.014260722
92	.014418557
93	.014576418
94	.014734302
95	.014892212
96	.015050146
97	.015208104
98	.015366087
99	.015524095
100	.015682127
101	.015840184
102	.015998265
103	.016156371
104	.016314502
105	.016472657
106	.016630837
107	.016789042
108	.016947271

1997 ANNUAL RATE, COMPOUNDED DAILY	
DAYS	5.68 PERCENT FACTOR
109	.017105524
110	.017263803
111	.017422106
112	.017580433
113	.017738786
114	.017897162
115	.018055564
116	.018213990
117	.018372441
118	.018530916
119	.018689417
120	.018847941
121	.019006491
122	.019165065
123	.019323664
124	.019482287
125	.019640936
126	.019799609
127	.019958306
128	.020117028
129	.020275775
130	.020434547
131	.020593343
132	.020752165
133	.020911010
134	.021069881
135	.021228776
136	.021387696
137	.021546641
138	.021705610
139	.021864604
140	.022023623
141	.022182667
142	.022341736
143	.022500829
144	.022659947
145	.022819089
146	.022978257
147	.023137449
148	.023296666
149	.023455908
150	.023615174
151	.023774466
152	.023933782
153	.024093123

1997 ANNUAL RATE, COMPOUNDED DAILY

DAYS	5.68 PERCENT FACTOR
154	.024252489
155	.024411879
156	.024571294
157	.024730734
158	.024890199
159	.025049689
160	.025209204
161	.025368743
162	.025528307
163	.025687896
164	.025847510
165	.026007149
166	.026166813
167	.026326501
168	.026486214
169	.026645953
170	.026805716
171	.026965503
172	.027125316
173	.027285154
174	.027445016
175	.027604903
176	.027764816
177	.027924753
178	.028084715
179	.028244702
180	.028404713
181	.028564750
182	.028724812
183	.028884898
184	.029045010
185	.029205146
186	.029365307
187	.029525493
188	.029685704
189	.029845940
190	.030006201
191	.030166487
192	.030326798
193	.030487134
194	.030647495
195	.030807880
196	.030968291
197	.031128727
198	.031289187

1997 ANNUAL RATE, COMPOUNDED DAILY

DAYS	5.68 PERCENT FACTOR
199	.031449673
200	.031610183
201	.031770719
202	.031931279
203	.032091865
204	.032252475
205	.032413111
206	.032573771
207	.032734457
208	.032895167
209	.033055902
210	.033216663
211	.033377448
212	.033538259
213	.033699094
214	.033859955
215	.034020841
216	.034181751
217	.034342687
218	.034503648
219	.034664633
220	.034825644
221	.034986680
222	.035147741
223	.035308827
224	.035469938
225	.035631074
226	.035792236
227	.035953422
228	.036114633
229	.036275870
230	.036437131
231	.036598418
232	.036759730
233	.036921067
234	.037082428
235	.037243816
236	.037405228
237	.037566665
238	.037728127
239	.037889615
240	.038051128
241	.038212666
242	.038374229
243	.038535817

1997 ANNUAL RATE, COMPOUNDED DAILY

DAYS	5.68 PERCENT FACTOR
244	.038697430
245	.038859068
246	.039020732
247	.039182420
248	.039344134
249	.039505873
250	.039667638
251	.039829427
252	.039991242
253	.040153081
254	.040314946
255	.040476836
256	.040638752
257	.040800692
258	.040962658
259	.041124649
260	.041286665
261	.041448706
262	.041610773
263	.041772864
264	.041934981
265	.042097124
266	.042259291
267	.042421484
268	.042583702
269	.042745945
270	.042908213
271	.043070507
272	.043232826
273	.043395170
274	.043557539
275	.043719934
276	.043882354
277	.044044799
278	.044207270
279	.044369766
280	.044532287
281	.044694833
282	.044857405
283	.045020002
284	.045182624
285	.045345272
286	.045507945
287	.045670643
288	.045833366

DAYS	1997 ANNUAL RATE, COMPOUNDED DAILY 5.68 PERCENT FACTOR
289	.045996115
290	.046158889
291	.046321689
292	.046484514
293	.046647364
294	.046810240
295	.046973140
296	.047136067
297	.047299018
298	.047461995
299	.047624998
300	.047788025
301	.047951078
302	.048114157
303	.048277260
304	.048440390
305	.048603544
306	.048766724
307	.048929929
308	.049093160
309	.049256416
310	.049419698
311	.049583005
312	.049746337
313	.049909695
314	.050073078
315	.050236487
316	.050399921
317	.050563380
318	.050726865
319	.050890376
320	.051053912
321	.051217473
322	.051381060
323	.051544672
324	.051708309
325	.051871972
326	.052035661
327	.052199375
328	.052363115
329	.052526880
330	.052690670
331	.052854486
332	.053018327
333	.053182194
334	.053346087
335	.053510005
336	.053673948
337	.053837917
338	.054001912
339	.054165932
340	.054329977
341	.054494048
342	.054658145
343	.054822267
344	.054986415
345	.055150588
346	.055314787
347	.055479011
348	.055643261
349	.055807537
350	.055971838
351	.056136164
352	.056300516
353	.056464894
354	.056629297
355	.056793726
356	.056958181
357	.057122661
358	.057287166
359	.057451698
360	.057616255
361	.057780837
362	.057945445
363	.058110079
364	.058274738
365	.058439423
366	.058604134
367	.058768870
368	.058933632
369	.059098419
370	.059263232
371	.059428071

Section 1441.—Withholding of Tax on Nonresident Aliens

26 CFR 1.1441–7: Requirement for the deduction and withholding of tax on payments to foreign persons.

Guidance is provided to payors of substitute interest and dividend concerning their obligations as withholding agents on payments made to foreign beneficial owners that are individuals. See Notice 97–66, page 8.

Section 1442.—Withholding of Tax on Nonresident Corporations

26 CFR 1.1441–7: Requirement for the deduction and withholding of tax on payments to foreign persons.

Guidance is provided to payors of substitute interest and dividend concerning their obligations as withholding agents on payments made to foreign beneficial owners that are corporations. See Notice 97–66, page 8.

Part III. Administrative, Procedural, and Miscellaneous

Notice 97–61

The Internal Revenue Service has undertaken a large-scale effort to address the year 2000 issue. The Year 2000 Conversion Project's primary goal is to make all current and future IRS information systems year 2000 compliant. That is, ensure that all computer systems function correctly before and after January 1, 2000.

The Internal Revenue Service has adopted a standard for the year representation and date representation. This standard will be used in all data exchanges with external trading partners (ETPs), Federal, state and local governments as well as the private sector. The standard is:

— an 8-position year when using the Gregorian data format; the 8 characters (YYYYMMDD) must be contiguous and the 4-position year field must be at the beginning of the date field;

— a four-position year when using the Julian date format; the date field would be represented as YYYYDDD;

— a four-position year when using the Epock/Offset date format where the Epoch (year field) contains four characters and the Offset is a time element determined by the system owner; and,

— a four-position year will be used in conjunction with all other date formats and the other elements of the date field.

The IRS said it will be contacting its external trading partners to inform them of the date by which data exchanges will be converted. The trading partners will be expected to certify that they will be ready to receive the data and that they will provide any related exchanges to the IRS as specified in the standard.

External Trading Partners who provide data in accord with specifications generally issued in Revenue Procedures will continue to be informed of the date requirements through Revenue Procedures. Others, with whom IRS has agreements for specific exchanges, such as with state revenue departments involved in tax administration, will be contacted individually by the IRS.

Certain Payments Made Pursuant to a Securities Lending Transaction

Notice 97–66

SECTION 1. SUMMARY

On October 14, 1997, final regulations were published in the Federal Register [T.D. 8735], RIN 1545-AP71, (the "final regulations") which source substitute interest and substitute dividend payments that are made pursuant to a securities lending or sale-repurchase transaction by reference to the income that would be earned with respect to the underlying transferred debt security or stock. The final regulations also provide that substitute interest and dividend payments that are U.S. source under the regulations are also characterized as interest and dividends for purposes of determining the fixed or determinable annual or periodical income of foreign resident individuals and corporations subject to tax under sections 871, 881, 4948(a) and Chapter 3 of the Internal Revenue Code and for purposes of granting tax treaty benefits with respect to interest and dividends. As promulgated, the final regulations were made applicable in all respects for substitute interest (as defined in § 1.861–2(a)(7) of the income tax regulations) and substitute dividend payments (as defined in § 1.861–3(a)(6)) made after November 13, 1997.

This Notice provides guidance on complying with the statement requirement of section 871(h)(5) for substitute interest payments made after November 13, 1997, and before January 1, 1999. In addition, the Treasury and the Service intend to propose new regulations to provide specific guidance on how substitute dividend payments made by one foreign person to another foreign person ("foreign-to-foreign payments") are to be treated. Until the proposed regulations are promulgated, this Notice clarifies how the amount of the tax imposed under §§ 1.871–7(b)(2) and 1.881–2(b)(2) will be determined with respect to foreign-to-foreign payments. The Treasury and the Service request comments on the treatment of foreign-to-foreign payments provided in this Notice.

SECTION 2. SUBSTITUTE INTEREST PAYMENTS

Substitute interest payments made by a foreign person that are U.S. source interest under the final regulations must satisfy the statement requirement of section 871(h)(5) to qualify as portfolio interest. The final regulations refer taxpayers to § 1.871–14(c) for this purpose, but those regulations are not generally applicable until January 1, 1999. Under this Notice, the statement requirement of section 871(h)(5) will be satisfied with respect to substitute interest payments made after November 13, 1997 and before January 1, 1999, if any written, electronic, or oral statement that reasonably establishes that the payee is a foreign person is given or made to the payor prior to, or within a reasonable period of time after, the payment. The statement requirement of the preceding sentence is deemed to be satisfied if the payor is subject to, and satisfies with respect to the payee, the regulatory rules in the jurisdiction in which the payor is operating regarding establishing the identity of a customer (i.e., "know your customer" rules). Also, if a taxpayer makes an election under § 1.1441-1(f)(2)(ii), such election will be effective, pursuant to this Notice, to allow a withholding agent to apply retroactively the documentation requirements of § 1.871–14(c) with respect to one or more substitute interest payments made after November 13, 1997. Treas. Reg. § 1.871–14(c)(3) allows a withholding agent to collect a certificate or documentary evidence at any time until the expiration of the beneficial owner's period of limitation for claiming a refund of tax with respect to portfolio interest.

SECTION 3. SUBSTITUTE DIVIDEND PAYMENTS

The final regulations were adopted to eliminate unjustifiable differences between the taxation of similar economic investments. It has been brought to the at-

tention of the Treasury and the Service, however, that, in certain circumstances, the total U.S. withholding tax paid with respect to a securities loan or sale-repurchase transaction, or series of such transactions, could be excessive due to the application of the final regulations. The Treasury and the Service believe that taxpayers can avoid such excessive withholding taxes in the vast majority of cases by structuring their transactions appropriately. In some circumstances, however, such structuring may be difficult or impossible.

To address these concerns, under this Notice, the amount of U.S. withholding tax to be imposed under §§ 1.871–7(b)(2) and 1.881–2(b)(2) with respect to a foreign-to-foreign payment will be the amount of the underlying dividend multiplied by a rate equal to the excess of the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute payment over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment. This amount may be reduced or eliminated to the extent that the total U.S. tax actually withheld on the underlying dividend and any previous substitute payments is greater than the amount of U.S. withholding tax that would be imposed on U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment. The recipient of a substitute payment may not, however, disregard the form of its transaction in order to reduce the U.S. withholding tax. Therefore, a recipient of a foreign-to-foreign payment will not be entitled to a refund or tax credit against any other U.S. tax liability to reflect the fact that the rate of U.S. withholding tax that would be applicable to a U.S. source dividend paid by a U.S. person directly to such recipient is less than the rate of U.S. withholding tax that would be applicable to a U.S. source dividend paid by a U.S. person directly to the payor of the substitute payment (or any payor of a previous substitute payment or the underlying dividend).

As a result of this formula, substitute payments with respect to foreign-to-foreign securities loans and sale-repurchase transactions that do not reduce the overall U.S. withholding tax generally will not be subject to withholding tax. For example, no withholding tax is required in situations where transactions are entered into between residents of the same country. The Treasury and the Service believe that this Notice adequately addresses the concerns of those foreign persons who are required by their local regulators to enter into transactions only with residents of the same country. Conversely, to the extent a foreign-to-foreign securities loan or sale-repurchase transaction would reduce the overall U.S. withholding tax, an incremental amount of U.S. withholding tax is imposed on the substitute payment.

SECTION 4. LIABILITY OF WITHHOLDING AGENTS

Each person who makes a foreign-to-foreign payment shall be treated as a withholding agent under section 1.1441–7 with respect to such payment. If a U.S. withholding agent withholds the highest rate of tax which would be imposed on all foreign recipients of dividends and substitute payments in a chain of such payments, each foreign withholding agent will be treated as having satisfied its withholding obligation under §1.1441–7.

SECTION 5. EXAMPLES

The following examples illustrate the principles of this Notice:

Example 1. *Same Country Securities Loan.* FP, a pension fund resident in Country X, owns stock issued by USCo, a corporation resident in the United States. An income tax treaty between Country X and the United States limits the U.S. withholding tax on gross dividends to 15 percent. USBroker, a U.S. broker-dealer, needs to borrow the stock owned by FP. Under Country X rules intended to safeguard the interests of workers, however, FP is required to deal only with Country X residents in connection with its investment activities. Accordingly, FP enters into a securities loan with FBroker, a broker-dealer also resident in Country X. FBroker then enters into a securities loan with USBroker. USCo pays a dividend of $100 on March 15, 1998. USBroker is the shareholder of record with respect to the dividend. Since USBroker is a U.S. person, USCo does not withhold on the dividend. USBroker makes a substitute payment of $100 to FBroker from which USBroker withholds $15. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to FP is the same as the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to FBroker. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments made by FBroker to FP.

Example 2. *Non-Same Country Securities Loan.* A, a resident of Country X, owns shares of USCo, a U.S. resident corporation. Country X has a treaty with the United States which limits the United States tax on gross dividends to 15 percent. A enters into a securities loan with B, a resident of Country Y, whose treaty with the United States also limits the United States tax on gross dividends to 15 percent. USCo pays a dividend of $100 on March 15, 1998. B is the shareholder of record with respect to the dividend. USCo withholds $15 and pays B a net dividend of $85. B makes a substitute payment of $85 to A. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to A is the same as the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to B. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments made by B to A.

Example 3. *Increased Treaty Benefits.* The facts are the same as in example 2, except that Country X has no treaty with the United States. Since a dividend payment made by a U.S. person directly to A would have been subject to a 30-percent withholding tax, B must withhold an additional $15 ((30 percent - 15 percent) x $100) on the substitute payment it makes to A. Alternatively, USCo could have withheld 30 percent from the dividend payment made to B, thereby satisfying B's withholding liability under § 1.1441–7.

Example 4. *Multiple Country Securities Loans.* A, a resident of Country W, owns shares of USCo, a U.S. resident corporation. Country W has an income tax treaty with the United States that limits the United States tax on gross dividends to 15 percent. B, a resident of Country X, enters into a securities loan with A. Country X does not have an income tax treaty with the United States. C, a resident of Country Y, enters into a securities loan with B. Country Y has an income tax treaty with the United States which limits the United States tax on gross dividends to 10 percent. D, a resident of country Z, enters into a securities loan with C. Country Z has an income tax treaty with the United States which limits the United States tax on gross dividends to 15 percent.

USCo pays a dividend of $100 on March 15, 1998. D is the shareholder of record with respect to the dividend. USCo withholds $15 and pays D a net dividend of $85. D makes a substitute payment of $85 to C. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to C is less than the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to D. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments received by C. However, C is not entitled to a refund or tax credit against any other U.S. tax liability for the additional 5-percent tax reflected in its substitute payment from D over the amount to which C would have been subject had C received a dividend directly from USCo.

C makes a substitute payment of $85 to B from which C withholds $15. Since a dividend payment made by a U.S. person directly to B would have been subject to a 30-percent withholding tax, C generally would be required to withhold an additional $20 ((30 percent - 10 percent) x $100) on the substitute payment it makes to B. However, because $15

actually was withheld with respect to a $100 gross dividend paid to D, C may reduce by $5 ((15 percent - 10 percent) x $100) the $20 withholding obligation on its substitute payment to B.

B makes a substitute payment of $70 to A. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to A is less than the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to B. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payment received by A. However, A is not entitled to a refund or tax credit against any other U.S. tax liability for the additional 15-percent tax reflected in its substitute payment from B over the amount to which A would have been subject had A received a dividend directly from USCo.

Alternatively, USCo could have withheld 30 percent from the dividend payment made to D, thereby satisfying C's withholding obligation under § 1.1441–7.

SECTION 6. EFFECTIVE DATE OF REGULATIONS

The provisions of this Notice are effective for purposes of applying the final regulations as of November 14, 1997, the effective date of those regulations. Because some withholding agents may require additional time to adjust their business practices to implement the provisions of the final regulations and this Notice, a withholding agent can elect to defer the application of the final regulations, other than Treas. Reg. § 1.864–5(b)(2)(ii), and this Notice until January 1, 1998. A withholding agent makes such an election by attaching a statement to such effect to a timely filed tax return (Form 1042) for the period that includes November 14, 1997, or if no such return is otherwise required for the period including that date, on a timely filed return (Form 1042) for the period that includes January 1, 1998. Withholding agents making this election must apply the provisions of the final regulations and this Notice for substitute payments made after December 31, 1997.

SECTION 7. REQUEST FOR COMMENTS

Treasury and the Service invite comments on the guidance provided by this Notice. Written comments should be submitted by January 12, 1998, to the Internal Revenue Service, P.O. Box 7604 Ben Franklin Station, Attention: CC:CORP:T:R: (Notice 97-66) Room 5228, Washington, DC 20044. Alternatively, comments may be submitted via the internet at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The comments submitted will be available for public inspection and copying.

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information contained in this Notice 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 1545–1566.

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 contained in this Notice are in Sections 2 and 6. The information is required to qualify substitute interest payments as portfolio interest and to defer, on election by the taxpayer, the effective date of this Notice and the final securities lending regulations (T.D. 8735, 62 FR 53498) for substitute payments made after December 31, 1997. The information will be used for the same purpose described in the preceding sentence. The collections of information are required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 61,750 hours.

The estimated annual burden per respondent/recordkeeper varies from 1 minute to 15 minutes, depending on individual circumstances, with an estimated average of 10 minutes. The estimated number of respondents and/or recordkeepers is 377,500.

The estimated frequency of responses (used for reporting requirements only) 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.

SECTION 9. CONTACT INFORMATION

The principal author of this Notice is Paul Epstein of the Office of the Associate Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. For further information regarding this Notice contact Milton Cahn or Paul Epstein at 202-622-3870 (not a toll-free call).

Grace Period Interest

Notice 97–67

Many credit card agreements provide for a grace period during which the credit card issuer does not charge interest for a billing cycle if the credit card holder pays off its account balance by a specified date. Under section 1004 of the Taxpayer Relief Act of 1997 (the "Act"), Pub. L. No. 105–34, 111 Stat. 788, 911, if a taxpayer holds a pool of credit card receivables, the taxpayer must accrue interest and original issue discount on the receivables based on a reasonable assumption regarding the timing of the payments by the obligors of the receivables in the pool. Thus, the taxpayer is not permitted to assume that all of its credit card holders will pay their balances by the date specified in the grace period provision of the credit card agreement and, based on this assumption, defer the inclusion of grace period interest. Section 1004 of the Act is effective for taxable years beginning after August 5, 1997. The Internal Revenue Service will issue guidance that provides the procedures for a taxpayer to automatically change its method of accounting to comply with section 1004 for the taxpayer's first taxable year beginning after August 5, 1997.

The Service will process requests by taxpayers to change their methods of accounting for grace period interest that were pending with the Service on August 4, 1997. For any requests filed on or after August 5, 1997 (the date of enactment of the Act), the Service will exercise its discretion to deny requests to change to a method of accounting for grace period interest other than the method required by section 1004 of the Act. *See* § 446(e) of the Internal Revenue Code. *See also* H.R. Conf. Rep. No.

220, 105th Cong., 1st Sess. 523 (1997); H.R. Rep. No. 148, 105th Cong., 1st Sess. 457 (1997).

For further information about this notice, contact William E. Blanchard of the Office of Assistant Chief Counsel (Financial Institutions and Products) at (202) 622-3950, or Wendy MacDonald of the Office of Assistant Chief Counsel (Income Tax and Accounting), at (202) 622-6299 (not toll-free numbers).

Guidance on Making Payments for Charitable Remainder Trusts

Notice 97–68

This notice informs taxpayers that the rules in §§ 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i)(*e*) of the proposed Income Tax Regulations, published in a Notice of Proposed Rulemaking on April 18, 1997 (62 Fed. Reg. 19072), will not be effective for certain charitable remainder trusts (CRTs) for the 1997 taxable year.

BACKGROUND

Generally, a CRT is a trust that provides for a specified distribution at least annually over a specified period to one or more noncharitable beneficiaries and holds an irrevocable remainder interest in the trust for a charitable organization. Section 664 of the Internal Revenue Code provides for two types of CRTs: a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT). A CRAT pays a fixed annuity amount at least annually to the noncharitable beneficiary or beneficiaries. A CRUT pays a fixed percentage of the fair market value of the assets held by the trust as of the annual valuation date (the unitrust amount) at least annually to the noncharitable beneficiary or beneficiaries.

Section 664(d) provides that to qualify as a CRT, the trust must pay the annuity or unitrust amount at least annually to the noncharitable beneficiaries. As an administrative convenience, §§ 1.664–2(a)(1) and 1.664–3(a)(1) of the Income Tax Regulations have allowed CRTs to pay the annuity or unitrust amount within a reasonable time after the close of the tax year in which it is due without the timing of the payment causing the trust to fail to function exclusively as a CRT.

PROPOSED REGULATIONS REGARDING PAYING ANNUITY OR UNITRUST AMOUNT

The proposed amendments to §§ 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i)(*e*) of the proposed regulations (the proposed timing amendments) would require a CRT to pay the annuity amount or the unitrust amount under the fixed percentage method of § 664(d)(2) by the close of the tax year in which the payment is due in order to function exclusively as a CRT. Under the effective date in the proposed regulations, once final, the proposed timing amendments would apply to taxable years ending after April 18, 1997, the date the proposed regulations were published in the Federal Register.

The Service and Treasury issued the proposed timing amendments in response to abuses associated with the use of accelerated CRTs described in Notice 94–78, 1994–2 C.B. 555. Taxpayers using accelerated CRTs characterize the payment of the annuity or unitrust amount as a distribution of trust corpus that is not subject to tax by delaying the required payment until after the end of the tax year in which it is due.

Since publishing the proposed regulations, the Service and Treasury have received a significant number of comments expressing concern that the proposed timing amendments will place a significant burden on many trusts that are not engaging in abuses. Some commentators observed that for many CRTs the character of the annuity or unitrust amount is not affected by the time at which the payment is made. Because these trusts have accumulated sufficient income in the ordinary, capital gains, and other income categories of § 664(b)(1), (2), and (3), no portion of the annuity or unitrust amount distributed will be characterized as trust corpus under § 664(b)(4) irrespective of whether the amount is paid before or after the close of the tax year for which it is due. The commentators add that being required to pay the annuity or unitrust amount by the close of the calendar year would create a hardship if the trustee is relying on end-of-the-year dividends and similar income, which may not arrive until January of the following year, to make the annuity or unitrust payment. The commentators also argue that the proposed timing amendments would create a hardship for trustees of CRUTs that have a December 31 valuation date because such a trustee would be forced to value the assets in the trust and make a payment of the unitrust amount after the close of business and before midnight on that date.

In light of the enactment of the Taxpayer Relief Act of 1997 (the Act) on August 5, 1997, other commentators have argued that the proposed timing amendments are no longer necessary to stop the abuses created by accelerated CRTs. The Act amended the definition of a CRT to include a maximum allowable percentage of 50 percent for calculating the annuity amount or unitrust amount and a minimum 10 percent present value for the charitable remainder interest. Taxpayer Relief Act of 1997, Pub. L. No. 105–34, § 1089, 111 Stat. 960, 961. We note that the Senate Finance Committee explicitly stated that it did not intend for the Act to "limit or alter the validity of the regulations proposed by the Treasury Department on April 18, 1997, or the Treasury Department's authority to address this or other abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries." S. Rep. No. 33, 105th Cong., 1st Sess. 201 (1997).

Several commentators have asked for relief from the effective date for the proposed timing amendments while their comments are considered and before the regulations are finalized.

APPLICATION OF PROPOSED TIMING AMENDMENTS

The Service and Treasury recognize that complying with the proposed timing amendments in 1997 may create an unnecessary burden on those trusts for which the potential for abuse is minimal. Therefore, when the proposed regulations are adopted as final regulations under a Treasury Decision, the Service and Treasury intend to provide that for the taxable year 1997 a CRT created before January 1, 1998, will not be made subject to the rules stated in §§ 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i)(*e*) of the proposed regulations if in 1997 the trust is:

(1) A CRAT under which the sum certain to be paid each year to one or more persons is 15 percent or less of the initial

net fair market value of all property placed in the trust, or

(2) A CRUT under which the fixed percentage of the net fair market value of the unitrust's assets to be paid each year to one or more persons is 15 percent or less, or

(3) A CRAT or CRUT from which all of the annuity amounts or unitrust amounts paid for 1997 are characterized in the hands of the beneficiary as income from the categories described in § 664(b)(1), (2), and (3), and not as trust corpus. Thus, a CRT created before January 1, 1998, that meets any one of these three exceptions may pay its annuity amount or unitrust amount for the taxable year 1997 within a reasonable period of time after the close of the tax year under §§ 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i) of the Income Tax Regulations.

The Service and Treasury will continue to consider the comments submitted on the proposed regulations before deciding whether to adopt an amended version of the proposed regulations as final regulations.

For further information regarding this notice, please call Mary Beth Collins or Jeff Erickson of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries) on (202) 622-3070 (not a toll-free call).

Weighted Average Interest Rate Update

Notice 97–69

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for October 1997 is 6.33 percent.

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

Month	Year	Weighted Average	90% to 107% Permissible Range	90% to 110% Permissible Range
November	1997	6.81	6.13 to 7.29	6.13 to 7.49

DRAFTING INFORMATION

The principal author of this notice is Donna Prestia of the Employee Plans Division. For further information regarding this notice, call (202) 622-6076 between 2:30 and 3:30 p.m. Eastern time (not a toll-free number). Ms. Prestia's number is (202) 622-7377 (also not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Treatment of Changes in Elective Entity Classification

REG–105162–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations addressing elective changes in entity classification. The proposed regulations describe how elective changes in classification will be treated for federal tax purposes. The proposed regulations would affect business entities and their members. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by January 26, 1998. Requests to speak (with outlines of oral comments) at the public hearing scheduled for February 24, 1998, must be submitted by January 26, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-105162–97), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–105162–97), 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 of 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 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jeff Erickson, (202) 622-3070 (not a toll-free number); concerning international issues, Philip Tretiak or Ronald M. Gootzeit, (202) 622-3860 (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 amend the current Income Tax Regulations (26 CFR Parts 1 and 301) relating to the classification of entities for federal tax purposes. On December 18, 1996, the IRS and Treasury published final regulations under section 7701 (final regulations), replacing the former classification rules with an elective regime. See T.D. 8697 (1997–2 I.R.B. 11).

Under the final regulations, a business entity that is not specifically classified as a corporation in the final regulations (an eligible entity) can elect its classification for federal tax purposes under certain circumstances. An eligible entity with at least two members can elect to be classified as a partnership or as an association taxable as a corporation. An eligible entity with a single member can elect to be classified as an association or as an entity that is disregarded as an entity separate from its owner. An eligible entity may also elect to change its classification, except that an election may not be made more than once in any sixty month period. An eligible entity that does not make an election is classified under certain default provisions.

Explanation of Provisions

Characterization of Elective Changes in Classification

The proposed regulations describe how elective changes in an entity's classification will be treated for federal tax purposes. Under the final regulations, there are four possible changes in classification by election: (i) a partnership elects to be an association; (ii) an association elects to be a partnership; (iii) an association elects to be a disregarded entity; and (iv) a disregarded entity elects to be an association. There are two other possible ways in which an entity's classification could change (a partnership converts to a disregarded entity or a disregarded entity converts to a partnership) but these changes occur only as a result of a change in the number of members, not as the result of an elective change. The proposed regulations do not address the form of these two possible types of changes.

The proposed regulations provide a specific characterization for each of the four possible elective changes. In each case, the characterization provided in the proposed regulations attempts to minimize the tax consequences of the change in classification and achieve administrative simplicity. The proposed regulations provide that if an association elects to be classified as a partnership, the association is deemed to liquidate by distributing its assets and liabilities to its shareholders. Then, the shareholders are deemed to contribute all of the distributed assets and liabilities to the partnership. This characterization of an elective change from an association to a partnership is consistent with Rev. Rul. 63–107 (1963–1 C.B. 71).

If a partnership elects to be classified as an association, the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association. Then, the partnership is deemed to liquidate by distributing stock in the association to its partners. The proposed regulations do not affect the holdings in Rev. Rul. 84–111 (1984–2 C.B. 88), in which the IRS ruled that it would respect the particular form undertaken by the taxpayers when a partnership converts to a corporation.

If an association elects to be disregarded as an entity separate from its owner, the association is deemed to liquidate by distributing its assets and liabilities to its sole owner. Conversely, if an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to contribute all of the assets and liabilities of that entity to the association in exchange for stock of the association.

The proposed regulations also provide that the tax treatment of an elective change in classification is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction

doctrine. This provision in the proposed regulations is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations. The IRS and Treasury request comments on the application of general principles of tax law to the transactions that are deemed to occur on an elective change in classification.

Change in Number of Members of Entity

The proposed regulations address the effect of a change in the number of members on the classification of an entity. Under the proposed regulations, if there is a change in the number of members of an association, the classification of the entity is not affected. If an eligible entity classified as a partnership subsequently has only one member (and is still treated as an entity under local law), the entity will be disregarded as an entity separate from its owner. If a single member entity that is disregarded as an entity separate from its owner subsequently has more than one member, the entity is classified as a partnership as of the date the entity has more than one member. The classifications provided in the proposed regulations can be changed by election, assuming that the entity is not subject to the sixty month limitation on elections.

Timing of Elective Changes in Classification

The proposed regulations provide that an election to change the classification of an entity is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur as a result of the change in classification are treated as occurring immediately before the close of the day before the effective date of the election. For example, if an election is made to convert from an association to a partnership effective on January 1, the entity is treated as a partnership on January 1, and the deemed transactions specified in the proposed regulations are treated as occurring immediately before the close of December 31. As a result, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

Treatment of Foreign Eligible Entities

Any eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification. The IRS and Treasury request comments on the appropriateness of allowing such a foreign eligible entity to make a classification election, and comments on what the federal tax consequences of such an election should be (e.g., with respect to the basis of property held by the entity).

Foreign Per Se Entities

The final regulations provide a list of the names of certain foreign business entities that are treated as corporations for federal tax purposes. In most cases, the name by which an entity will be known is provided by the statutory corporate law of the relevant jurisdiction. In certain cases, however, the corporate law does not provide a statutory name. In these jurisdictions, taxpayers and practitioners often fill the statutory void with a name derived from a number of the statutory characteristics of the entity. In an effort to make the list of foreign per se corporations more accessible, the final regulations use the commonly used non-statutory term in certain cases where the statute does not provide a defined name. To minimize any uncertainty, however, the provisions of §301.7701–2(b)(8)(iii) and (iv) were included in the final regulations to address this issue. In response to comments from taxpayers, these subsections of the final regulations are clarified to provide guidance on the terms used in the final regulations. Furthermore, the regulations clarify that the term Berhad used with regard to Malaysia does not include a "Sendirian Berhad" (the equivalent of a private limited company). The regulations also clarify that, in relation to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable). The fact that capital may be varied does not make this a different type of entity from a Sociedad Anonima that does not choose to apply the variable capital provision. These clarifications are not intended to change the interpretation of the final regulations.

The proposed regulations also clarify the treatment of the Finnish, Maltese, and Norwegian entities specified in the final regulations. Effective January 1, 1996, Maltese and Norwegian corporate law recognized a distinction between public and private companies, and the proposed regulations reflect this change. The proposed regulations also provide that the rules of the final regulations with regard to the Maltese and Norwegian entities may be applied (when these proposed regulations are finalized) as though the entities specified in the proposed regulations had been included in the final regulations issued on December 18, 1996. Thus, a Maltese or Norwegian entity that is no longer treated as a per se corporation under the regulations would be able to make an election within 75 days of the date these proposed regulations are finalized, and such election could be effective as of January 1, 1997. Finnish law, since September 1, 1997, has recognized a similar distinction between public and private companies. It is proposed that a Finnish entity that is no longer treated as a per se corporation under the regulations would be able to make an election within 75 days of the date these proposed regulations are finalized, and such election could be effective as of September 1, 1997.

Special Basis Adjustments Under Section 743

Section 743 provides that the basis of partnership property is not adjusted as the result of a transfer of an interest in the partnership by sale or exchange unless the partnership has made an election under section 754. If a section 754 election is made, the transferee partner is treated as having a special basis adjustment with respect to partnership property. This adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee partner only. Some uncertainty has remained as to the treatment of this special basis adjustment upon the contribution of the partnership property to a corporation in a section 351 exchange, and because the proposed regulations provide for a deemed contribution by the partnership to a corporation in an elective conversion to an association, the proposed regulations address this uncertainty.

The proposed regulations provide that a

corporate transferee's basis in property transferred by a partnership in a transfer described in section 351 includes any special basis adjustment under section 743. The special basis adjustment is also taken into account in determining the partner's basis in the stock received in the exchange. For example, assume a partnership owns Property X, which has a common basis of $100 for the partnership and in which Partner A has a $5 special basis adjustment under section 743(b). Subsequently, the partnership validly elects to be classified as an association. The partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners. If the transfer of the assets to the association would be a transfer described in section 351, then under the proposed regulations, the association's basis in Property X includes Partner A's $5 special basis adjustment. Thus, the association has a $105 basis in Property X (Partner A's $5 special basis adjustment plus the partnership's $100 common basis). Partner A's basis in the association's stock will reflect the $5 special basis adjustment previously on Property X.

The proposed regulations also provide, however, that the amount of gain, if any, recognized by the partnership on the transfer is determined without reference to any special basis adjustment. The partner with the special basis adjustment can then use the special basis adjustment to reduce its share of any gain recognized by the partnership. This approach of determining gain at the partnership level and allowing the partner to use the special basis adjustment as an offset is similar to the treatment of a sale of property with a special basis adjustment.

Proposed Effective Date

Except as otherwise specified, these regulations are proposed to apply as of the date the 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 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 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 Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for February 24, 1998, at 10 a.m., in room 2615, 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 timely written comments and an outline of the topics to be discussed and the time to be devoted to each topic by (preferably a signed original and eight (8) copies) January 26, 1998.

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 Ann M. Veninga, Office of Chief Counsel (Passthroughs and Special Industries) and Philip Tretiak, Office of 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 parts 1 and 301 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.743-2 is added under the undesignated centerheading "Transfer of Interests in a Partnership" to read as follows:

§1.743-2 Transfer of property to a corporation.

(a) *Basis in transferred property.* A corporation's adjusted tax basis in property transferred to the corporation by a partnership in a transfer described in section 351 is determined with reference to any special basis adjustment to the property under section 743(b) (other than any special basis adjustment that reduces a partner's gain under paragraph (b) of this section).

(b) *Partnership gain.* The amount of gain, if any, recognized by a partnership on a transfer of property by the partnership to a corporation in a transfer described in section 351 is determined without reference to any special basis adjustment to the transferred property under section 743(b). The amount of gain, if any, recognized by the partnership on the transfer that is allocated to a partner with a special basis adjustment in the transferred property is adjusted to reflect the partner's special basis adjustment in the transferred property.

(c) *Basis in stock.* The partnership's adjusted tax basis in stock received from a corporation in a transfer described in section 351 is determined without reference to the special basis adjustment in property transferred to the corporation in the section 351 exchange. A partner with a special basis adjustment in property transferred to the corporation, however, has a special basis adjustment in the stock re-

ceived by the partnership in the section 351 exchange in an amount equal to the partner's special basis adjustment in the transferred property, reduced by any special basis adjustment that reduced the partner's gain under paragraph (b) of this section.

(d) *Effective date.* This section applies to transfers that occur on or after the date final regulations are published in the **Federal Register**.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

Par. 4. Section 301.6109-1 is amended as follows:

1. Paragraph (d)(2)(ii) is removed and reserved.

2. Paragraph (h) is redesignated as paragraph (i) and the first sentence of newly designated paragraph (i)(1) is amended by removing the language "paragraph (h)" and adding "paragraph (i)" in its place.

3. A new paragraph (h) is added.

The addition reads as follows:

§301.6109-1 Identifying numbers.

* * * * *

(h) *Special rules for certain entities under §301.7701–3*—(1) *General rule.* Any entity that has an employer identification number (EIN) will retain that EIN if its federal tax classification changes under §301.7701–3.

(2) *Special rules for entities that are disregarded as entities separate from their owners*—(i) *When an entity becomes disregarded as an entity separate from its owner.* Except as otherwise provided in regulations or other guidance, a single owner entity that is disregarded as an entity separate from its owner under §301.7701–3, must use its owner's taxpayer identifying number (TIN) for federal tax purposes.

(ii) *When an entity that was disregarded as an entity separate from its owner becomes recognized as a separate entity.* If a single owner entity's classification changes so that it is recognized as a separate entity for federal tax purposes, and that entity had an EIN, then the entity must use that EIN and not the TIN of the single owner. If the entity did not already have its own EIN, then the entity must acquire an EIN and not use the TIN of the single owner.

(3) *Effective date*. This paragraph (h) applies to changes in classification that occur on or after the date on which these regulations are published as final regulations in the **Federal Register**.

Par. 5. Section 301.7701–2 is amended as follows:

1. Paragraph (b)(8)(i) is amended by revising the entries for Finland, Malta, and Norway.

2. Paragraph (b)(8)(ii)(A) is redesignated as paragraph (b)(8)(ii)(A)(*1*) and the language "and" at the end of the paragraph is removed.

3. Paragraph (b)(8)(ii)(B) is redesignated as paragraph (b)(8)(ii)(A)(*2*) and the period at the end of the paragraph is removed and the language "; and " is added in its place.

4. Paragraph (b)(8)(ii) heading and introductory text are redesignated as paragraph (b)(8)(ii)(A) heading and introductory text, and a new paragraph heading is added for paragraph (b)(8)(ii).

5. Paragraphs (b)(8)(ii)(A)(*3*) and (b)(8)(ii)(B) are added.

6. Paragraphs (b)(8)(iii), (b)(8)(iv), and (e) are revised.

The revisions and additions read as follows:

§301.7701-2 Business entities; definitions.

* * * * *

(b) * * *

(8) * * *

(i) * * *

Finland, Julkinen Osakeyhtio/Publikt Aktiebolag

* * * * *

Malta, Public Limited Company

* * * * *

Norway, Allment Aksjeselskap

* * * * *

(ii) *Clarification of list of corporations in paragraph (b)(8)(i) of this section*—(A) *Exceptions in certain cases.* * * *

* * * * *

(*3*) With regard to Malaysia, a Sendirian Berhad.

(B) *Inclusions in certain cases.* With regard to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable).

(iii) *Public companies.* For purposes of paragraph (b)(8)(i) of this section, with regard to Cyprus, Hong Kong, Jamaica, and Trinidad and Tobago, the term Public Limited Company includes any Limited Company that is not defined as a private company under the corporate laws of those jurisdictions. In all other cases, where the term Public Limited Company is not defined, that term shall include any Limited Company defined as a public company under the corporate laws of the relevant jurisdiction.

(iv) *Limited companies.* For purposes of this paragraph (b)(8), any reference to a Limited Company includes, as the case may be, companies limited by shares and companies limited by guarantee.

* * * * *

(e) *Effective date*. Except as otherwise provided in this paragraph (e), the rules of this section apply as of January 1, 1997. The reference to the Finnish, Maltese, and Norwegian entities in paragraph (b)(8)(i) of this section is applicable on the date the final regulations are published in the **Federal Register**. Any Maltese or Norwegian entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on the date final regulations are published in the **Federal Register** may elect (within 75 days of the date final regulations are published in the **Federal Register)** to be classified for federal tax purposes as an entity other than a corporation retroactive to any period from and including January 1, 1997. Any Finnish entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on the date final regulations are published in the **Federal Register** may elect (within 75 days of the date final regulations are published in the **Federal Register**) to be classified for federal tax purposes as an entity other than a corporation retroactive to any period from and including September 1, 1997.

Par. 6. Section 301.7701–3 is amended as follows:

1. A sentence is added at the end of paragraph (c)(1)(iv).

2. Paragraph (c)(2)(iii) is added.

3. A heading is added to paragraph (d)(1).

4. Paragraph (f) is redesignated as paragraph (h) and newly designated paragraph (h)(1) is revised.

5. Paragraphs (f) and (g) are added.

The revision and additions read as follows:

§301.7701–3 Classification of certain business entities.

* * * * *

(c) * * *

(1) * * *

(iv) *Limitation*. * * * An election by a newly-formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv).

* * * * *

(2) * * *

(iii) *Changes in classification.* For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is made to change the classification of an entity, each person who was an owner on the date that any transactions under paragraph (g) of this section are deemed to occur, and who is not an owner at the time the election is filed, must also sign the election. This paragraph (c)(2)(iii) applies to elections filed on or after the date final regulations are published in the **Federal Register**.

(d) *Special rules for foreign eligible entities*—(1) *Definition of relevance.* * * *

* * * * *

(f) *Changes in number of members of an entity*—(1) *Associations.* The classification of an eligible entity as an association is not affected by any change in the number of members of the entity.

(2) *Partnerships and single member entities*. An eligible entity classified as a partnership is disregarded as an entity separate from its owner as of the date the entity has only one member. A single member entity disregarded as an entity separate from its owner is classified as a partnership as of the date the entity has more than one member.

(3) *Effect on sixty month limitation.* A change in the number of members of an entity does not result in the creation of a new entity for purposes of the sixty month limitation on elections under paragraph (c)(1)(iv) of this section.

(4) *Examples*. The following examples illustrate the application of this paragraph (f):

Example 1. (i) On April 1, 1998, A and B, U.S. persons, form X, a foreign eligible entity. X is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and X does not make an election to be classified as a partnership. A subsequently purchases all of B’s interest in X.

(ii) Under paragraph (f)(1) of this section, X continues to be classified as an association. X, however, can subsequently elect to be disregarded as an entity separate from A. The sixty month limitation of paragraph (c)(1)(iv) of this section does not prevent X from making an election because X has not made a prior election under paragraph (c)(1)(i) of this section.

Example 2. (i) On April 1, 1998, A and B, U.S. persons, form X, a foreign eligible entity. X is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and X does not make an election to be classified as a partnership. On January 1, 1999, X elects to be classified as a partnership effective on that date. Under the sixty month limitation of paragraph (c)(1)(iv) of this section, X cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after the effective date of the election to be classified as a partnership).

(ii) On June 1, 1999, A purchases all of B’s interest in X. After A’s purchase of B’s interest, X can no longer be classified as a partnership because X has only one member. Under paragraph (f)(2) of this section, X is disregarded as a separate entity as of the date A becomes the only member of X. X, however, is not treated as a new entity for purposes of paragraph (c)(1)(iv) of this section. As a result, the sixty month limitation of paragraph (c)(1)(iv) of this section continues to apply to X and X cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after January 1, 1999, the effective date of the election by X to be classified as a partnership).

(5) *Effective date.* This paragraph (f) applies as of the date the final regulations are published in the **Federal Register**.

(g) *Elective changes in classification*—(1) *Deemed treatment of elective change*—(i) *Partnership to association.* If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

(ii) *Association to partnership.* If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

(iii) *Association to disregarded entity.* If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

(iv) *Disregarded entity to an association*. If an eligible entity that is disregarded as an entity separate from its owner elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.

(2) *Effect of elective changes.* The tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of this section is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(3) *Timing of election.* An election under paragraph (c)(1)(i) of this section that changes the classification of an eligible entity for federal tax purposes is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur under this paragraph (g) as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification of an entity from an association to a partnership effective on January 1, the deemed transactions specified in paragraph (g)(1)(ii) of this section (including the liquidation of the association) are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. As a result, the last day of the association’s taxable year will be December 31 and the first

day of the partnership's taxable year will be January 1.

(4) *Effective date.* This paragraph (g) applies to elections that are filed on or after the date the final regulations are published in the **Federal Register**.

(h) *Effective date*—(1) *In general.* Except as otherwise provided in this section, the rules of this section are applicable as of January 1, 1997.

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 27, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 28, 1997, 62 F.R. 55768)

Notice of Proposed Rulemaking and Notice Of Public Hearing

Source of Income From Sales of Inventory Partly From Sources Within a Possession of the United States; Also, Source of Income Derived From Certain Purchases From a Corporation Electing Section 936

REG–251985–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 863 governing the source of income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States. It also contains proposed regulations under section 863 governing the source of income from sales of inventory purchased in a possession of the United States and sold in the United States. This document affects persons who produce (in whole or in part) inventory in the United States and sell in a possession, or produce (in whole or in part) inventory in a possession and sell in the United States, as well as persons who purchase inventory in a possession and sell in the United States. This document also contains proposed regulations under section 936 governing the source of income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of oral comments to be presented at the public hearing scheduled for January 29, 1998, at 10 a.m. must be received by January 8, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL–0003–95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–251985–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or electronically, via the IRS Internet site at: http://www.irsustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Anne Shelburne, (202) 622-3880; concerning submissions and the hearing, Ms. Evangelista Lee, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by December 9, 1998. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

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

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

How the burden of complying with the proposed collection 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 requirements are in proposed §1.863–3(f)(6). This information is required by the IRS to monitor compliance with the federal tax rules for determining the source of income from the sale of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States, or from the sale of inventory purchased in a possession of the United States and sold in the United States. The likely respondents are taxpayers who produce inventory in the United States and sell in a possession, or who produce inventory in a possession and sell in the United States, or who purchase inventory in a possession and sell in the United States. Responses to this collection of information are required to properly determine the source of a taxpayer's income from such sales.

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.

Estimated total annual reporting burden: 500 hours. The estimated annual burden per respondent varies from 1 hour to 5 hours, depending on individual circumstances, with an estimated average of 2.5 hours.

Estimated number of respondents: 200

Estimated annual frequency of responses: One time per year.

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

Background

These proposed regulations contain rules under section 863 relating to the source of income from cross-border sales of certain property. These regulations also contain rules under section 936 relating to the source of income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect. These regulations are proposed to be effective for taxable years beginning 30 days after publication of final regulations.

Explanation of Provisions

I. *Income Partly From Sources Within a Possession*

A. Current Regulations

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning to sources within or without the United States all items of gross income, expenses, losses, and deductions other than those items specified in sections 861(a) and 862(a).

Guidance to determine the source of possession income is divided into two types of transactions: transactions described in section 863(b)(2) for property produced in the United States and sold in a possession (or vice versa), and transactions described in section 863(b)(3) for property purchased in a possession and sold in the United States (collectively, Section 863 Possession Sales).

Section 1.863–3 of the income tax regulations contains rules for determining the source of income derived from sales of certain property. These regulations were published in the **Federal Register** on November 29, 1996 (61 F.R. 60540), and the prior regulations were renumbered §§1.863–3A and 1.863–3AT. The new regulations retain the prior rules for Section 863 Possession Sales by providing in paragraph §1.863–3(f) that taxpayers must apply the rules of §1.863–3A(c) in allocating and apportioning income derived from sources partly within the United States and partly within a possession of the United States. These proposed regulations would modify the existing rules for allocating and apportioning income between the United States and a possession.

1. Property produced and sold

Currently, income derived from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States (Possession Production Sales), is allocated or apportioned between the United States and a possession according to one of three methods. Such income is allocated under the independent factory price method, apportioned under an apportionment method, or, with permission of the District Director, allocated or apportioned on the basis of the taxpayer's books and records.

Under the current regulations, if an independent factory or production price (IFP) exists for Possession Production Sales, taxpayers must use the IFP method to determine the income attributable to production activities in both the sale establishing the IFP and in sales of similar products.

If an IFP does not exist, the current possessions regulations provide that the taxable income from Possession Production Sales is first computed and then apportioned between the United States and the possession. One-half of the taxable income is apportioned on the basis of the taxpayer's property within the United States and within the possession. In applying the property fraction, the taxpayer's property includes property held or used to produce income derived from Possession Production Sales. The other half of the taxpayer's taxable income is apportioned between U.S. and possession sources on the basis of the business of the taxpayer within the United States and within the possession. Currently, business of the taxpayer is measured by the sum of certain expenses, including amounts paid for labor, and the purchase of certain supplies, plus receipts from Possession Production Sales. Finally, as a third method, the existing regulations allow a taxpayer to request permission from the District Director to use the taxpayer's books and records to allocate or apportion income to sources within or without the United States if those books reflect more clearly than the other methods the taxable income derived from sources within the United States.

2. Property purchased and sold

The second type of possession transaction governed by the existing regulations is the sale of inventory purchased in a possession and sold in the United States (Possession Purchase Sales) as described in section 863(b)(3). Under the current regulations, the income from such sales is divided between the United States and possession sources under one of two methods. The income can be apportioned, or, with permission of the District Director, allocated or apportioned on the basis of the taxpayer's books and records.

Under the apportionment method, taxable income is first determined, and then apportioned by a fraction, the numerator being the business of the taxpayer in the United States, the denominator being the total business of the taxpayer in the United States and in the possession. The fraction is computed in the same manner as the business fraction discussed previously, except that such expenses, purchases, and sales are limited to those attributable to Possession Purchase Sales.

B. Issues Under Current Regulations

The IRS and Treasury believe the rules for allocating and apportioning income between the United States and the possessions of the United States should be amended to reflect certain changes made to the regulations under §1.863–3 governing cross-border sales of inventory involving the United States and a foreign country (other than those involving possessions). Thus, for example, under the apportionment method provided in the proposed regulations, the property and business activity fractions apportioning income between the United States and a possession are modified to apportion

gross income attributable to an activity, rather than to apportion net income.

The IRS and Treasury also believe certain ambiguities exist in the current regulations. The possessions rules were originally promulgated in 1926, and may not reflect current business practices. The current regulations use examples to illustrate methods for allocating or apportioning income between the United States and a possession, and should be modified to state rules.

Further, although the apportionment method for allocating Possession Production Sales income under the existing possessions regulations treats half of the income as production income, the production formula is not necessarily limited to production assets. The current inclusion of sales assets in the formula apportioning production income results in excessive income being allocated to sales activities. The production income formula should only take into account assets directly involved in production of inventory. In addition, the IRS and Treasury have reexamined the business activity fraction, and have concluded it should be revised to more clearly reflect the taxpayer's business other than production. The current fraction, for example, omits certain investments or expenses, such as marketing and advertising expenses, although income attributable in part to such expenses or investments is then included in the income apportioned by the fraction. The current regulations also take into account production expenses in the business activity fraction apportioning income from Possession Production Sales. The Service and Treasury believe that this is inappropriate in the context of Possession Production Sales because the business activity fraction is not intended to determine the source of income attributable to production activity. In the proposed regulations, the fraction apportioning Possession Production Sales is renamed the business sales activity fraction and excludes factors reflecting production activity.

The current regulations also do not address issues in attributing to the United States or to the possession, the activities reflected in the business activity fraction. For example, the current regulations provide no guidance on whether a particular expense should be represented in the fraction as attributable to the United States or to a possession.

Accordingly, the IRS and Treasury are issuing proposed regulations under section 863 to make the possessions rules more consistent with the other regulations governing the source of income from cross-border sales of inventory, and to address certain ambiguities and problems in the existing regulations.

C. Proposed Regulations

Section 1.863-3(f) generally retains the methods of the current regulations for dividing income between the United States and a possession of the United States, with several modifications.

1. Methods to allocate gross income to activities of the taxpayer

a. Property produced and sold

i. The possession 50/50 method

Consistent with the final regulations under §1.863–3, paragraph (f)(2)(i)(A) of the proposed regulations makes the 50/50 method the general rule to allocate gross income from Possession Production Sales between production and business sales activity, so that the income from each type of activity can then be apportioned between U. S. and foreign sources. The taxpayer, however, may elect to apply the IFP method (described in paragraph (f)(2)(i)(B)), or, with the consent of the District Director, the books and records method (described in paragraph (f)(2)(i)(C)).

Under the possession 50/50 method, the proposed regulations allocate half of the taxpayer's gross income from Possession Production Sales to production activity and half to business sales activity. The income is then apportioned between U.S. and possession sources based on a property fraction and a business sales activity fraction. As described below, the proposed regulations make certain changes to the existing property fraction and to the existing business activity fraction.

The proposed regulations apply the property fraction in §1.863–3(c) to apportion the half of a taxpayer's income allocated to production activity. Thus, income is apportioned to the United States or to a possession based on the location of the taxpayer's production assets. In a change from the current regulations, and consistent with the changes made to the regulations under §1.863–3(c), production assets are defined as tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory sold in Possession Production Sales, instead of all its assets that produce income from Possession Production Sales. Production assets are included in the fraction at their adjusted tax basis.

The other half of the taxpayer's gross income is apportioned according to a business sales activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business sales activity of the taxpayer in the possession, and the denominator being the business sales activity of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States. Although some of the business sales activity factors not incurred in a possession may be incurred in a foreign country, Treasury and the Internal Revenue Service believe that the business sales activity fraction is only intended to source the business sales activity portion of Possession Production Sales outside the United States to the extent of business sales activity located in a possession.

The proposed regulations make some modifications to the factors in the fraction representing the business sales activity of the taxpayer. Business sales activity is measured by the sum of certain expenses, including amounts paid for labor, materials, advertising, and marketing (but excluding any expenses or other amounts that are nondeductible under section 263A, interest, and research and development), plus receipts for the sale of goods. This formula is intended to reflect better the business sales activity producing the income by including more of the factors responsible for producing that income. Cost of goods sold is also excluded from the business sales activity fraction apportioning income from Possession Production Sales, because such costs generally reflect production activity. Production activity is already represented in the formula by the one-half of the taxpayer's income apportioned according to the location of production assets.

Finally, the proposed regulations provide more explicit guidance for attributing business sales activity between the

United States and a possession. Expenses are allocated and apportioned between the United States and a possession based on the rules in §§1.861–8 through 1.861–14T. Gross sales are allocated to the United States or a possession based on the place of sale.

ii. The IFP method

The proposed regulations make the IFP method elective, and thus eliminate any bias against taxpayers choosing to export through independent distributors. The regulations rely upon the revised regulations under §1.863–3 for rules in applying the IFP method.

iii. Books and records method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The proposed regulations refer to revised §1.863–3(b)(3) in applying the method to Possession Production Sales.

b. Property purchased and sold

i. The business activity method

Paragraph (f)(3)(i)(A) makes the business activity method the general rule to apportion income from Possession Purchase Sales between the United States and a possession. The taxpayer may, however, elect to apply, with consent of the District Director, the books and records method.

The proposed regulations retain the structure of the existing regulations by apportioning the taxpayer's income from Possession Purchase Sales on the basis of a business activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business of the taxpayer in the possession, and the denominator being the business of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States.

The business activity fraction is similar to that discussed previously, used to apportion the taxpayer's income in Possession Production Sales, except that the fraction applies only to expenses, cost of goods sold, and sales attributable to Possession Purchase Sales. In addition, the business activity fraction apportioning Possession Purchase Sales includes amounts paid for cost of goods sold. Such costs are attributed to the possession, however, only to the extent the property purchased is manufactured, produced, grown, or extracted in the possession. Treasury and the Internal Revenue Service anticipate that if a taxpayer acts in the reasonable belief that the products were manufactured in the possession, the taxpayer could act on that basis in preparing its tax return. As modified, the business activity fraction reflects the view of Treasury and the Internal Revenue Service that section 863(b)(3)'s purchase rule was intended to apply only to purchase and resale transactions, where the goods purchased are created or derived from the possession.

ii. Books and records method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The proposed regulations refer to revised §1.863–3(b)(3) in applying the method to Possession Purchase Sales.

2. Determination of source of gross income

Unlike the current regulations which provide specific rules for determining the source of income attributable to production activity and business activity only for purposes of the 50/50 method, the proposed regulations adopt rules applicable to each of the methods. Under the proposed regulations, once gross income attributable to production activity, business activity, or sales activity has been determined under one of the prescribed methods, the source of the gross income is determined separately for each type of income. The source of gross income attributable to production activity (when applying the possession 50/50 method) is determined under paragraph (c)(1), based on the location of production assets. The source of gross income attributable to sales activity (when applying the IFP method or the books and records method) is determined under paragraph (c)(2), based generally on the location of the sale. The source of gross income attributable to business sales activity (when applying the possession 50/50 method) is determined under paragraph (f)(2)(ii)(B), based on expenses, and gross sales attributable to Possession Production Sales. The source of gross income attributable to business activity (when applying the business activity method) is determined under paragraph (f)(3)(ii), based on expenses, cost of goods sold, and gross sales attributable to Possession Purchase Sales.

3. Determination of source of taxable income

Once the source of gross income is determined under paragraph (f)(2) or (3), taxpayers then determine the source of taxable income. Under proposed paragraph (f)(4), taxpayers must allocate or apportion under §§1.861–8 through 1.861–14T the amounts of expenses, losses and other deductions to gross income determined under each of the prescribed methods. In the case of amounts of expenses, losses and other deductions allocated or apportioned to gross income determined under the IFP method or the books and records method, the taxpayer must apply the rules of §§1.861–8 through 1.861–14T to allocate or apportion these amounts between gross income from sources within the United States and within a possession. For expenses, losses and other deductions allocated or apportioned to gross income determined under the possessions 50/50 method, taxpayers must apportion expenses and other deductions pro rata based on the relative amounts of U.S. and possession source gross income. The research and experimental (R&E) expense allocation rules in §1.861–17 apply to taxpayers using the 50/50 method, so that the R&E set aside (described in §1.861–17) remains available to such taxpayers.

4. Treatment of gross income derived from certain purchases from a corporation that has an election in effect under section 936

The proposed regulations clarify that section 863 does not apply to determine the source of a taxpayer's gross income derived from a purchase of inventory from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936(h)(5)(C) for the section 936 corporation.

5. Treatment of partners and partnerships

The proposed regulations rely on the rules in §1.863–3(g) for determining the appropriate treatment in transactions involving partnerships. Under those rules, the aggregate approach applies to a partnership's production and sales activity for two purposes only. First, the aggregate approach applies in determining the character of a partner's distributive share of partnership income. Second, the aggregate approach applies in sourcing income from sales of inventory property that is transferred in-kind from or to a partnership.

6. Election and reporting rules

Under paragraph (f)(6)(i) of the proposed regulations, a taxpayer must use the 50/50 method to determine the source of income from Possession Production Sales unless the taxpayer elects to use the IFP method, or elects the books and records method. For Possession Purchase Sales, a taxpayer must use the business activity method, unless the taxpayer elects the books and records method. The taxpayer makes an election by using the method on its timely filed original tax return. That method must be used in later taxable years unless the Commissioner or his delegate consents to a change. Permission to change methods in later years will not be withheld unless the change would result in a substantial distortion of the source of income.

A taxpayer must fully explain the methodology used in applying either paragraph (f)(2) or (3), and the amount of income allocated or apportioned to U.S. and foreign sources, in a statement attached to its tax return.

II. *Income Derived From Certain Purchases From a Corporation That Has an Election in Effect Under Section 936*

These proposed regulations clarify that where a taxpayer purchases a product from a corporation that has an election in effect under section 936, the source of the taxpayer's gross income derived from sales of that product (in whatever form sold) in the United States is U.S. source, if the taxpayer's income from sales of that product is taken into account to determine benefits under section 936(h)(5)(C)(i) for the section 936 corporation. The taxpayer's income is U.S. source without regard to whether a possession product is a component, end-product form, or integrated product. No inference should be drawn from the proposed effective date concerning the treatment of transactions involving sales of property purchased from a section 936 corporation entered into before the regulations are applicable.

Proposed Effective Dates

These regulations are proposed to be effective for taxable years beginning on or after the date that is 30 days after the date of publication of final regulations.

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 is hereby certified that 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 rules of this section principally impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described under the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 29, 1998, at 10 a.m., in room 2615, 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 comments and an outline of topics to be discussed and the time to be devoted to each topic (in the manner described under the ADDRESSES caption of this preamble) by January 8, 1998.

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 Anne Shelburne, Office of 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 citation for part 1 is amended by revising the entry for "Section 1.863-3", removing the entry for "Sections 1.936-4 through 1.936-7" and adding entries in numerical order to read as follows:

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

Section 1.863-3 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).***

Section 1.936-4 also issued under 26 U.S.C. 936(h).

Section 1.936-5 also issued under 26 U.S.C. 936(h).

Section 1.936-6 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).

Section 1.936-7 also issued under 26 U.S.C. 936(h).***

Par. 2 Section 1.863-3 is amended as follows:

1. Paragraph (f) is revised.

2. Paragraph (h) is amended by adding a sentence at the end of the paragraph.

The revision and addition read as follows:

§1.863-3 Allocation and apportionment of income from certain sales of inventory.

* * * * *

(f) *Income partly from sources within a possession of the United States*—(1) *In general*. This paragraph (f) relates to gains, profits, and income, which are treated as derived partly from sources within the United States and partly from sources within a possession of the United States (Section 863 Possession Sales). This paragraph (f) applies to determine the source of income derived from the sale of inventory produced (in whole or in part) by the taxpayer within the United States and sold within a possession, or produced (in whole or in part) by a taxpayer in a possession and sold within the United States (Possession Production Sales). It also applies to determine the source of income derived from the purchase of personal property within a possession of the United States and its sale within the United States (Possession Purchase Sales). A taxpayer subject to this paragraph (f) must divide gross income from Section 863 Possession Sales using one of the methods described in either paragraph (f)(2)(i) of this section (in the case of Possession Production Sales) or paragraph (f)(3)(i) of this section (in the case of Possession Purchase Sales). Once a taxpayer has elected a method, the taxpayer must separately apply that method to the applicable category of Section 863 Possession Sales in the United States and to those in a possession. The source of gross income from each type of activity must then be determined under either paragraph (f)(2)(ii) or (3)(ii) of this section, as appropriate. The source of taxable income from Section 863 Possession Sales is determined under paragraph (f)(4) of this section. The taxpayer must apply the rules for computing gross and taxable income by aggregating all Section 863 Possession Sales to which a method in this section applies after separately applying that method to Section 863 Possession Sales in the United States and to Section 863 Possession Sales in a possession. This section does not apply to determine the source of a taxpayer's gross income derived from a sale of inventory purchased from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936 for the section 936 corporation. For rules to be applied to determine the source of such income, see §1.936-6(a)(5) Q&A 7a and (b)(1) Q&A 13.

(2) *Allocation or apportionment for Possession Production Sales*—(i) *Methods for determining the source of gross income for Possession Production Sales*—(A) *Possession 50/50 method*. Under the possession 50/50 method, gross income from Possession Production Sales is allocated between production activity and business sales activity as described in this paragraph (f)(2)(i)(A). Under the possession 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(A) of this section. The remaining one-half of such gross income will be considered income attributable to business sales activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(B) of this section.

(B) *IFP method*. In lieu of the possession 50/50 method, a taxpayer may elect the independent factory price (IFP) method. Under the IFP method, gross income from Possession Production Sales is allocated to production activity or sales activity using the IFP method, as described in paragraph (b)(2) of this section, if an IFP is fairly established under the rules of paragraph (b)(2) of this section. See paragraphs (f)(2)(ii)(A) and (C) of this section for rules for determining the source of gross income attributable to production activity and sales activity.

(C) *Books and Records method*. A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, if it has received in advance the permission of the District Director having audit responsibility over its return. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from production, business sales, and sales activity*—(A) *Gross income attributable to production activity*. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, except that the term possession is substituted for foreign country wherever it appears.

(B) *Gross income attributable to business sales activity*—(*1*) *Source of gross income*. Gross income from the taxpayer's business sales activity is sourced in the possession in the same proportion that the amount of the taxpayer's business sales activity for the taxable year within the possession bears to the amount of the taxpayer's business sales activity for the taxable year both within the possession and outside the possession, with respect to Possession Production Sales. The remaining income is sourced in the United States.

(*2*) *Business sales activity*. For purposes of this paragraph (f)(2)(ii)(B), the taxpayer's business sales activity is equal to the sum of—

(*i*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Production Sales (other than amounts that are nondeductible under section 263A, interest, and research and development); and

(*ii*) Possession Production Sales for the taxable period.

(*3*) *Location of business sales activity*. For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*i*) *Sales*. Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*ii*) *Expenses*. Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(C) *Gross income attributable to sales activity*. The source of the taxpayer's income that is attributable to sales activity, as determined under the IFP method or the books and records method, will be determined under the provisions of paragraph (c)(2) of this section.

(3) *Allocation or apportionment for Possession Purchase Sales*—(i) *Methods for determining the source of gross income for Possession Purchase Sales*—(A) *Business activity method*. Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned

between U.S. and possession sources under paragraph (f)(3)(ii) of this section.

(B) *Books and records method.* A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, subject to the conditions set forth in paragraph (b)(3) of this section. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from business activity*—(A) *Source of gross income.* Gross income from the taxpayer's business activity is sourced in the possession in the same proportion that the amount of the taxpayer's business activity for the taxable year within the possession bears to the amount of the taxpayer's business activity for the taxable year both within the possession and outside the possession, with respect to Possession Purchase Sales. The remaining income is sourced in the United States.

(B) *Business activity.* For purposes of this paragraph (f)(3)(ii), the taxpayer's business activity is equal to the sum of—

(*1*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Purchase Sales (other than amounts that are nondeductible under section 263A, interest, and research and development);

(*2*) Cost of goods sold attributable to Possession Purchase Sales during the taxable period; and

(*3*) Possession Purchase Sales for the taxable period.

(C) *Location of business activity.* For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*1*) *Sales.* Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*2*) *Cost of goods sold.* Payments for cost of goods sold will be properly attributable to gross receipts from sources within the possession only to the extent that the property purchased was manufactured, produced, grown, or extracted in the possession (within the meaning of section 954(d)(1)(A)).

(*3*) *Expenses.* Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(iii) *Examples.* The following examples illustrate the rules of paragraph (f)(3)(ii) relating to the determination of source of gross income from business activity:

Example 1. (i) U.S. Co. purchases in a possession product X for $80 from A. A manufactures X in the possession. Without further production, U.S. Co. sells X in the United States for $100. Assume U.S. Co. has sales and administrative expenses in the possession of $10.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income from sales of X is allocated entirely to U.S. Co.'s business activity. Forty-seven dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($80) plus possessions sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The remaining $53 is sourced in the United States.

Example 2. (i) Assume the same facts as in *Example 1*, except that A manufactures X outside the possession.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income is allocated entirely to U.S. Co.'s business activity. Five dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($0) plus possession sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The $80 purchase is not included in the numerator used to determine U.S. Co.'s business activity in the possession, since product X was not manufactured in the possession. The remaining $95 is sourced in the United States.

(4) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (f)(2) or (3) of this section, the taxpayer must properly allocate and apportion separately under §§1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Possession Sales determined separately under each method described in paragraph (f)(2) or (3) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Possession Sales under §1.861–8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of §1.861–8(e)(3)(i)(A). In the case of gross income from Section 863 Possession Sales determined under the IFP method or books and records method, a taxpayer must apply the rules of §§1.861–8 through 1.861–14T to properly allocate or apportion amounts of expenses, losses and other deductions, allocated and apportioned to such gross income, between gross income from sources within and without the United States. In the case of gross income from Possession Production Sales determined under the possessions 50/50 method or gross income from Possession Purchase Sales computed under the business activity method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under those methods.

(5) *Special rules for partnerships.* In applying the rules of this paragraph (f) to transactions involving partners and partnerships, the rules of paragraph (g) of this section apply.

(6) *Election and reporting rules*—(i) *Elections under paragraph (f)(2) or (3) of this section.* If a taxpayer does not elect one of the methods specified in paragraph (f)(2) or (3) of this section, the taxpayer must apply the possession 50/50 method in the case of Possession Production Sales or the business activity method in the case of Possession Purchase Sales. The taxpayer may elect to apply a method specified in either paragraph (f)(2) or (3) of this section by using the method on a timely filed original return (including extensions). Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.

(ii) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (f)(2) or (3) of this section must fully explain in a statement attached to the tax return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

* * * * *

(h) *Effective dates.* * * * However, the rules of paragraph (f) of this section apply to taxable years beginning on or

after the date that is 30 days after the date of publication of final regulations.

Par. 3. In §1.936-6, paragraph (a)(5) Q&A 7a is added to read as follows:

§1.936-6 Intangible property income when an election out is made: Cost sharing and profit split options; covered intangibles.

* * * * *

(a) * * *

(5) * * *

Q.7a: What is the source of the taxpayer's gross income derived from a sale in the United States of a possession product purchased by the taxpayer (or an affiliate) from a corporation that has an election in effect under section 936, if the income from such sale is taken into account to determine benefits under cost sharing for the section 936 corporation? Is the result different if the taxpayer (or an affiliate) derives gross income from a sale in the United States of an integrated product incorporating a possession product purchased by the taxpayer (or an affiliate) from the section 936 corporation, if the taxpayer (or an affiliate) processes the possession product or an excluded component in the United States?

A.7a: Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for taxable years beginning on or after the date that is 30 days after the date of publication of final regulations.

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 9, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 10, 1997, 62 F.R. 52953)

Foundations Status of Certain Organizations

Announcement 97–116

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:

Babys Exchange, Parker, AZ
Bachman Northwest Highway Community Association, Dallas, TX
Baillie Players Inc., Columbia, SC
Bainbridge-Decatur County Council for the Arts, Inc., Bainbridge, GA
Balkan Relief Fund, Inc., Fern Park, FL
Bamberg Kiddie Kampus Inc., Bamberg, SC
Bandits Football Association, Ofallon, MO
Bankhead Learning Academy Inc., Atlanta, GA
Baptist Hill House Inc., Detroit, MI
Baptist Ministrers Conference of Cincinnati and Vicinity, Cincinnati, OH
Baptist Village Residents Association, Phoenix, AZ
Barnabas Ministries, Springfield, OH
Bartow County Coalition for Substance Abuse Prevention, Cartersville, GA
BASE Camp Childrens Cancer Foundation, Inc., Windermere, FL
Basic Interdenominational Lackland Shelter, Incorporated, San Antonio, TX
Bastrop County Crime Stoppers, Inc., Bastrop, TX
Baton Rouge Black Alcoholism Council, Baton Rouge, LA
Battered Women as Survivors Inc., Columbus, OH
Bay Area Neighborhood Development Corporation, Sandusky, OH
Bay Area Raiders Football Inc., Tampa, FL
Bay Area Youth Wheelchair Athletic Association, St. Petersburg, FL
Bay Hope House, Bokeelia, FL
Bayou-River Social Services, Luling, LA
Bayshore Volunteer Fire Department, Inc., North Ft. Myers, FL
Baytown Youth Development Center, Inc., Baytown, TX
Beall Society for Sight Preservation, Inc., Cleveland, OH
Bear Buddies Educational Resources, Inc., Hudson, WI
Bedford City Schools Foundation, Bedford, OH
Beech Economic Development Association, Philadelphia, PA
Beechwood Resource Center Inc., River Rouge, MI
Behavioral Communication Research, Lexington, KY
Bel Canto Lyric Opera Company, Philadelphia, PA
Belle Babb Nansfield Foundation, Des Moines, IA
Belleville Public Library Foundation, Belleville, KS
Ben Davis Youth Sports Association, Inc., Indianapolis, IN
Bengali Association of Greater Dallas-Ft. Worth, Plano, TX
Benjamin House Inc., Cleveland, OH
Benzie Housing Council, Benzonia, MI
Berlitz Gallery Theatre, Chandler, AZ
Berryville Baseball Association, Inc., Berryville, AR
Best Southwest Business Center, Duncanville, TX
Bethel Foundation, Des Moines, IA
Bethlehem Ministries Inc., Paterson, NJ
Better Business Bureau of the Golden Spread Educational Foundation, Amarillo, TX
Better Community Relations Inc., Toledo, OH
Better Homes for North Carolina Inc., Raleigh, NC
Better Life Inc., Birmingham, MI
Better Way of Life, Chicago, IL

Bexar Metropolitan Housing Association, San Antonio, TX
Beyer School Parent Teacher Organization, Rockford, IL
Beyond the Limits–Childrens Outreach Services, Jackson, MS
Bhagavat Dharma Samaj Inc., Baltimore, MD
Bibleway Community Outreach Projects, Inc., Annapolis, MD
Biblical Counseling Ministries Inc., Merrian, KS
Big Bend People and Goats, Alpine, TX
Big Brothers-Big Sisters of Ford County, Inc., Dodge City, KS
Big Brothers-Big Sisters of Owensboro, Inc., Owensboro, KY
Big Brothers-Big Sisters of Morgan County, Inc., Decatur, AL
Big Horn Basin of Wyoming Resource Conservation and Developmental Project, Worland, WY
Billings Senior High Band Parents Inc., Billings, MT
Binghampton Fellowship Foundation, Inc., Memphis, TN
Birmingham Chapter of the American Association of Energy, Birmingham, AL
Birmingham Regional Sports Club Inc., Birmingham, AL
Birmingham Schools Athletic Foundation, Birmingham, AL
Birthline of Wellington Inc., Wellington, KS
Birthright of Sterling, Sterling, CO
BJ Nutritional Service Inc., Houston, TX
Black & White Medical Transportation, Inc., Pine Bluff, AR
Black Activities at a Glance, Columbus, OH
Black Bear Awareness, Trufant, MI
Black Belt Improvement Group, Hope Hull, AL
Black Business Entrepreneurs, Sandy, UT
Black Professional Men Inc., Baltimore, MD
Black State Employees Association, Dallas, TX
Blind Comprehensive Action Network, St. John, MO
Blind People of America Entertainment BPOA, Inc., Albuquerque, NM
Blossomland Arts and Cultural Council, Saint Joseph, MI
Blue Ash Revitalization Inc., Blue Ash, OH
Blue Ridge Home for Boys, Greer, SC
Bluebirds Over Georgia Inc., Atlanta, GA
Bluegrass Brass Inc., Lexington, KY
Blues Club Inc., Jonesboro, AR
Blues Society of Indiana Incorporated, Indianapolis, IN
Bnai Brith Athletic and Achievement Award Endowment Fund, Roanoke, VA
Bnai Brith Covenant House of Tucson Arizona Inc., Tucson, AZ
Boardwalk Estates Inc., Garden City, KS
Bob Johnson Ice Hockey Foundation, Colorado Springs, CO
Bogalusa Humane Society, Bogalusa, LA
Bone Marrow International, Greensboro, NC
Book Bank Project, Mesa, AZ
Book of Hope Inc., Deerfield, FL
Booksellers for Social Responsibility, Chicago, IL
Boone County Youth Soccer Association, Florence, KY
Bootstrap Inc., New Berlin, WI
Boston Township Hall Committee Inc., Peninsula, OH
Bowling Green Choral Society Inc., Bowling Green, KY
Boys & Girls Club of the Smoky Mountains, Inc., Sevierville, TN
BRACE Inc., Winston-Salem, NC
BREATHE, Boulder, CO

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.

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 Procedral 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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Key to Abbreviations:

RR	Revenue Ruling
RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

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