Internal Revenue
bulletin

Bulletin No. 1998–36
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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

Ct.D. 2063, page 13.

Lien for taxes; validity and priority against third parties; judgement creditor. The Supreme Court has affirmed that under section 6323 of the Code a federal tax lien need not be given preference over a judgement creditor's perfected lien on real property in a decedent's insolvent estate. United States v. Estate of Francis J. Romani, *et al*.

Rev. Rul. 98–43, page 9.

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 1998.

T.D. 8778, page 4.
REG–115446–97, page 23.

Temporary and proposed regulations under section 936 of the Code provide guidance regarding the addition of a substantial new line of business by a possessions corporation that is an existing credit claimant. A public hearing on the proposed regulations will be held on December 1, 1998.

ESTATE TAX

T.D. 8779, page 11.

Final regulations under section 2044 of the Code amend the estate tax marital deduction regulations.

EXCISE TAX

Announcement 98–83, page 36.

This announcement provides excise tax changes for the fourth quarter of 1998 based on recent legislation.

ADMINISTRATIVE

REG–209446–82, page 24.

Proposed regulations under section 1366 of the Code relate to the pass through of items of an S corporation to its shareholders, the adjustments to the basis of stock of the shareholders, and the treatment of distributions by an S corporation. A public hearing will be held on December 15, 1998.

Rev. Proc. 98–46, page 21.

Last-in, first-out inventories; truck dealers. Rev. Proc. 97–44, 1997–41 I.R.B. 8, is modified to extend the relief provided by that revenue procedure for certain LIFO conformity violations of section 472(c) or (e)(2) of the Code to medium- and heavy-duty truck dealers.

Notice 98–46, page 21.

Information reporting; Hope Scholarship Credit; Lifetime Learning Credit. Taxpayers are informed that the Service and Treasury are extending the application of Notice 97–73, 1997–51 I.R.B. 16, to information reporting required under section 6050S of the Code for 1999.

Announcement 98–81, page 35.

The disaster relief provided in section 5.02 of Rev. Proc. 95–28, 1995–1 C.B. 704 and 705, is extended to include an area in Nevada County, California, bordering a declared major disaster area.

Finding Lists begin on page 38.
Index for January-August begins on page 40.

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 semiannual basis and are published in the first Bulletin of the succeeding semiannual period, respectively.

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-in Losses Following Ownership Change

The adjusted federal long-term rate is set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 936.—Puerto Rico and Possession Tax Credit

26 CFR 1.936–11T: New lines of business prohibited (temporary).

T.D. 8778

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Termination of Puerto Rico and Possession Tax Credit; New Lines of Business Prohibited

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance regarding the addition of a substantial new line of business by a possessions corporation that is an existing credit claimant. These temporary regulations reflect changes made by the Small Business Job Protection Act of 1996. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in REG–115446–97, page 23.

DATES: These regulations are effective September 18, 1998.

Applicability: These regulations apply to taxable years of a possessions corporation beginning after August 19, 1998.

FOR FURTHER INFORMATION CONTACT: Patricia A. Bray or Elizabeth Beck, (202) 622-3880, or Jacob Feldman, (202) 622-3830 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1601(a) of the Small Business Job Protection Act of 1996, Public Law 104–188, 110 Stat. 1755 (1996), amended the Internal Revenue Code by adding section 936(j). Section 936(j) generally repeals the Puerto Rico and possession tax credit for taxable years beginning after December 31, 1995. However, the section provides grandfather rules under which a corporation that is an existing credit claimant would be eligible to claim credits for a transition period. The Puerto Rico and possession tax credit will phase out for these existing credit claimants ending with the last taxable year beginning before January 1, 2006.

For taxable years beginning after December 31, 1995 and before January 1, 2006, the Puerto Rico and possession tax credit applies only to a corporation that qualifies as an existing credit claimant (as defined in section 936(j)(9)(A)). The determination of whether a corporation is an existing credit claimant is made separately for each possession. A possessions corporation that adds a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) after October 13, 1995, ceases to be an existing credit claimant as of the beginning of the taxable year during which such new line of business is added. Therefore, a possessions corporation that

ceases to be an existing credit claimant either because it has added a substantial new line of business, or because a new line of business becomes substantial, during a taxable year may not claim the Puerto Rico and possessions tax credit for that taxable year or any subsequent taxable year.

Explanation of Provisions

This document provides temporary regulations that interpret section 936(j)(9)(B). In particular, temporary regulation §1.936–11T adopts principles similar to those in §1.7704–2(c) and (d) (transition rules for existing publicly traded partnerships) for determining whether a corporation has added a substantial new line of business.

Paragraph (a) of §1.936–11T states the general rule that, if a possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A), adds a substantial new line of business during a taxable year, it will cease to be an existing credit claimant as of the close of the taxable year ending before the date of such addition. The paragraph also generally describes the subjects discussed in the other paragraphs in §1.936–11T.

Paragraph (b) addresses the meaning of the term *new line of business.* The temporary regulation generally follows the approach of §1.7704–2(d)(1), providing the general rule derived from §1.7704–2(d)(2) that explains when a business activity is a *pre-existing business,* and from §1.7704–2(d)(3) that defines when that activity is *closely related* to a pre-existing business. Paragraph (b)(1) provides that a new line of business is any activity of the possessions corporation that is not closely related to a pre-existing business of the possessions corporation.

Paragraph (b)(2) explains that, except as provided in paragraph (b)(2)(ii), all the facts and circumstances (including factors A through H in paragraph (b)(2)(i)) must be considered to determine whether a new activity is closely related to a pre-existing business of the possessions corporation. Paragraph (b)(2)(i) applies the same eight factors considered in §1.7704–2(d)(3), except that the temporary regulation provides that in applying factor H, the possessions corporation may use either the new North American Industry Classification System Code (NAICS code) or the Standard Industrial Classification Code (SIC code).

Factor (H) is whether the United States Bureau of the Census assigns the activity the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business. In the case of a pre-existing business or activity that is listed under a NAICS code of 99999, Unclassified establishments, or under a miscellaneous category (most NAICS codes ending in a "9" are miscellaneous categories), the similarity in NAICS codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the NAICS codes is considered in determining whether the activity is closely related to the pre-existing business. For purposes of this section, NAICS codes must be set forth in the North American Industry Classification System Manual, United States, that is in effect for the taxable year during which a new line of business is added.

Similarly, in the case of a pre-existing business or activity that is listed under a SIC code of 9999, Nonclassifiable Establishments, or under a miscellaneous category (most SIC codes ending in a "9" are miscellaneous categories), the similarity in SIC codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the SIC codes is considered as a factor in determining whether the activity is closely related to the pre-existing business. The SIC codes are set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, that is in effect for the taxable year during which a new line of business is added.

Paragraph (b)(2)(ii) provides safe harbors for determining whether an activity is closely related to a pre-existing business in three cases. First, an activity will be closely related to a pre-existing business if the activity is within the same six-digit NAICS code or four-digit SIC code as the pre-existing business. Second, an activity will be closely related to a pre-existing business if the activity is within the same five-digit NAICS code or three-digit SIC code as the pre-existing business and the facts related to the new activity satisfy at least three of the factors in paragraphs (b)(2)(i)(A) through (G) of this section. Third, an activity will be closely related to a pre- existing business if the pre-existing business is making a component product or end-product form, as defined in §1.936–5(a)(1), Q & A1, and the new activity is making an integrated product (or end-product form with fewer excluded components), that is not within the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business solely because the component product and the integrated product (or the two end-product forms) have different end-uses.

Paragraph (b)(3) provides that a business activity of a possessions corporation is considered to be a pre-existing business if the possessions corporation was actively engaged in the activity within the possession on or before October 13, 1995, and the possessions corporation elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which was in effect for the taxable year that included October 13, 1995.

Paragraph (b)(3)(ii) explains how the acquisition of all of the assets or the stock of an existing credit claimant can affect the determination of whether an activity is a pre-existing business. It is intended that an activity that is a pre-existing business of an existing credit claimant and that continues to be carried on in the possession by any affiliated or non-affiliated existing credit claimant should continue to be characterized as a pre-existing activity since all the assets and activity remain in the possession and no new activity is introduced there. A non-affiliated acquiring corporation will not be bound by any section 936(h) election made by the predecessor existing credit claimant with respect to that business activity.

Where all of the assets related to a pre-existing activity of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, but that continues the activity in the possession, the regulation provides that if the acquiring corporation makes an election under section 936(e) for the taxable year of the acquisition, the acquired activity will be treated as a pre-existing activity of the acquiring corporation, and the acquiring corporation will be treated as an existing credit claimant. The acquiring corporation will be deemed to satisfy the rules of section 936(a)(2) for the year of acquisition.

In the case of an acquisition of all the assets of a non-affiliated existing credit claimant, the acquiring corporation will not be bound by its predecessor's elections under sections 936(a)(4) and (h) regarding that business activity.

A mere change in the ownership of a possessions corporation will not affect its status as an existing credit claimant for purposes of determining whether an activity is closely related to a pre-existing business.

Paragraph (b)(4) provides that the test for a new line of business is only applied at the time the new activity is added (as opposed to the test of whether a new line of business is substantial, which is applied annually under paragraph (c) of this section).

Paragraph (c)(1) provides the general rule for determining when a new line of business becomes substantial. The paragraph explains that, for purposes of section 936 and section 30A, a new line of business of a possessions corporation is treated as substantial in the first taxable year in which it satisfies either of the following two tests: (1) the possessions corporation derives more than 15 percent of its gross income for the taxable year from that line of business (the gross income test); or (2) the possessions corporation directly uses in that line of business more than 15 percent of its total assets (the assets test). This position generally reflects the rules of §1.7704–2(c)(1).

For purposes of the gross income test, paragraph (c)(2) provides that the denominator is the amount that is the gross income of the possessions corporation for the current taxable year, while the numerator is the gross income of the new line of business for the current taxable year. The gross income test must be applied at the end of each taxable year. The income is not to be annualized when a new activity begins late in the taxable year. Testing should occur on a company-by-company basis, if a consolidated group election was made pursuant to section 936(i)(5). In the case of a new line of business acquired through the purchase of all of the assets of an existing credit claimant, the gross income test for the acquiring corporation for the year of the acquisition includes only the income from the date of acquisition through the end of the taxable year that includes the date of acquisition.

Paragraph (c)(3) provides rules for applying the annual assets test. For purposes of the assets test, paragraph (c)(3) provides that the denominator is the adjusted tax bases of the total assets of the possessions corporation for the current taxable year, while the numerator is the adjusted tax bases of the total assets utilized in the new line of business for the current taxable year. Total assets include intangibles, cash and receivables. In order to provide for administrative convenience for both the taxpayer and the IRS and for greater certainty in the result, the test uses the adjusted tax bases of the applicable assets since these amounts are already reflected in the books and records of the possessions corporation.

Paragraph (c)(3)(ii) permits an exception to the assets test. A new line of business of a possessions corporation will not be treated as substantial as a result of the assets test if an event that is not reasonably anticipated causes the adjusted tax bases of the assets used in the new line of business to exceed 15 percent of the adjusted tax basis of the possessions corporation's total assets. An event that is not reasonably anticipated would include the destruction of plant and equipment of the pre-existing business due to a hurricane or other natural disaster or other similar circumstances beyond the control of the possessions corporation. The expiration of a patent is not such an event and thus will not trigger this exception.

Paragraph (d) contains five examples that illustrate the rules of this temporary regulation.

Paragraph (e) provides that a possessions corporation that adds a significant new line of business during a taxable year may not claim the Puerto Rico and possession tax credit on its return for the taxable year in which the substantial new line of business is added or a new line of business becomes substantial.

Paragraph (f) provides that the temporary regulation will apply to taxable years of the possessions corporation beginning after August 19, 1998. However, taxpayers may elect to apply all of the provisions of the regulation for any open taxable years beginning after December 31, 1995. Once an election is made, the regulation will apply for all subsequent taxable years. The temporary regulations will not apply to the activities of pre-existing businesses for taxable years beginning before January 1, 1996.

Special Analyses

It has been determined that this temporary regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Moreover, the rules contained in this Treasury decision provide taxpayers with immediate guidance necessary to comply with section 936(j)(9)(B), which was effective for taxable years beginning after December 31, 1995. In the absence of temporary regulations, the only guidance regarding what is a *new line of business* is a reference in the legislative history to the principles of §1.7704–2(d) of the regulations. The only guidance regarding what is *substantial* is a reference to §1.7704–2(c) in the Joint Committee Explanation (Blue Book) of Public Law 104–188. Although a possessions corporation might be able to construct a tax return position based on this information, the effect of misinterpretation is severe—disqualification as an existing credit claimant, without benefits for either the substantial new line of business or the pre-existing business. Taxpayers must have unambiguous guidance on which they can immediately rely in structuring their possession corporation business activities. For these reasons this temporary regulation is needed to ensure the efficient administration of the tax laws. Pursuant to section 7805(f) of the Internal Revenue Code, this temporary regulation will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its effect on small business.

Drafting Information

The principal author of these regulations is Patricia A. Bray of the Office of the Associate Chief Counsel (International), within the office of Chief Counsel, IRS. However, other personnel from the IRS and the Department of the Trea-

sury participated in the development of these regulations.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * * Section 1.936–11T also issued under 26 U.S.C. 936(j). ***

Par. 2. Section 1.936–11T is added to read as follows:

§1.936–11T New lines of business prohibited (temporary).

(a) *In general.* A possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A), and that adds a substantial new line of business during a taxable year, or that has a new line of business that becomes substantial during the taxable year, will cease to be an existing credit claimant as of the close of the taxable year ending before either such taxable year. The term *new line of business* is defined in paragraph (b) of this section. The term *substantial* is defined in paragraph (c) of this section. Paragraph (d) of this section provides examples illustrating paragraphs (a) through (c) of this section. Paragraph (e) of this section instructs a possessions corporation not to claim the Puerto Rico and possession tax credit on its return if it has added a substantial new line of business during the taxable year. Paragraph (f) of this section is the effective date provision.

(b) *New line of business*—(1) *In general.* A new line of business is any business activity of the possessions corporation that is not closely related to a pre-existing business of the possessions corporation. The term *closely related* is defined in paragraph (b)(2) of this section. The term *pre-existing business* is defined in paragraph (b)(3) of this section.

(2) *Closely related.* All the facts and circumstances must be considered, including paragraphs(b)(2)(i)(A) through (H) of this section, to determine whether a new activity is closely related to a pre-existing business of the possessions corporation, and thus is not a new line of business.

(i) *Factors.* The following factors will help to establish that a new activity is closely related to a pre-existing business activity of the possessions corporation—

(A) The activity provides products or services very similar to the products or services provided by the pre-existing business;

(B) The activity markets products and services to the same class of customers as that of the pre-existing business;

(C) The activity is of a type that is normally conducted in the same business location as the pre-existing business;

(D) The activity requires the use of similar operating assets as those used in the pre-existing business;

(E) The activity's economic success depends on the success of the pre-existing business;

(F) The activity is of a type that would normally be treated as a unit with the pre-existing business in the business' accounting records;

(G) If the activity and the pre-existing business are regulated or licensed, they are regulated or licensed by the same or similar governmental authority; and

(H) The United States Bureau of the Census assigns the activity the same six-digit North American Industry Classification System (NAICS) code or four-digit Industry Number Standard Identification code (SIC code) as the pre-existing business. In the case of a pre-existing business or activity that is listed under a NAICS code of 99999, Unclassified Establishments, or under a miscellaneous category (most NAICS codes that end in a "9" are miscellaneous categories), the similarity in NAICS codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the NAICS code is considered in determining whether the activity is closely related to the pre-existing business. For purposes of this section, NAICS codes must be set forth in the North American Industry Classification System (United States) Manual that is in effect for the taxable year during which a new line of business is added. The official NAICS-United States Manual is available in both printed and electronic versions from the National Technical Information Service (NTIS) at 1-800-553-6847 or at the NTIS NAICS web site at <http://www.ntis.gov/naics>. In the case of a pre-existing business or activity that is listed under a SIC code of 9999, Nonclassifiable Establishments, or under a miscellaneous category (most SIC codes ending in "9" are miscellaneous categories), the similarity in SIC codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the SIC codes is considered in determining whether the activity is closely related to the pre-existing business. The SIC codes are set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, that is in effect for the taxable year during which a new line of business is added. A printed version of the official SIC Manual is available from the National Technical Information Service (NTIS) at 1-800-553-6847.

(ii) *Safe harbors.* An activity is closely related to a pre-existing business and thus is not a new line of business in the following three cases—

(A) If the activity is within the same six-digit NAICS code (or four-digit SIC code);

(B) If both the pre-existing business activity and the new activity are within the same five-digit NAICS code (or three-digit SIC code) and the facts relating to the new activity satisfy at least three of the factors listed in paragraph (b)(2)(i)(A) through (G) of this section; or

(C) If the pre-existing business is making a component product or end-product form, as defined in §1.936–5(a)(1),Q & A1, and the new business activity is making an integrated product, or an end-product form with fewer excluded components, that is not within the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business solely because the component product and the integrated product (or two end-product forms) have different end-uses.

(3) *Pre-existing business*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) and (4) of this section, a business activity is a pre-existing business of the existing credit claimant if—

(A) The existing credit claimant was actively engaged in the activity within the

possession on or before October 13, 1995; and

(B) The existing credit claimant has elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which is in effect for the taxable year that includes October 13, 1995.

(ii) *Acquisition of all of the assets or stock of an existing credit claimant.* (A) If all the assets of a pre-existing business of an existing credit claimant are acquired by an affiliated or non-affiliated existing credit claimant which carries on the business activity of the predecessor existing credit claimant, the acquired business activity will be treated as a pre-existing business of the acquiring corporation. A non-affiliated acquiring corporation will not be bound by any section 936(h) election made by the predecessor existing credit claimant with respect to that business activity.

(B) Where all of the assets of a pre-existing business of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, if the acquiring corporation makes a section 936(e) election for the taxable year in which the assets are acquired—

(*1*) The acquiring corporation will be treated as an existing credit claimant for the year of acquisition;

(*2*) The activity will be considered a pre-existing business of the acquiring corporation;

(*3*) The acquiring corporation will be deemed to satisfy the rules of section 936(a)(2) for the year of acquisition; and

(*4*) After making an election under section 936(e), a non-affiliated acquiring corporation will not be bound by elections under sections 936(a)(4) and (h) made by the predecessor existing credit claimant.

(C) A mere change in the stock ownership of a possessions corporation will not affect its status as an existing credit claimant for purposes of this section.

(4) *Timing rule.* The tests for a new line of business in this paragraph (whether the new activity is closely related to a pre-existing business) are applied only at the end of the taxable year during which the new activity is added.

(c) *Substantial*—(1) *In general.* For purposes of section 936 and section 30A, a new line of business is considered to be substantial as of the earlier of—

(i) The taxable year in which the possessions corporation derives more that 15 percent of its gross income from that new line of business (gross income test); or

(ii) The taxable year in which the possessions corporation directly uses in that new line of business more that 15 percent of its assets (assets test).

(2) *Gross income test.* The denominator in the gross income test is the amount that is the gross income of the possessions corporation for the current taxable year, while the numerator is the amount that is the gross income of the new line of business for the current taxable year. The gross income test is applied at the end of each taxable year. For purposes of this test, if a new line of business is added late in the taxable year, the income is not to be annualized in that year. In the case of a new line of business acquired through the purchase of assets, the gross income of such new line of business for the taxable year of the acquiring corporation that includes the date of acquisition is determined from the date of acquisition through the end of the taxable year. In the case of a consolidated group election made pursuant to section 936(i)(5), the test applies on a company by company basis and not on a consolidated basis.

(3) *Assets test*—(i) *Computation.* The denominator is the adjusted tax basis of the total assets of the possessions corporation for the current taxable year. The numerator is the adjusted tax basis of the total assets utilized in the new line of business for the current taxable year. The assets test is computed annually using all assets including cash and receivables.

(ii) *Exception.* A new line of business of a possessions corporation will not be treated as substantial as a result of meeting the assets test if an event that is not reasonably anticipated causes assets used in the new line of business of the possessions corporation to exceed 15 percent of the adjusted tax basis of the possession corporation's total assets. For example, an event that is not reasonably anticipated would include the destruction of plant and equipment of the pre-existing business due to a hurricane or other natural disaster, or other similar circumstances beyond the control of the possessions corporation. The expiration of a patent is not such an event and will not trigger this exception.

(d) *Examples.* The following examples illustrate the rules described in paragraphs (a), (b), and (c) of this section. In the following examples, X Corp. is an existing credit claimant unless otherwise indicated:

Example 1. X Corp. is a pharmaceutical corporation which manufactured bulk chemicals (a component product). In March 1997, X Corp. began to also manufacture pills (e.g., finished dosages or an integrated product). The new activity provides products very similar to the products provided by the pre-existing business. The new activity is of a type that is normally conducted in the same business location as the pre-existing business. The activity's economic success depends on the success of the pre-existing business. The manufacture of bulk chemicals is in NAICS code 325411, Medicinal and Botanical Manufacturing, while the manufacture of the pills is in NAICS code 325412, Pharmaceutical Preparation Manufacturing. Although the products have a different end-use, may be marketed to a different class of customers, and may not use similar operating assets, they are within the same five-digit NAICS code and the activity also satisfies paragraphs (b)(2)(i)(A), (C), and (E) of this section. The manufacture of the pills by X Corp. will be considered closely related to the manufacture of the bulk chemicals. Therefore, X Corp. did not add a new line of business because it falls within the safe harbor rule of paragraph (b)(2)(ii)(B) of this section.

Example 2. X Corp. currently manufactures printed circuit boards in a possession. As a result of a technological breakthrough, X Corp. could produce the printed circuit boards more efficiently if it modified its existing production methods. Because demand was high, X Corp. expanded its facilities to support the production of its current products when it modified its production methods. After these modifications to the facilities and production methods, the products produced through the new technology were in the same six-digit NAICS code as products produced previously by X Corp. See paragraph (b)(2)(ii)(A) of this section. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section.

Example 3. X Corp. has manufactured Device A in Puerto Rico for a number of years and began to manufacture Device B in Puerto Rico in 1997. Device A and Device B are both used to conduct electrical current to the heart and are both sold to cardiologists. There is no significant change in the type of activity conducted in Puerto Rico after the transfer of the manufacturing of Device B to Puerto Rico. Similar manufacturing equipment, manufacturing processes and skills are used in the manufacture of both devices. Both are regulated and licensed by the Food and Drug Administration. The economic success of Device B is dependent upon the success of Device A only to the extent that the liability and manufacturing prowess with respect to one reflects favorably on the other. Depending upon the heart abnormality, the cardiologist may choose to use Device A, Device B or both on a patient. Both devices are within the same business sector of the taxpayer's business. The manufacture of Device A is in the six-digit NAICS code 339112, Surgical and Medical Instrument Manufacturing. The manufacture of Device B is in the six-digit NAICS code 334510, Electromedical and electro- therapeutic Apparatus Manufacturing. (The manufacture of Device A is in the four-digit SIC code 3845, Electromedical and Electrotheraputic Apparatus. The manufacture of Device B is in the four-digit SIC code 3841, Surgi-

cal and Medical Instruments and Apparatus.) The safe harbor of paragraph (b)(2)(ii)(B) of this section applies because the two activities are within the same three-digit SIC code and Corp. X satisfies paragraphs (b)(2)(i)(A), (B), (C), (D), (F), and (G) of this section.

Example 4. X Corp. has been manufacturing house slippers in Puerto Rico since 1990. Y Corp. is a U.S. corporation that is not affiliated with X Corp. and is not an existing credit claimant. Y Corp. has been manufacturing snack food in the United States. In 1997, X Corp. purchased the assets of Y Corp. and began to manufacture snack food in Puerto Rico. House slipper manufacturing is in the six-digit NAICS code 316212 (Four-digit SIC code 3142, House Slippers). The manufacture of snack foods falls under the six-digit NAICS code 311919, Other Snack Food Manufacturing (four-digit SIC code 2052, Cookies and Crackers (pretzels)). Because these activities are not within the same five or six digit NAICS code (or the same three or four-digit SIC code), and because snack food is not an integrated product that contains house slippers, the safe harbor of paragraph (b)(2)(ii) of this section cannot apply. Considering all the facts and circumstances, including the eight factors of paragraph (b)(2)(i) of this section, the snack food manufacturing activity is not closely related to the manufacture of house slippers, and is a new line of business, within the meaning of paragraph (b) of this section.

Example 5. X Corp. is an existing credit claimant that has elected the profit-split method for computing taxable income. P Corp. was not an existing credit claimant and manufactured a product in a different five-digit NAICS code than the product manufactured by X Corp. In 1997, X Corp. acquired the stock of P Corp. and liquidated P Corp. in a tax-free liquidation under section 332, but continued the business activity of P Corp. as a new business segment. Assume that this new business segment is a new line of business within the meaning of paragraph (c) of this section. In 1997, X Corp. has gross income from the active conduct of a trade or business in a possession computed under section 936(a)(2) of $500 million and the adjusted tax basis of its assets is $200 million. The new business segment had gross income of $60 million, or 12 percent of the X Corp. gross income, and the adjusted basis of the new segment's assets was $20 million, or 10 percent of the X Corp. total assets. In 1997, X Corp. does not derive more than 15 percent of its gross income, or directly use more that 15 percent of its total assets, from the new business segment. Thus, the new line of business acquired from P Corp. is not a *substantial* new line of business within the meaning of paragraph (c) of this section, and the new activity will not cause X Corp. to lose its status as an existing credit claimant during 1997. In 1998, however, the gross income of X Corp. grew to $750 million while the gross income of the new line of business grew to $150 million, or 20% of the X Corp. 1998 gross income. Thus, in 1998, the new line of business is substantial within the meaning of paragraph (c) of this section, and X Corp. loses its status as an existing credit claimant as of December 31, 1997.

(e) *Loss of status as existing credit claimant.* An existing credit claimant that adds a substantial new line of business in a taxable year, or that has a new line of business that becomes substantial in a taxable year, loses its status as an existing credit claimant as of the close of the taxable year ending before either such taxable year. In such case, the possession corporation must not claim the Puerto Rico and possession tax credit on its return for the taxable year in which the substantial new line of business is added or a new line of business becomes substantial.

(f) *Effective date*—(1) *General rule.* This section applies to taxable years of a possessions corporation beginning after August 19, 1998.

(2) *Election for retroactive application.* Taxpayers may elect to apply retroactively all the provisions of this section for any open taxable year beginning after December 31, 1995. Such election will be effective for the year of the election and all subsequent taxable years. This section will not apply to activities of pre-existing businesses for taxable years beginning before January 1, 1996.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 18, 1998, 8:45 a.m., and published in the issue of the Federal Register for August 19, 1998, 63 F.R. 44387)

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 1998.

Rev. Rul. 98–43

This revenue ruling provides various prescribed rates for federal income tax purposes for September 1998 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 98–43 TABLE 1

Applicable Federal Rates (AFR) for September 1998

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.42%	5.35%	5.31%	5.29%
110% AFR	5.98%	5.89%	5.85%	5.82%
120% AFR	6.52%	6.42%	6.37%	6.34%
130% AFR	7.08%	6.96%	6.90%	6.86%
Mid-Term				
AFR	5.54%	5.47%	5.43%	5.41%
110% AFR	6.11%	6.02%	5.98%	5.95%
120% AFR	6.67%	6.56%	6.51%	6.47%
130% AFR	7.24%	7.11%	7.05%	7.01%
150% AFR	8.38%	8.21%	8.13%	8.07%
175% AFR	9.80%	9.57%	9.46%	9.38%
Long-Term				
AFR	5.74%	5.66%	5.62%	5.59%
110% AFR	6.33%	6.23%	6.18%	6.15%
120% AFR	6.91%	6.79%	6.73%	6.70%
130% AFR	7.50%	7.36%	7.29%	7.25%

REV. RUL. 98–43 TABLE 2

Adjusted AFR for September 1998

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.66%	3.63%	3.61%	3.60%
Mid-term adjusted AFR	4.24%	4.20%	4.18%	4.16%
Long-term adjusted AFR	5.02%	4.96%	4.93%	4.91%

REV. RUL. 98–43 TABLE 3

Rates Under Section 382 for September 1998

Adjusted federal long-term rate for the current month	5.02%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.02%

REV. RUL. 98–43 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for September 1998

Appropriate percentage for the 70% present value low-income housing credit	8.32%
Appropriate percentage for the 30% present value low-income housing credit	3.57%

REV. RUL. 98–43 TABLE 5

Rate Under Section 7520 for September 1998

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	6.6%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 2044.—Certain Property for Which Marital Deduction Was Previously Allowed

26 CFR 1.2044–1: Certain property for which marital deduction was previously allowed.

T.D. 8779

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 20 and 602

Estate and Gift Tax Marital Deduction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations amending the estate tax marital deduction regulations. The amendments are made to conform the estate tax regulations to recent court decisions in *Estate of Clayton v. Commissioner,* 976 F.2d 1486 (5th Cir. 1992), *rev'g* 97 T.C. 327 (1991); *Estate of Robertson v. Commissioner,* 15 F.3d 779 (8th Cir. 1994), *rev'g* 98 T.C. 678 (1992); *Estate of Spencer v. Commissioner,* 43 F.3d 226 (6th Cir. 1995), *rev'g* T.C. Memo. 1992–579; and *Estate of Clack v. Commissioner,* 106 T.C. 131 (1996). The amendments affect estates of decedents electing the marital deduction for qualified terminable interest property (QTIP) and the estates of the surviving spouses of such decedents.

DATES: These regulations are effective August 19, 1998.

FOR FURTHER INFORMATION CONTACT: Susan B. Hurwitz, (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in these final regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545–1612.

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 OMB.

The collection of information in this regulation is in §20.2056(b)–7(d)(3)(ii). This information is required to provide a method for estates of decedents whose estate tax returns were due on or before February 18, 1997, to obtain an extension of time to make the qualified terminable interest property election under section 2056(b)(7)(B)(v). This information will be used to inform the IRS of the affected estates that are electing to obtain the relief granted in the regulation. The collection of information is mandatory for those estates that seek relief. The likely respondents are individuals representing estates.

Comments concerning the collection of information should be directed to OMB, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Any such comments should be submitted not later than October 19, 1998. Comments are specifically requested concerning:

Whether the 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 collection of information (see below);

How to enhance the quality, utility, and clarity of the information collected;

How to minimize the burden of complying with the collection of information, including 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.

Estimates of the reporting burden in these final regulations will be reflected in the burden of Form 843 (Claim for Refund and Request for Abatement) and Form 706 (Estate Tax Return) or 706NA (Estate Tax Return for Nonresident Noncitizens).

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

Background

On March 1, 1994, the IRS published final estate and gift tax regulations (26 CFR part 20 and part 25) under sections 2044, 2056, 2207A, 2519, 2523, and 6019 of the Internal Revenue Code (Code) in the **Federal Register** (59 F.R. 9642). At

that time, §20.2056(b)–7(d)(3) provided that an income interest (or life estate) that is contingent upon the executor's election under section 2056(b)(7)(B)(v) (the QTIP election) is not a qualifying income interest for life.

On February 18, 1997, temporary regulations (T.D. 8714) amending the existing final estate tax regulations relating to the marital deduction for qualified terminable interest property (QTIP) were published in the **Federal Register** (62 F.R. 7156). A notice of proposed rulemaking (REG–209830–96) cross-referencing the temporary regulations was published in the **Federal Register** (62 F.R. 7188) for the same day.

The temporary regulations provide that an income interest for life (or life estate) that is contingent upon the executor's QTIP election, will not, because of the contingency, fail to be a qualifying income interest for life.

Written comments responding to the notice of proposed rulemaking were received. A public hearing was held on June 3, 1997. After consideration of all the comments, the proposed regulations under sections 2044 and 2056 are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed.

Explanation of Revisions and Summary of Comments

Under section 2056(b)(7)(B)(ii), the surviving spouse has a qualifying income interest for life in property which passes from the decedent if (1) the surviving spouse is entitled to all of the income from the property, payable at least annually (or has a usufruct interest for life in the property), and (2) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Commentators suggested that the regulation, based on the case law, should specifically provide that as a result of the executor's election over a portion of the property, in cases where the unelected portion of the property passes to a beneficiary other than the surviving spouse, the executor will not be considered to have a power to appoint any part of the property to any person other than the surviving spouse.

The final regulation is clarified to provide that an interest in property is eligible for treatment as qualified terminable interest property if the income interest is contingent upon the executor's election and if that portion of the property for which no election is made will pass to or for the benefit of beneficiaries other than the surviving spouse. Two examples provided in the temporary regulations have been revised in the final regulations to conform to this clarification.

Comments were also received regarding the effective date of the temporary regulations. It was suggested that relief should be made available for estates of decedents that did not make the QTIP election on their estate tax returns because the surviving spouse's income interest in the property was contingent upon the election or because the nonelected portion of the property was to pass to a beneficiary other than the surviving spouse. Accordingly, the final regulations provide that estates of decedents whose estate tax returns were due on or before February 18, 1997, are granted an extension of time to make the QTIP election if: (1) the period of limitations on filing a claim for credit or refund under section 6511(a) has not expired; and (2) the estate submits a statement providing that, pursuant to section 2044, the surviving spouse's gross estate will include the value, at the date of the surviving spouse's death, of the property for which the QTIP election is being made. The statement must be signed, under penalties of perjury, by the surviving spouse, the surviving spouse's legal representative (if the surviving spouse is legally incompetent), or the surviving spouse's executor (if the surviving spouse is deceased).

Special Analyses

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

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 20 and 602 are amended as follows:

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

Paragraph 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. In §20.2044-1, paragraph (e) *Example 8* is added to read as follows:

§20.2044–1 Certain property for which marital deduction was previously allowed.

* * * * *

(e) * * *

Example 8. Inclusion of trust property when surviving spouse dies before first decedent's estate tax return is filed. D dies on July 1, 1997. Under the terms of D's will, a trust is established for the benefit of D's spouse, S. The will provides that S is entitled to receive the income from that portion of the trust that the executor elects to treat as qualified terminable interest property. The remaining portion of the trust passes as of D's date of death to a trust for the benefit of C, D's child. The trust terms otherwise provide S with a qualifying income interest for life under section 2056(b)(7)(B)(ii). S dies on February 10, 1998. On April 1, 1998, D's executor files D's estate tax return on which an election is made to treat a portion of the trust as qualified terminable interest property under section 2056(b)(7). S's estate tax return is filed on November 10, 1998. The value on the date of S's death of the portion of the trust for which D's executor made a QTIP election is includible in S's gross estate under section 2044.

§20.2044–1T [Removed]

Par. 3. Section 20.2044–1T is removed.

Par. 4. In §20.2056(b)–(7), paragraphs (d)(3) and (h) *Example 6* are revised to read as follows:

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

* * * * *

(d) * * *

(3) *Contingent income interests.* (i) An income interest for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g., remarriage), is not a qualifying income interest for life. However, a qualifying income interest for life that is contingent upon the executor's election under section 2056(b)(7)(B)(v) will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse. This paragraph (d)(3)(i) applies with respect to estates of decedents whose estate tax returns are due after February 18, 1997. This paragraph (d)(3)(i) also applies to estates of decedents whose estate tax returns were due on or before February 18, 1997, that meet the requirements of paragraph (d)(3)(ii) of this section.

(ii) Estates of decedents whose estate tax returns were due on or before February 18, 1997, that did not make the election under section 2056(b)(7)(B)(v) because the surviving spouse's income interest in the property was contingent upon the election or because the nonelected portion of the property was to pass to a beneficiary other than the surviving spouse are granted an extension of time to make the QTIP election if the following requirements are satisfied:

(A) The period of limitations on filing a claim for credit or refund under section 6511(a) has not expired.

(B) A claim for credit or refund is filed on Form 843 with a revised Recapitulation and Schedule M, Form 706 (or 706NA) that signifies the QTIP election. Reference to this section should be made on the Form 843.

(C) The following statement is included with the Form 843: "The undersigned certifies that the property with respect to which the QTIP election is being made will be included in the gross estate of the surviving spouse as provided in section 2044 of the Internal Revenue Code, in determining the federal estate tax liability on the spouse's death." The statement must be signed, under penalties of perjury, by the surviving spouse, the surviving spouse's legal representative (if the surviving spouse is legally incompetent), or the surviving spouse's executor (if the surviving spouse is deceased).

* * * * *

(h) * * *

Example 6. Spouse's qualifying income interest for life contingent on executor's election. D's will established a trust providing that S is entitled to receive the income, payable at least annually, from that portion of the trust that the executor elects to treat as qualified terminable interest property. The portion of the trust which the executor does not elect to treat as qualified terminable interest property passes as of D's date of death to a trust for the benefit of C, D's child. Under these facts, the executor is not considered to have a power to appoint any part of the trust property to any person other than S during S's life.

* * * * *

§20.2056(b)–7T [Removed]

Par. 5. Section 20.2056(b)–7T is removed.

Par. 6. Section 20.2056(b)–10 is revised to read as follows:

§20.2056(b)–10 Effective dates.

Except as specifically provided in §§20.2056(b)–5(c)(3)(ii) and (iii), 20.2056(b)–7(d)(3), 20.2056(b)–7(e)(5), and 20.2056(b)–8(b), the provisions of §§20.2056(b)–5(c), 20.2056(b)–7, 20.2056(b)–8, and 20.2056(b)–9 are applicable with respect to estates of decedents dying after March 1, 1994. With respect to decedents dying on or before such date, the executor of the decedent's estate may rely on any reasonable interpretation of the statutory provisions.

§20.2056(b)–10T [Removed]

Par. 7. Section 20.2056(b)–10T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. In §602.101, paragraph (c), the entry in the table for 20.2056(b)–7 is revised to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
20.2056(b)–7	1545–0015 1545–1612
* * * * *	

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved July 27, 1998.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 18, 1998, 8:45 a.m., and published in the issue of the Federal Register for 63 F.R. 44391)

Section 6323.—Validity and Priority Against Certain Persons

Ct.D. 2063

SUPREME COURT OF THE UNITED STATES

No. 96–1613

UNITED STATES v. ESTATE OF FRANCIS J. ROMANI *ET AL.*

523 U.S.______(1998)

CERTIORARI TO THE SUPREME COURT OF PENNSYLVANIA, WESTERN DISTRICT

APRIL 19,1998

Syllabus

After a third party perfected a $400,000 judgment lien under Pennsylvania law on Francis Romani's Cambria County real property, the Internal Revenue Service filed notices of tax liens on the property, totaling some $490,000. When Mr. Romani died, his entire estate consisted of real estate worth only $53,001. Because

the property was encumbered by both the judgment lien and the federal tax liens, the estate's administrator sought the county court's permission to transfer the property to the 'judgment creditor in hen of execution. The court authorized the conveyance, overruling the Federal Government's objection that the transfer violated the federal priority statute, 31 U. S. C. §3713(a), which provides that a Government claim "shall be paid first" when a decedent's estate cannot pay all of its debts. The Superior Court of Pennsylvania affirmed, as did the Pennsylvania Supreme Court. The latter court determined that there was a "plain inconsistence" between §3713 and the Federal Tax Lien Act of 1966, which provides that a federal tax hen "shall not be valid" against judgment lien creditors until a prescribed notice has been given, 26 U. S. C. §6323(a). The court concluded that the 1966 Act effectively limited §3713's operation as to tax debts, relying on United States v. Kimbell Foods, Inc., 440 U. S. 715, 738, which noted that the 1966 Act modified the Government's preferred position in the tax area and recognized the priority of many state claims over federal tax liens.

Held: Section 3713(a) does not require that a federal tax claim be given preference over a judgment creditor's perfected hen on real property. Pp. 4– 17.

(a) There is no dispute about the meaning of either the Pennsylvania hen statute or the Tax Lien Act. It is undisputed that, under the state law, the judgment creditor acquired a valid lien on Romani's real property before his death and before the Government served notice of its tax hens. That lien was therefore perfected in the sense that there is nothing more to be done to have a choate hen. *E.g., United States v. City of New Britain,* 347 U. S. 81, 84. And a review of the Tax Lien Act's history reveals that each time Congress has revisited the federal tax lien, it has ameliorated pre-existing harsh consequences for the delinquent taxpayer's other secured creditors. Here, all agree that by §6323(a)'s terms, the Government's liens are not valid as against the earlier recorded judgment lien. Pp. 4–7.

(b) Because this Court has never definitively resolved the basic question whether the federal priority statute gives the United States a preference only over other unsecured creditors, or whether it also applies to the antecedent perfected liens of secured creditors, see, *e.g., United States v. Vermont,* 377 U. S. 351, 358, n. 8, it does not seem appropriate to view the issue here as whether the Tax Lien Act has implicitly amended or repealed §3713(a). Instead, the proper inquiry is how best to harmonize the two statutes' impact on the Government's power to collect delinquent taxes. Pp. 7–12.

(c) Nothing in the federal priority statute's text or its long history justifies the conclusion that it authorizes the equivalent of a secret lien as a substitute for the expressly authorized tax lien that the Tax Lien Act declares "shall not be valid" in a case of this kind. On several occasions, this Court has concluded that a specific policy embodied in a later federal statute should control interpretation of the older federal priority statute, despite that law's literal, unconditional text and the fact that it had not been expressly amended by the later Act. See, *e.g., Cook County Nat. Bank v. United States,* 107 U. S. 445, 448451. *United States v. Emory,* 314 U. S. 423, 429–433, and *United States v. Key,* 397 U. S. 322, 324–333, distinguished. So too here, there are sound reasons for treating the Tax Lien Act as the governing statute. That Act is the later statute, the more specific statute, and its provisions are comprehensive, reflecting an obvious attempt to accommodate the strong policy objections to the enforcement of secret liens. It represents Congress' detailed judgment as to when the Government's claims for unpaid taxes should yield to many different sorts of interests (including, *e.g.,* judgment liens, mechanic's liens, and attorneys' liens) in many different types of property (including, *e.g.,* real property, securities, and motor vehicles). See §6323. Indeed, given this Court's unambiguous determination that the federal interest in the collection of taxes is paramount to its interest in enforcing other claims, see *Kimbell Foods Inc.,* 440 U. S., at 733735, it would be anomalous to conclude that Congress intended the priority statute to impose greater burdens on the citizen than those specifically crafted for tax collection purposes. Pp. 12–17.

__Pa.__, 688 A. 2d 703, affirmed.

STEVENS, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and O'CONNER, KENNEDY, SOUTHER, THOMAS, GINSBURG, and BREYER, J.J., joined. SCALIA J., filed an opinion concurring in part and concurring in the judgment.

SUPREME COURT OF THE UNITED STATES

No. 96–1613

UNITED STATES, PETITIONER v. ESTATE OF FRANCIS J. ROMANI *ET AL.*

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF PENNSYLVANIA, WESTERN DISTRICT

[April, 29, 1998]

JUSTICE STEVENS delivered the opinion of the Court.

The federal priority statute, 31 U. S. C. §3713(a), provides that a claim of the United States Government "shall be paid first" when a decedent's estate cannot pay all of its debts.[1] The question presented is whether that statute requires that a federal

[1]"§3713. Priority of Government claims

"(a)(1) A claim of the United States Government shall be paid first when—

"(A) a person indebted to the Government is insolvent and—

"(i) the debtor without enough property to pay all debts makes a voluntary assignment of property;

"(ii) property of the debtor, if absent, is attached; or

"(iii) an act of bankruptcy is committed; or

"(B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.

"(2) This subsection does not apply to a case under title ll." 31 U.S.C. §3713.

The present statute is the direct descendent of §3466 of the Revised Statutes, which had been codified in 31 U. S. C. § 191.

tax claim be given preference over a judgment creditor's perfected lien on real property even though such a preference is not authorized by the Federal Tax Lien Act of 1966, 26 U. *S. C.* §6321 *et seq.*

I

On January 25, 1985, the Court of Common Pleas of Cambria County, Pennsylvania, entered a judgment for $400,000 in favor of Romani Industries, Inc., and against Francis J. Romani. The judgment was recorded in the clerk's office and therefore, as a matter of Pennsylvania law, it became a lien on all of the defendant's real property in Cambria County. Thereafter, the Internal Revenue Service filed a series of notices of tax liens on Mr. Romani's property. The claims for unpaid taxes, interest and penalties described in those notices amounted to approximately $490,000.

When Mr. Romani died on January 13, 1992, his entire estate consisted of real estate worth only $53,001. Because the property was encumbered by both the judgment lien and the federal tax liens, the estate's administrator sought permission from the Court of Common Pleas to transfer the property to the judgment creditor, Romani Industries, in lieu of execution. The Federal Government acknowledged that its tax liens were not valid as against the earlier judgment hen; but, giving new meaning to Franklin's aphorism that "in this world nothing can be said to be certain, except death and taxes,"[2] it opposed the transfer on the ground that the priority statute (§3713) gave it the right to "be paid first."

The Court of Common Pleas overruled the Government's objection and authorized the conveyance. The Superior Court of Pennsylvania affirmed, and the Supreme Court of the State also affirmed. 547 Pa. 41, 688 A. 2d 703 (1997). That court first determined that there was a "plain inconsistency" between §3713, which appears to give the United States "absolute priority" over all competing claims, and the Tax Lien Act of 1966, which provides that the federal tax lien "shall not be valid" against judgment hen creditors until a prescribed notice has been given. *Id.,* at 45, 688 A. 2d, at 705.[3] Then, relying on the reasoning in *United States v. Kimbell Foods, Inc.,* 440 U. S. 715 (1979), which had noted that the Tax Lien Act of 1966 modified the Federal Government's preferred position in the tax area and recognized the priority of many state claims over federal tax liens, *id.,* at 738, the court concluded that the 1966 Act had the effect of limiting the operation of §3713 as to tax debts.

The decision of the Pennsylvania Supreme Court conflicts with two federal court of appeals decisions, *Kentucky ex rel. Luckett v. United States,* 383 F. 2d 13 (CA6 1967), and *Nesbitt v. United States,* 622 F. 2d 433 (CA9 1980). Moreover, in its petition for certiorari, the Government submitted that the decision is inconsistent with our holding in *Thelusson v. Smith,* 2 Wheat. 396 (1817), and with the admonition that "'[o]nly the plainest inconsistency would warrant our finding an implied exception to the operation of so clear a command as that of [31 U. S. C. §3713],"' *United States v. Key,* 397 U.S. 322, 324-325 (1970) (quoting *United States v. Emory,* 314 U.S. 423, 433 (1941)). We granted certiorari, 521 U. S. (1997), to resolve the conflict and to consider whether *Thelusson, Key,* or any of our other cases construing the priority statute requires a different result.

II

There is no dispute about the meaning of two of the three statutes that control the disposition of this case. It is therefore appropriate to comment on the Pennsylvania lien statute and the Federal Tax Lien Act before considering the applicability of the priority statute to property encumbered by an antecedent judgment creditor's lien.

The Pennsylvania statute expressly provides that a judgment shall create a lien against real property when it is recorded in the county where the property is located. 42 Pa. Cons. Stat. §4303(a) (1995). After the judgment has been recorded, the judgment creditor has the same right to notice of a tax sale as a mortgagee.[4] The recording in one county does not, of course, create a lien on property located elsewhere. In this case, however, it is undisputed that the judgment creditor acquired a valid lien on the real property in Cambria County before the judgment debtor's death and before the Government served notice of its tax liens. Romani Industries' lien was "perfected in the sense that there is nothing more to be done to have a choate lien—when the identity of the lienor, the property subject to the lien, and the amount of the hen are established." United States v. City of New Britain, 347 U. S. 81, 84 (1954); see also *Illinois ex rel. Gordon v. Campbell,* 329 U.S. 362, 375 (1946).

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[2]Letter of November 13, 1789 to Jean Baptiste Le Roy, in 10 The Writings of Benjamin Franklin 69 (A. Smyth ed. 1907). As is often the case, the original meaning of the aphorism is clarified somewhat by its context: "Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes." *Ibid.*

[3]The Federal Tax Lien Act of 1966, 26 U. S. C. §6321 *et seq.,* provides in pertinent part:

"§6321. Lien for taxes

"If any person liable to pay any tax neglects or refuuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."

"§6323. Validity and priority against certain persons

"(a) Purchasers, holders of security interests, mechanic's henors, and judgment lien creditors

"The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's henor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary."

Section 6323(f)(1)(A)(i) provides that the required notice 'shall be filed … [i]n the case of real property, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the hen is situated." If the State has not designated such an office, notice is to be filed with the clerk of the federal district court "for the judicial district in which situated." §6323(f)(1)(B). the property subject to the lien is situated." §6232(f)(1)(B).

[4]The Pennsylvania Supreme Court has elaborated:

"We must now decide whether judgment creditors are also entitled to personal or general notice by the [County Tax Claim] Bureau as a matter of due process of law.

"Judgment liens are a product of centuries of statutes which authorize a judgment creditor to seize and sell the land of debtors at a judicial sale to satisfy their debts out of the proceeds of the sale. The judgment represents a binding judicial determination of the rights and duties between the parties, and establishes their debtor-creditor relationship for all the world to notice when the judgment is recorded in a Prothonotary's Office. When entered of record, the judgment also operates as a lien upon all real property of the debtor in that county." *In re Upset Sale, Tax Claiin Bureau of Berks County,* 505 Pa. 327, 334, 479 A. 2d 940,943(1984).

The Federal Government's right to a hen on a delinquent taxpayer's property has been a part of our law at least since 1865.[5] Originally the lien applied, without exception, to all property of the taxpayer immediately upon the neglect or failure to pay the tax upon demand.[6] An unrecorded tax lien against a delinquent taxpayer's property was valid even against a bona fide purchaser who had no notice of the lien. *United States v. Snyder,* 149 U. S. 210, 213– 215 (1893). In 1913, Congress amended the statute to provide that the federal tax hen "shall not be valid as against any mortgagee, purchaser, or judgment creditor" until notice has been filed with the clerk of the federal district court or with the appropriate local authorities in the district or county in which the property subject to the hen is located. Act of Mar. 4, 1913, 37 Stat. 1016. In 1939, Congress broadened the protection against unfiled tax hens to include pledgees and the holders of certain securities. Act of June 29, 1939, §401, 53 Stat. 882–883. The Federal Tax Lien Act of 1966 again broadened that protection to encompass a variety of additional secured transactions, and also included detailed provisions protecting certain secured interests even when a notice of the federal hen previously has been filed. 80 Stat. 1125-1132, as amended, 26 U. *S. C.* §6323.

[5]The post-Civil War Reconstruction Congress imposed a tax of three cents per pound on "the producer, owner, or holder" of cotton and a hen on the cotton until the tax was paid. Act of July 13, 1866, §1, 14 Stat. 98. The same statute also imposed a general lien on all of a delinquent taxpayer's property, see §9, 14 Stat. 107, which was nearly identical to a provision in the revenue act of Mar. 3, 1865, 13 Stat. 470–471, quoted in n. 6, *infra.*

[6]The 1865 revenue act contained the following sentence: 'And if any person, bank, association, company, or corporation, liable to pay any duty, shall neglect or refuse to pay the same after demand, the amount shall be a hen in favor of the United States from the time it was due until paid, with the interests, penalties, and costs that may accrue m addition thereto, upon all property and rights to property; and the collector, after demand, may levy or by warrant may authorize a deputy collector to levy upon all property and rights to property belonging to such person, bank, association, company, or corporation, or on which the said hen exists, for the payment of the sum due as aforesaid, with interest and penalty for non-payment, and also of such further sum as shall be sufficient for the fees, costs, and expenses of such levy." 13 Stat. 470–471. This provision, as amended, became §3186 of the Revised Statutes.

In sum, each time Congress revisited the federal tax lien, it ameliorated its original harsh impact on other secured creditors of the delinquent taxpayer.[7] In this case, it is agreed that by the terms of §6323(a), the Federal Government's liens are not valid as against the hen created by the earlier recording of Romani Industries' judgment.

III

The text of the priority statute on which the Government places its entire reliance is virtually unchanged since its enactment in 1797.[8] As we pointed out in *United States v. Moore,* 423 U. S. 77 (1975), not only were there earlier versions of the statute,[9] but "its roots reach back even further into the English common law," *id.,* at 80. The sovereign prerogative that was exercised by the English Crown and by many of the States as "an inherent incident of sovereignty," *ibid.,* applied only to unsecured claims. As Justice Brandeis noted in *Marshall v. New York,* 254 U. S. 380, 384 (1920), the common law priority "[did] not obtain over a specific lien created by the debtor before the sovereign undertakes to enforce its right." Moreover, the statute itself does not create a lien in favor of the United States.[10] Given this background, respondent argues that the statute should be read as giving the United States a preference over other unsecured creditors but not over secured creditors.[11]

There are dicta in our earlier cases that support this contention as well as dicta that tend to refute it. Perhaps the strongest support is found in Justice Story's statement:

> "What then is the nature of the priority, thus limited and established in favour of the United States? Is it a right, which supersedes and overrules the assignment of the debtor, as to any property which the United States may afterwards elect to take in execution, so as to prevent such property from passing by virtue of such assignment to the assignees? Or, is it a mere right of prior payment, out of the general funds of the debtor, in the hands of the assignees? We are of opinion that it clearly falls, within the latter description. The language employed is that which naturally would be employed to express such an intent; and it must be strained from its ordinary import, to speak any other." *Conard v. Atlantic Ins. Co. of N.Y,* 1 Pet. 386, 439 (1828).

Justice Story's opinion that the language employed in the statute "must be

[7]For a more thorough description of the early history and of Congress' reactions to this Court's tax lien decisions, see Kennedy, The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien, 63 Yale L. J. 905, 919–922 (1954) (hereinafter Kennedy)

[8]The Act of Mar. 3, 1797, §5, 1 Stat. 515, provided:

"And be it further enacted, That where any revenue officer, or other person hereafter becoming indebted to the United States, by bond or otherwise, shall become insolvent, or where the estate of any deceased debtor, in the hands of executors or administrators, shall be insufficient to pay all the debts due from the deceased, the debt due to the United States shall be first satisfied; and the priority hereby established shall be deemed to extend, as well to cases in which a debtor, not having sufficient property to pay all his debts, shall make a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor, shall be attached by process of law, as to cases in which an act of legal bankruptcy shall be committed." Compare §3466 of the Revised Statutes, and the present statutequoted in n. 1, *supra.*

It has long been settled that the federal priority covers the Government's claims for unpaid taxes. *Price v. United States,* 269 U. S. 492, 499–502 (1926); *Massachusetts v. United States,* 333 U. S. 611, 625626, and n. 24 (1948).

[9]"The earliest priority statute was enacted in the Act of July 31, 1789, 1 Stat. 29, which dealt with bonds posted by importers in lieu of payment of duties for release of imported goods. It provided that the 'debt due to the United States' for such duties shall be discharged first 'in all cases of insolvency, or where any estate in the hands of executors or administrators, shall be insufficient to pay all the debts due from the deceased . . . .' §21, 1 Stat. 42. A 1792 enactment broadened the Act's coverage by providing that the language 'cases of insolvency' should be taken to include cases in which a debtor makes a voluntary assignment for the benefit of creditors, and the other situations that §3466, 31 U.S.C. §191, now covers. l Stat.263." *United States v.Moore,* 423 U.S., at 81.

[10]"In construing the statutes on this subject, it has been stated by the court, on great deliberation, that the priority to which the United States are entitled, does not partake of the character of a *lien* on the property of public debtors. This distinction is always to be recollected." *United States v. Hooe,* 3 Cranch 73, 90 (1805).

[11]Although this argument was not presented to the state courts, respondent may defend the judgment on a ground not previously raised. *Heckler v. Cainpbell,* 461 U. S. 458, 468–469, n. 12 (1983). We will rarely consider such an argument, however. *Ibid.*; see also *Matsushita Elec. Industrial Co. v. Epstien,* 516 U. S. 367, 379, n. 5 (1996).

strained" to give it any other meaning is entitled to special respect because he was more familiar with 18th-century usage than judges who view the statute from a 20th-century perspective.

We cannot, however, ignore the Court's earlier judgment in *Thelusson v. Smith,* 2 Wheat. 396, 426 (1817), or the more recent dicta in *United States v. Key,* 397 U. S. 322, 324–325 (1970). In *Thelusson,* the Court held that the priority statute gave the United States a preference over the claim of a judgment creditor who had a general hen on the debtor's real property. The Court's brief opinion[12] is subject to the interpretation that the statutory priority always accords the Government a preference over judgment creditors. For two reasons, we do not accept that reading of the opinion.

First, as a factual matter, in 1817 when the case was decided, there was no procedure for recording a judgment and thereby creating a choate lien on a specific parcel of real estate. See generally 2 L. Dembitz, A Treatise on Land Titles in the United States §127, pp. 948–952 (1895). Notwithstanding the judgment, a bona fide purchaser could have acquired the debtor's property free from any claims of the judgment creditor. See *Semple v. Burd,* 7 Serg. & Rawle 286, 291 (Pa. 1821) ("The prevailing object of the Legislature, has uniformly been, to support the security of a judgment creditor, by confirming his lien, except when it interferes with the circulation of property by embarrassing a fair purchaser"). That is not the case with respect to Romani Industries' choate hen on the property in Cambria County.

Second, and of greater importance, in his opinion for the Court in the *Conard* case, which was joined by Justice Washington, the author of *Thelusson,*[13] Justice Story explained why that holding was fully consistent with his interpretation of the text of the priority statute:

> "The real ground of the decision, was, that the judgment creditor had never perfected his title, by any execution and levy on the Sedgely estate; that he had acquired no title to the proceeds as his property, and that if the proceeds were to be deemed general funds of the debtor, the priority of the United States to payment had attached against all other creditors; and that a mere potential lien on land, did not carry a legal title to the proceeds of a sale, made under an adverse execution. This is the manner in which this case has been understood, by the Judges who concurred in the decision; and it is obvious, that it established no such proposition, as that a specific and perfected hen, can be displaced by the mere priority of the United States; since that priority is not of itself equivalent to a lien." *Conard,* I Pet., at 444.[14]

The Government also relies upon dicta from our opinion in *United States v. Key,* 397 U. S., at 324–325, which quoted from our earlier opinion in *United States v. Emory,* 314 U.S., at 433: "Only the plainest inconsistency would warrant our finding an implied exception to the operation of so clear a command as that of [§3713]." Because both *Key* and *Emory* were cases in which the competing claims were unsecured, the statutory command was perfectly clear even under Justice Story's construction of the statute. The statements made in that context, of course, shed no light on the clarity of the command when the United States relies on the statute as a basis for claiming a preference over a secured creditor. Indeed, the *Key* opinion itself made this specific point: "This case does not raise the question, never decided by this Court, whether §3466 grants the Government priority over the prior specific liens of secured creditors. See *United States v. Gilbert Associates, Inc.,* 345 U. S. 361, 365-366 (1953)." 397 U. S., at 332, n. 11.

The *Key* opinion is only one of many in which the Court has noted that despite the age of the statute, and despite the fact that it has been the subject of a great deal of litigation, the question whether it has any application to antecedent perfected liens has never been answered definitively. See *United States v. Vermont,* 377 U.S. 351, 358, n. 8 (1964) (citing cases). In his dissent in the *Gilbert Associates* case, Justice Frankfurter referred to the Court's reluctance to decide the issue "not only today but for almost a century and a half." 345 U. S., at 367.

The Government's priority as against specific, perfected security interests is, if possible, even less settled with regard to real property. The Court has sometimes concluded that a competing creditor who has not "divested" the debtor of "either title or possession" has only a "general, unperfected lien" that is defeated by the Government's priority. *Eg., id.,* at 366. Assuming the validity of this "title or possession" test for deciding whether a lien on personal property is sufficiently choate for purposes of the priority statute (a question of federal law, see *Illinois ex rel. Gordon v. Campbell,* 329 U. S., at 371), we are not aware of any decisions since *Thelusson* applying that theory to claims for real property, or of any reason to require a lienor or mortgagee to acquire possession in order to perfect an interest in real estate.

Given the fact that this basic question of interpretation remains unresolved, it does not seem appropriate to view the issue in this case as whether the Tax Lien

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[12]The relevant portion of the opinion reads, in full, as follows:

"These [statutory] expressions are as general as any which could have been used, and exclude all debts due to individuals, whatever may be their dignity.... The law makes no exception in favour of prior judgment creditors; and no reason has been, or we think can be, shown to warrant this court in making one....

"The United States are to be first satisfied; but then it must be out of the debtor's estate. If, therefore, before the right of preference has accrued to the United States, the debtor has made a *bona fide* conveyance of his estate to a third person, or has mortgaged the same to secure a debt; or if his property has been seized under a *fi. fa.,* the property is devested out of the debtor, and cannot be made liable to the United States. A judgment gives to the judgment creditor a lien on the debtor's lands, and a preference over all subsequent judgment creditors. But the act of congress defeats this preference in favour of the United States, in the cases specified in the 65th section of the act of 1799." *Thelusson v. Smith,* 2 Wheat. 396, 425–426 (1817).

In the later *Conard* case, Justice Story apologized for *Thelusson:* "The reasons for that opinion are not, owing to accidental circumstances, as fully given as they are usually given in this Court." *Conard v. Atlantic Ins. Co. of N. Y.,* 1 Pet. 386, 442 (1828).

[13]Justice Washington's opinion for this Court in *Thelusson* affirmed, and was essentially the same as, his own opinion delivered in the Circuit Court as a Circuit Justice. 2 Wheat., at 426, n. h.

[14]Relying on this and several other cases, in 1857 the Attorney General of the United States issued an opinion concluding that *Thelusson* "has been distinctly overruled" and that the priority of the United States under this statute "will not reach back over any hen, whether it be general or specific." 9 Op. Att. Gen. 28, 29. See also Kennedy 908–911 (advancing this same interpretation of the early priority act decisions).

Act of 1966 has implicitly amended or repealed the priority statute. Instead, we think the proper inquiry is how best to harmonize the impact of the two statutes on the Government's power to collect delinquent taxes.

IV

In his dissent from a particularly harsh application of the priority statute, Justice Jackson emphasized the importance of considering other relevant federal policies. Joined by three other Justices, he wrote:

> "This decision announces an unnecessarily ruthless interpretation of a statute that at its best is an arbitrary one. The statute by which the Federal Government gives its own claims against an insolvent priority over claims in favor of a state government must be applied by courts, not because federal claims are more meritorious or equitable, but only because that Government has more power. But the priority statute is an assertion of federal supremacy as against any contrary state policy. It is not a limitation on the Federal Government itself, not an assertion that the priority policy shall prevail over all other federal policies. Its generalities should not lightly be construed to frustrate a specific policy embodied in a later federal statute." *Massachusetts v. United States,* 333 U. S. 611, 635 (1948) (Jackson, J., dissenting).

On several prior occasions the Court had followed this approach and concluded that a specific policy embodied in a later federal statute should control our construction of the priority statute, even though it had not been expressly amended. Thus, in *Cook County Nat. Bank v. United States,* 107 U. S. 445, 448–451 (1883), the Court concluded that the priority statute did not apply to federal claims against national banks because the National Bank Act comprehensively regulated banks' obligations and the distribution of insolvent banks' assets. And in *United States v. Guaranty Trust Co. of N.Y,* 280 U. S. 478, 485 (1930), we determined that the Transportation Act of 1920 had effectively superseded the priority statute with respect to federal claims against the railroads arising under that Act.

The bankruptcy law provides an additional context in which another federal statute was given effect despite the priority statute's literal, unconditional text. The early federal bankruptcy statutes had accorded to "'all debts due to the United States, and all taxes and assessments under the laws thereof " a preference that was "coextensive" with that established by the priority statute. *Guarantee Title & Trust Co. v. Title Guaranty & Surety Co.,* 224 U.S. 152, 158 (1972) (quoting the Bankruptcy Act of 1867, Rev. Stat. §5101). As such, the priority act and the bankruptcy laws "were to be regarded as in *pari materia,* and both were unqualified; . . . as neither contained any qualification, none could be interpolated." *Ibid.* The Bankruptcy Act of 1898, however, subordinated the priority of the Federal Government's claims (except for taxes due) to certain other kinds of debts. This Court resolved the tension between the new bankruptcy provisions and the priority statute by applying the former and thus treating the Government like any other general creditor. *Id.,* at 158–160; *Davis v. Pringle,* 268 U. S. 315, 317–319 (1925).[15]

There are sound reasons for treating the Tax Lien Act of 1966 as the governing statute when the Government is claiming a preference in the insolvent estate of a delinquent taxpayer. As was the case with the National Bank Act, the Transportation Act of 1920, and the Bankruptcy Act of 1898, the Tax Lien Act is the later statute, the more specific statute, and its provisions are comprehensive, reflecting an obvious attempt to accommodate the strong policy objections to the enforcement of secret hens. It represents Congress' detailed judgment as to when the Government's claims for unpaid taxes should yield to many different sorts of interests (including, for instance, judgment liens, mechanic's liens, and attorneys' hens) in many different types of property (including, for example, real property, securities, and motor vehicles). See 26 U.S.C. §6323. Indeed, given our unambiguous determination that the federal interest in the collection of taxes is paramount to its interest in enforcing other claims, see *United States v. Kimbell Foods, Inc.,* 440 U. S., at 733–735, it would be anomalous to conclude that Congress intended the priority statute to impose greater burdens on the citizen than those specifically crafted for tax collection purposes.

Even before the 1966 amendments to the Tax Lien Act, this Court assumed that the more recent and specific provisions of that Act would apply were they to conflict with the older priority statute. In the *Gilbert Associates* case, which concerned the relative priority of the Federal Government and a New Hampshire town to funds of an insolvent taxpayer, the Court first considered whether the town could qualify as a "judgment creditor" entitled to preference under the Tax Lien Act. 345 U.S., at 363–364. Only after deciding that question in the negative did the Court conclude that the United States obtained preference by operation of the priority statute. *Id.,* at 365–366. The Government would now portray *Gilbert Associates* as a deviation from two other relatively recent opinions in which the Court held that the priority statute was not trumped by provisions of other statutes: *United States v. Emory,* 314 U. S., at 429–433 (the National Housing Act), and *United States v. Key,* 397 U. S., at 324–333 (Chapter X of the Bankruptcy Act). In each of those cases, however, there was no "plain inconsistency" between the commands of the priority statute and the other federal act, nor was there reason to believe that application of the priority statute would frustrate Congress' intent. *Id.,* at 329. The same cannot be said in the present suit.

The Government emphasizes that when Congress amended the Tax Lien Act in 1966, it declined to enact the American Bar Association's proposal to modify the federal priority statute, and Congress again failed to enact a similar proposal in 1970. Both proposals would have expressly provided that the Government's

[15] Congress amended the priority statute in 1978 to make it expressly inapplicable to Title 11 bankruptcy cases. Pub. L. 95–598, §322(b), 92 Stat. 2679, codified in 31 U. S. C. §3713(a)(2). The differences between the bankruptcy laws and the priority statute have been the subject of criticism: "as a result of the continuing discrepancies between the bankruptcy and insolvency rules, some creditors have had a distinct incentive to throw into bankruptcy a debtor whose case might have been handled, with less expense and less burden on the federal courts, in another form of proceeding." Plumb, The Federal Priority in Insolvency: Proposals for Reform, 70 Mich. L. Rev. 3, 8–9 (1971) (hereinafter Plumb).

priority in insolvency does not displace valid liens and security interests, and therefore would have harmonized the priority statute with the Tax Lien Act. See Hearings on H. R. 11256 and 11290 before the House Committee on Ways and Means, 89th Cong., 2d Sess., 197 (1966) (hereinafter Hearings); S. 2197, 92d Cong., lst Sess. (1971). But both proposals also would have significantly changed the priority statute in many other respects to follow the priority scheme created by the bankruptcy laws. See Hearings, at 85, 198; Plumb 10, n. 53, 33–37. The earlier proposal may have failed because its wide-ranging subject matter was beyond the House Ways and Means Committee's jurisdiction. Plumb 8. The failure of the 1970 proposal in the Senate Judiciary Committee—explained by no reports or hearings—might merely reflect disagreement with the broad changes to the priority statute, or an assumption that the proposal was not needed because, as Justice Story had believed, the priority statute does not apply to prior perfected security interests, or any number of other views. Thus, the Committees' failures to report the proposals to the entire Congress do not necessarily indicate that any legislator thought that the priority statute should supersede the Tax Lien Act in the adjudication of federal tax claims. They provide no support for the hypothesis that both Houses of Congress silently endorsed that position.

The actual measures taken by Congress provide a superior insight regarding its intent. As we have noted, the 1966 amendments to the Tax Lien Act bespeak a strong condemnation of secret liens, which unfairly defeat the expectations of innocent creditors and frustrate "the needs of our citizens for certainty and convenience in the legal rules governing their commercial dealings." 112 Cong. Rec. 22227 (1966) (remarks of Rep. Byrnes); *cf. United States v. Speers,* 382 U.S. 266, 275 (1965) (referring to the "general policy against secret liens"). These policy concerns shed light on how Congress would want the conflicting statutory provisions to be harmonized:

> "Liens may be a dry-as-dust part of the law, but they are not without significance in an industrial and commercial community where construction and credit are thought to have importance. One does not readily impute to Congress the intention that many common commercial liens should be congenitally unstable." E. Brown, The Supreme Court, 1957 Term—Foreword: Process of Law, 72 Harv. L. Rev. 77, 87 (1958) (footnote omitted).

In sum, nothing in the text or the long history of interpreting the federal priority statute justifies the conclusion that it authorizes the equivalent of a secret hen as a substitute for the expressly authorized tax lien that Congress has said "shall not be valid" in a case of this kind.

The judgment of the Pennsylvania Supreme Court is affirmed.

It is so ordered.

JUSTICE SCALIA concurring in part and concurring in the judgment.

I join the opinion of the Court except that portion which takes seriously, and thus encourages in the future, an argument that should be laughed out of court. The Government contended that 31 U. S. C. §3713(a) must have priority over the Federal Tax Lien Act of 1966, because in 1966 and again in 1970 Congress "failed to enact" a proposal put forward by the American Bar Association that would have subordinated §3713(a) to the Tax lien Act, citing hearings before the House Committee on Ways and Means, and a bill proposed in, but not passed by, the Senate. See Brief for United States 25–27, and n. 10 (citing American Bar Association, Final Report of the Committee on Federal Liens 7, 122–124 (1959), contained in Hearings on H. R. 11256 and 11290 before the House Committee on Ways and Means, 89th Cong., 2d Sess., 85, 199 (1966); S. 2197, 92d Cong., lst Sess. (1971)). The Court responds that these rejected proposals "provide no support for the hypothesis that both Houses of Congress silently endorsed" the supremacy of §3713, *ante,* at 16, because those proposals contained other provisions as well, and might have been rejected because of those other provisions, or because Congress thought the existing law already made §3713 supreme. This implies that, if the proposals had not contained those additional features, or if Members of Congress (or some part of them) had somehow made clear in the course of rejecting them that they wanted the existing supremacy of the Tax Lien Act to subsist, the rejection *would* "provide support" for the Government's case.

That is not so, for several reasons. First and most obviously, Congress can not-express its will by a *failure* to legislate. The act of refusing to enact a law (if that can be called an act) has utterly no legal effect, and thus has utterly no place in a serious discussion of the law. The Constitution sets forth the only manner in which the Members of Congress have the power to impose their will upon the country: by a bill that passes both Houses and is either signed by the President or repassed by a supermajority after his veto. Art. 1, §7. Everything else the Members of Congress do is either prelude or internal organization. Congress can no more express its will by not legislating than an individual Member can express his will by not voting.

Second, even if Congress *could* express its will by not legislating, the will of a later Congress that a law enacted by an earlier Congress should bear a particular meaning is of no effect whatever. The Constitution puts Congress in the business of writing new laws, not interpreting old ones. "[L]ater-enacted lows . . . do not declare the meaning of earlier law." *Almendarez-Torres v. United States,* 523 U. S.____ (1998) (slip op., at 12); *id.,* at ___ (SCALIA, J., dissenting) ("This later amendment can of course not cause [the statute] to have meant, at the time of petitioner's conviction, something different from what it then said") (slip op., at 23). If the *enacted* intent of a later Congress cannot change the meaning of an earlier statute, then it should go without saying that the later *unenacted intent* cannot possibly do so. It should go without saying, and it should go without arguing as well.

I have in the past been critical of the Court's using the so-called legislative history of an enactment (hearings, committee reports, and floor debates) to determine its meaning. See, *e.g., Conroy v. Aniskoff,* 507 U. S. 511, 518–529 (1993) (SCAUA, J., concurring in judgment); *United States v. Thompson/Center Arms Co.,* 504 U. S. 505, 521 (1992) (SCALIA, J., concurring in judgment); *Blanchard v. Bergeron,* 489 U. S. 87, 98–100 (1989) (SCALIA, J., concurring in part and concurring in judgment). Today, however,

the Court's fascination with the files of Congress (we must consult them, because they are there) is carried to a new silly extreme. Today's opinion ever-so-carefully analyzes, not legislative history, but the history of legislation-that never-was. If we take this sort of material seriously, we require conscientious counsel to investigate (at clients' expense) not only the hearings, committee reports, and floor debates pertaining to the history of the law at issue (which is bad enough), but to find, and then investigate the hearings, committee reports, and floor debates pertaining to, later bills on the same subject that were never enacted. This is beyond all reason, and we should say so.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Section 7872.—Treatment of Loans with Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1998. See Rev. Rul. 98–43, page 9.

Part III. Administrative, Procedural, and Miscellaneous

Returns Relating to Higher Education Tuition and Related Expenses

Notice 98–46

PURPOSE

This notice provides that the Internal Revenue Service and the Treasury Department are extending the application of Notice 97–73, 1997–51 I.R.B. 16, to information reporting required under § 6050S of the Internal Revenue Code for 1999.

BACKGROUND

Section 6050S, enacted by the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, § 201(c), 111 Stat. 804, requires the filing of information returns to assist taxpayers and the Service in determining the Hope Scholarship credit and the Lifetime Learning credit that taxpayers may claim pursuant to § 25A of the Code. Section 6050S requires that institutions file the specified information returns with the Service and provide a corresponding statement to the individuals named on the information return showing the information that has been reported.

The requirements of § 6050S are generally described in Notice 97–73, along with specific information reporting requirements for 1998. However, as a result of amendments to § 6050S made by the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105–206, 112 Stat. 685, certain information reporting requirements under § 6050S have been clarified or changed. First, the amendments clarify that § 6050S requires institutions to report the aggregate amount of payments made with respect to each student for qualified tuition and related expenses without any amounts being subtracted for qualified scholarships or other tax-free educational assistance received with respect to the student. Further, § 6050S(b)(2)(C), as amended, specifically requires that the amount of any grant received by the student for payment of costs of attendance and processed by the institution making the information return be reported as a separate item. Section 6050S(b)(2)(C) was also amended to clarify that an institution must report only the aggregate amount of reimbursements and refunds of qualified tuition and related expenses paid to a student by the institution (and not by any other party). Finally, § 6050S(a) was amended to clarify that only eligible educational institutions and persons engaged in a trade or business of making payments to individuals under insurance arrangements are required to report information under § 6050S. In all other respects, the requirements of § 6050S remain the same as described in Notice 97–73.

The Treasury Department intends to issue regulations soon on the information reporting requirements of § 6050S. In light of the recent statutory changes and legislative history prepared in connection with those changes indicating Congress's intent that Notice 97–73 remain in effect until the regulations are issued, the Service is extending the application of Notice 97-73 for an additional year, *i.e.,* to information reporting required under § 6050S for 1999.

DISCUSSION

For 1999, eligible educational institutions must follow the rules provided in Notice 97–73 for reporting information required under § 6050S. For example, an eligible educational institution that receives payments of qualified tuition and related expenses in 1999 must file a Form 1098-T, Tuition Payments, that includes the same information that was required by Notice 97–73 for 1998. The Forms 1098–T must be filed with the Service by February 28, 2000, if filed on paper or by magnetic media, or by March 31, 2000, if filed electronically. A statement containing the same information as the Form 1098-T filed with the Service must be furnished to the student by January 31, 2000. Similarly, Notice 97–73 applies for 1999 with respect to how penalties will be administered under §§ 6721 and 6722 for information returns required under § 6050S.

EFFECT ON OTHER DOCUMENTS

Notice 97–73 is modified.

DRAFTING INFORMATION

The principal author of this notice is John J. McGreevy of the Office of the Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this notice contact him on (202) 622-4910 (not a toll-free call).

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26 CFR 1.472–2: Requirements incident to adoption and use of LIFO inventory method. (Also Part I, § 472; § 1.472–1.)

Rev. Proc. 98–46

SECTION 1. PURPOSE

.01 This revenue procedure modifies Rev. Proc. 97–44, 1997–41 I.R.B. 8, which provides relief for automobile and light-duty truck dealers that elected the last-in, first-out (LIFO) inventory method and violated the LIFO conformity requirement of § 472(c) or (e)(2) of the Internal Revenue Code by providing, for credit purposes, an income statement prepared in a format required by the franchisor or on a pre-printed form supplied by the franchisor (an automobile manufacturer), covering any taxable year ended on or before October 14, 1997, that fails to reflect the LIFO inventory method.

.02 Rev. Proc. 97–44 is modified to extend the relief provided in that revenue procedure to medium- and heavy-duty truck dealers that comply with Rev. Proc. 97–44 as modified herein. In addition, Rev. Proc. 97–44 is modified to extend the due dates for medium- and heavy-duty truck dealers to make installment payments of the settlement amount computed in accordance with that revenue procedure.

SECTION 2. MODIFICATIONS

.01 Section 1 of Rev. Proc. 97–44 is modified by adding the words "and truck" after the word "automobile" in the first and third sentences, and by adding the words "or truck" after the word "automobile" in the parenthetical phrase in the first sentence.

.02 Section 3 of Rev. Proc. 97–44 is modified by replacing the words "light-duty" with the words "light-, medium-, or heavy-duty" in the first sentence and by adding the words "or truck" after the word "automobile" in the parenthetical phrase in the first sentence.

.03 Section 5.02(2) of Rev. Proc. 97–44 is modified by replacing the words "light-

duty" with the words "light-, medium-, and heavy-duty" in the second sentence.

.04 Section 5.03(1) of Rev. Proc. 97–44 is modified by replacing the second sentence with the following two sentences:

Except as provided in section 5.03(2) or (3) of this revenue procedure, the first installment and the memorandum described in section 5.04 of this revenue procedure are due on or before May 31, 1998, in the case of inventory related to the purchase, sale, and service of automobiles or light-duty trucks. Except as provided in section 5.03(2) or (3) of this revenue procedure, the first installment and the memorandum described in section 5.04 of this revenue procedure are due on or before January 31, 1999, in the of case inventory related to the purchase, sale, and service of medium- or heavy-duty trucks.

.05 Section 5.03(2) of Rev. Proc. 97–44 is modified by replacing section 5.03(2) with the following paragraph:

(2) *Taxpayers under examination, before appeals, or before a federal court.* If any federal income tax return of a taxpayer is under examination, before an appeals office, or before a federal court on October 14, 1997, the first installment of the settlement amount and the memorandum described in section 5.04 of this revenue procedure with respect to inventory related to the purchase, sale, and service of automobiles and light-duty trucks are due on or before December 1, 1997. Such a taxpayer must notify the examining agent(s), appeals officer, or the counsel for the government, whichever is applicable, in writing on or before December 15, 1997, that it has applied for relief under this revenue procedure. If any federal income tax return of a taxpayer is under examination, before an appeals office, or before a federal court on September 8, 1998, the first installment of the settlement amount and the memorandum described in section 5.04 of this revenue procedure with respect to inventory related to the purchase, sale, and service of medium- and heavy-duty trucks are due on or before December 1, 1998. Such a taxpayer must notify the examining agent(s), appeals officer, or the counsel for the government, whichever is applicable, in writing on or before December 15, 1998, that it has applied for relief under this revenue procedure. For these purposes, the terms "under examination," "before an appeals office," and "before a federal court" have the same meaning as provided in Rev. Proc. 97–27, 1997–21 I.R.B. 10. Evidence that the first installment has been paid and a copy of the memorandum described in section 5.04 of this revenue procedure must be provided as part of this written notification.

.06 Section 5.03(3) of Rev. Proc. 97–44 is modified by replacing section 5.03(3) with the following paragraph:

(3) *Option to pay settlement amount in one installment.* A taxpayer may elect to pay the entire settlement amount in one installment. If a taxpayer makes this election, the entire settlement amount and the original memorandum described in section 5.04 of this revenue procedure with respect to inventory related to the purchase, sale, and service of automobiles and light-duty trucks are due on or before May 31, 1998, or, if any federal income tax return of such taxpayer is under examination, before an appeals office, or before a federal court, on or before December 1, 1997. The entire settlement amount and the original memorandum described in section 5.04 of this revenue procedure with respect to inventory related to the purchase, sale, and service of medium- and heavy-duty trucks are due on or before January 31, 1999, or, if any federal income tax return of such taxpayer is under examination, before an appeals office, or before a federal court, on or before December 1, 1998.

.07 Section 7.02 of Rev. Proc. 97–44 is modified by deleting the words "light-duty" in the first sentence.

.08 Section 9 of Rev. Proc. 97–44 is modified by adding the words "or trucks" after the word "automobiles" in the third sentence of the third paragraph.

DRAFTING INFORMATION

The principal author of this revenue procedure is Jeffery G. Mitchell of the Office of Assistant Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Mitchell on (202) 622-4970 (not a toll-free call).

Notice of Proposed Rulemaking and Notice of Public Hearing

Termination of Puerto Rico and Possession Tax Credit; New Lines of Business Prohibited

REG–115446–97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In T.D. 8778 on page 4, the IRS is issuing temporary regulations that provide guidance regarding the addition of a substantial new line of business by a possessions corporation that is an existing credit claimant. These regulations reflect changes made by the Small Business Job Protection Act of 1996. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by November 17, 1998. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Tuesday, December 1, 1998, at 10 a.m. must be received by Tuesday, November 10, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–115446–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–115446–97), 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 on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Patricia A. Bray or Elizabeth Beck, (202) 622-3880 or Jacob Feldman, (202) 622-3830; concerning submissions and the hearing, Michael Slaughter, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary Regulations in T.D. 8778 amend Income Tax Regulations (26 CFR Part 1) relating to section 936. Section 1.936–11T, published in T.D. 8778, provides guidance to possessions corporations that could lose their status as an existing credit claimant, and, as a result, their right to claim the possession tax credit, due to the addition of a substantial new line of business.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analysis

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

Comments and Public Hearing

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

A public hearing has been scheduled for December 1, 1998, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Ave., 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 this hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topic (preferably a signed original and eight (8) copies) to be discussed by November 10, 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 Patricia A. Bray of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and the Department of the Treasury participated in the development of these regulations.

* * * * *

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 adding an entry in numerical order to read as follows:

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

Section 1.936–11 also issued under 26 U.S.C. 936. * * *

Par. 2. Section 1.936–11 is added to read as follows:

§1.936–11 New lines of business prohibited.

[The text of this proposed section is the same as the text of §1.936–11T published in T.D. 8778.]

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 18, 1998, 8:45 a.m., and published in the issue of the Federal Register for August 19, 1998, 63 F.R. 44416)

Notice of Proposed Rulemaking and Notice of Public Hearing

Pass Through of Items of an S Corporation to its Shareholders

REG–209446–82

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the pass through of items of an S corporation to its shareholders, the adjustments to the basis of stock of the shareholders, and the treatment of distributions by an S corporation. Changes to the applicable law were made by the Subchapter S Revision Act of 1982, the Tax Reform Act of 1984, the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, and the Small Business Job Protection Act of 1996. These proposed regulations provide the public with guidance needed to comply with the applicable law and will affect S corporations and their shareholders. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by November 16, 1998. Outlines of topics to be discussed at the public hearing scheduled for Tuesday, December 15, 1998, at 10 a.m. must be received by Tuesday, November 24, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209446–82), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–209446–82), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations under section 1366, Deane M. Burke or Terri A. Belanger, (202) 622-3070; concerning the regulations under sections 1367 and 1368, Brenda Stewart, (202) 622-3120; concerning submissions and the hearing, Michael Slaughter, (202) 622-7180 (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 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 the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by October 19, 1998. Comments are specifically requested concerning:

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

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

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

How the burden of complying with the proposed 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 cost and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in this proposed regulation is in §1.1366–1. This information is required in order for a shareholder in an S corporation to properly compute its tax liability. This information will be used to determine whether the amount of tax has been computed correctly. Responses to this collection of information are mandatory for shareholders in S corporations. The likely respondents are individuals and businesses or other for-profit institutions.

The reporting burden contained in §1.1366–1 is reflected in the burden of Form 1040, U.S. Individual Income Tax Return, and Form 1120S, U.S. Income Tax Return for an S Corporation.

Newly designated §1.1367–1(g) does not impose a new collection of information. The election in newly designated §1.1367–1(g), previously contained in §1.1367–1(f), was approved by OMB under OMB Control Number 1545–1139.

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

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

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 1366, 1367, and 1368 of the Internal Revenue Code of 1986 (Code). Sections 1366, 1367, and 1368 were added by the Subchapter S Revision Act of 1982 (1982 Act) (Public Law 97–354, 96 Stat. 1669, 1697). Section 1366 was amended by the Tax Reform Act of 1984 (Public Law 98–369, 98 Stat. 844, 985), the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2085, 2277, 2343), the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100–647, 102 Stat. 3406), and the Small Business Job Protection Act of 1996 (1996 Act) (Public Law 104–188, 110 Stat. 1755).

Sections 1367 and 1368 were amended by the Technical Corrections Act of 1982 (Public Law 97–448, 96 Stat. 2365, 2399–2400), the Tax Reform Act of 1984 (Public Law 98–369), and the Tax Reform

Act of 1986 (Public Law 99–514). Final regulations conforming the regulations to these amendments were published in the **Federal Register** on January 3, 1994. The proposed amendments would conform the regulations to amendments made to sections 1367 and 1368 by the 1996 Act.

Explanation of Provisions

Determination of Shareholder's Tax Liability

Under section 1363, an S corporation generally computes its taxable income in the same manner as an individual, subject to certain modifications. Thus, for example, an S corporation is not entitled to a dividends received deduction under section 243.

Section 1366(a)(1) and the proposed regulations provide rules under which a shareholder of an S corporation takes into account the shareholder's pro rata share, as defined under section 1377, of the corporation's items of income, loss, deduction, or credit. A shareholder's share of these items is determined for the shareholder's taxable year in which the taxable year of the S corporation ends. If a shareholder dies before the end of the corporation's taxable year, the shareholder's pro rata share of these items is taken into account in the shareholder's final tax return. If a shareholder is an estate or trust, and the estate or trust terminates before the end of the corporation's taxable year, the shareholder's pro rata share of these items is taken into account in the shareholder's final tax return.

In the case of most items that must be separately stated by an S corporation, the provisions by which an S corporation accounts to its shareholders for tax purposes under section 1366 closely parallel the provisions for a partnership accounting to its partners under section 702. The proposed regulations provide rules outlining this general pass-through scheme for S corporations to their shareholders.

Under section 1366(a)(1)(A), an S corporation's items of income, loss, deduction, and credit must be separately stated if their separate treatment on any shareholder's income tax return could affect the shareholder's tax liability. These separately stated items include, but are not limited to, short-term and long-term capital gain or loss, other items that may be relevant to the shareholder in the computation of the shareholder's tax liability resulting from the sale or exchange of capital assets or assets described in section 1231(b), tax-exempt income, section 170(c) charitable contributions, certain foreign taxes, items used in determining certain credits, certain itemized deductions, items of portfolio income or loss and related expenses under section 469, and the corporation's adjustments in computing alternative minimum tax under sections 56 and 58 and any items of tax preference under section 57. All items of income, loss, and deduction that are not separately stated must be combined to compute the nonseparately computed income or loss of the S corporation under section 1366(a)(1)(B).

Identification of Tax-exempt Income

The proposed regulations define tax-exempt income as income that is permanently excludible from the gross income of an S corporation and its shareholders in all circumstances in which the relevant Code section applies. For example, tax-exempt income includes proceeds of life insurance contracts that are payable by reason of an individual's death and that are excludible from gross income under section 101, and interest on state and local bonds that is excludible from gross income under section 103.

However, income that is excludible from gross income pursuant to a provision of the Code that might have the effect of deferring income to the S corporation or its shareholders is not tax-exempt income. For example, income from improvements by a lessee on a lessor's property that is excludible from gross income under section 109 is not tax-exempt income because, for example, the lessor would recognize the value of the improvements as income when the property is sold by the lessor. Similarly, income from the discharge of indebtedness that is excludible from gross income under section 108 does not constitute tax-exempt income because the attribute reduction provisions of section 108(b) have the effect of deferring the recognition of such income in some circumstances while permanently excluding it, in whole or in part, in other circumstances.

Treasury and the IRS believe that Congress intended that section 108 would allow taxpayers to avoid the immediate adverse tax consequences that could otherwise result from the inclusion of income from discharge of indebtedness. The deferral of income excluded under section 108(a)(1) by reducing the basis of property or other tax attributes is one method of achieving this purpose. For example, the legislative history of section 108(a)(1)(D) provides that the exclusion from gross income for discharge of qualified real property business indebtedness income simply defers income to the shareholders of an S corporation and does not result in an adjustment to the basis of the stock of the corporation. See H.R. Rep. No. 111, 103d Cong., 1st Sess. 625 (1993); H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 555 (1993).

Other specific rules apply to the discharge of indebtedness of an S corporation. See section 108(d)(7). The legislative history of section 108(d)(7)(A) provides that in order to treat all shareholders in the same manner, the exclusion of income arising from discharge of indebtedness and the corresponding reductions in tax attributes (including losses that are not allowed by reason of any shareholder's basis limitation) are made at the corporate level. See H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, 1640–41 (1984). Furthermore, the legislative history of section 108 indicates that any cancellation of indebtedness income remaining after the reduction of the S corporation's tax attributes does not result in income or have other tax consequences. See S. Rep. No. 1035, 96th Cong., 2d Sess. 2 (1980). Thus, the absence of a stock basis increase for income of an S corporation excluded under section 108(a) is consistent with the legislative history of section 108 (and its purpose to avoid the immediate adverse tax consequences that could otherwise result from the inclusion of income from discharge of indebtedness) and the specific rules that apply to the discharge of indebtedness income of S corporations.

Finally, even though a partner is entitled to an increase in the basis of the partner's interest for income from discharge of indebtedness of a partnership that is excluded under section 108(a), a shareholder of an S corporation is not entitled to an increase in stock basis under similar circumstances. This difference is appro-

priate because the principal provisions of section 108 are applied at the corporate level in the case of an S corporation but at the partner level in the case of a partnership. See section 108(d)(6). A basis increase in the partner's interest in the partnership is necessary in order to apply these provisions at the partner level because, for example, the income may properly be excluded by some partners and included by others, and in order to offset the basis reduction that will occur under section 752(b) as the result of the deemed distribution arising out of the decrease in the partner's share of partnership liabilities. These considerations are not present in the case of an S corporation.

Accordingly, Treasury and the IRS believe that income excluded by an S corporation pursuant to section 108 is not tax-exempt income for purposes of section 1366 whether or not the application of section 108 in a particular circumstance results in the permanent exclusion, in whole or in part, of income. See also *Nelson v. Commissioner,* 110 T.C. 114 (1998).

Pass Through of Character and Gross Income

Consistent with the adoption of parallel operational rules between sections 702 and 1366, the items of an S corporation are generally characterized in the same manner that partnership items are characterized. The partnership rules provide that the character of a partnership item reported by a partner is generally determined at the entity level under a conduit rule. The proposed regulations provide a similar conduit rule under which the character of a corporate item that is passed through to and reported by a shareholder is generally determined at the corporate level. However, exceptions to the general rule apply for contributions of either non-capital gain property or capital loss property if an S corporation is formed or availed of by any shareholder or shareholders for a principal purpose of selling or exchanging the property to alter the character of the gain or loss. The character of the gain or loss will be the same as it would have been if the property were in the hands of the shareholder or shareholders at the time of the sale or exchange.

Section 1366(c), like section 702(c), provides for the pass through of gross income to a shareholder for federal income tax purposes. Thus, where it is necessary to determine the amount or character of the gross income of a shareholder, the shareholder's gross income includes the shareholder's pro rata share of the gross income of the S corporation. This amount is the amount of gross income of the corporation used to derive the shareholder's pro rata share of S corporation taxable income or loss. See Rev. Rul. 87–121 (1987–2 C.B. 217).

Limitation on Losses and Deductions

In general, section 1366(d)(1) and the proposed regulations provide that the amount of losses and deductions taken into account by a shareholder for any taxable year may not exceed the sum of the shareholder's adjusted bases in the stock of the S corporation and in any indebtedness of the S corporation to the shareholder. Moreover, any loss or deduction for the taxable year not taken into account by a shareholder by reason of the basis limitation rule is treated under section 1366(d)(2) and the proposed regulations as incurred by the corporation with respect to that shareholder in the corporation's first succeeding taxable year, and subsequent taxable years. For purposes of the basis limitation rule in section 1366(d), the basis of stock acquired by gift is the basis of the stock for determining loss under section 1015. The basis rules under section 1015 operate to minimize the loss recognized by a donee upon the sale or exchange of the loss stock acquired by gift. Therefore, the basis limitation rule limits a donee shareholder's pass-through items of loss or deduction to the basis used for determining loss upon the sale or exchange of the stock acquired by gift.

The proposed regulations provide that if a shareholder's aggregate pro rata share of the items of loss and deduction exceeds the sum of the shareholder's adjusted bases in stock and debt, the limitation on losses and deductions must be allocated among the shareholder's pro rata share of each loss or deduction. This allocation is determined by taking the proportion that each loss or deduction bears to the total of all losses and deductions, including those previously disallowed.

Also under the proposed regulations, a shareholder's disallowed losses and deductions are personal to that shareholder and cannot be transferred. Moreover, if a shareholder transfers all of the shareholder's stock in an S corporation, any disallowed loss or deduction is permanently disallowed.

The proposed regulations provide special rules for a shareholder to carry over disallowed losses and deductions to any post-termination transition period. Those special rules generally follow the limitation rules provided in the proposed regulations for years in which the S corporation election is in effect, except that the amount of losses and deductions that may be taken into account is limited to the adjusted basis of the shareholder's stock (rather than stock and debt) in the corporation determined at the close of the post-termination transition period. See section 1366(d)(3)(B).

Finally, the proposed regulations provide rules regarding the carryover of disallowed losses and deductions in the event of certain corporate reorganizations. If a corporation acquires, in a transaction to which section 381(a) applies, the assets of another S corporation for which disallowed losses and deductions would carry over with respect to a shareholder under section 1366(d)(2), except for the reorganization, the losses and deductions will be available to that shareholder. Where the acquiring corporation is an S corporation, the losses and deductions will be treated as incurred by the acquiring S corporation with respect to that shareholder. Where the acquiring corporation is a C corporation, the proposed regulations provide special rules for a shareholder to carry over disallowed losses and deductions to any post-termination transition period under section 1377 if the shareholder is a shareholder of the C corporation after the transaction.

In the case of an S corporation that transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, any disallowed loss or deduction with respect to a shareholder of the distributing corporation immediately before the transaction is allo-

cated between the distributing corporation and the controlled corporation with respect to the shareholder. This allocation is made in proportion to the fair market value of the shareholder's stock of the distributing corporation and the shareholder's stock of the controlled corporation, determined immediately after the transaction.

Treatment of Family Group

In general, the proposed regulations provide for the reallocation of items of the corporation among family members under certain conditions. Section 1366(e) requires a determination of whether an individual family member who renders services for or provides capital to the S corporation has received reasonable compensation. The proposed regulations provide that in determining a reasonable allowance for services rendered for, or capital furnished to, the S corporation, all the facts and circumstances are considered, including the amount that ordinarily would be paid in order to obtain comparable services or capital from a person who is neither a member of that family nor a shareholder in the corporation.

For purposes of section 1366(e), similar rules apply to services rendered, or capital furnished, to an S corporation by a pass-through entity in which a member of a shareholder's family holds an interest. The proposed regulations provide that if the pass-through entity does not receive reasonable compensation for the services rendered or capital furnished, the Commissioner may prescribe adjustments to the pass-through entity and the corporation as necessary to reflect the value of the services rendered or capital furnished.

Special Rules

Section 1366(f) and the proposed regulations provide special rules limiting the pass through of certain items of an S corporation to its shareholders. Section 1366(f)(1) and the proposed regulations provide that the pass-through rules under section 1366(a) are inapplicable with respect to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels). In addition, section 1366(f)(2) and (3) and the proposed regulations provide for a reduction in the pass through of items for tax imposed on an S corporation under section 1374 or section 1375.

Adjustments to Basis of Stock

Section 1367(a) and §1.1367–1 prescribe adjustments required by subchapter S to the basis of a shareholder's stock in an S corporation and the manner in which those adjustments are made. Section 1.1367–1 requires a shareholder in an S corporation to adjust the basis of the shareholder's stock for items of income and loss for any taxable year before adjusting the basis for distributions.

Section 1309 of the 1996 Act amended section 1368 to require that in the case of any distribution made during any taxable year, the adjusted basis of the stock is determined with regard to the adjustments provided in section 1367(a)(1) for the taxable year. Thus, the adjustments for distributions made by the S corporation during the taxable year are taken into account before applying the loss limitation for the year.

The proposed regulations amend §1.1367–1 to provide that for taxable years of the corporation beginning on or after August 18, 1998, adjustments to the basis of a share of stock are made in the following order: (1) increases for income items and the excess of deductions for depletion over the basis of the property subject to depletion; (2) decreases for distributions; (3) decreases for noncapital, nondeductible expenses, and certain oil and gas depletion deductions; and (4) decreases for items of loss or deduction.

Adjustments Required Before Determining Tax Effect of Distribution

Section 1368 provides rules for determining the source of a distribution made by an S corporation with respect to its stock and the tax effect of the distribution on the shareholders. Under §1.1368–1, the determination whether a distribution is made out of the accumulated adjustments account (AAA) or earnings and profits is made only after the AAA has been adjusted to reflect: (1) increases for income items (other than income that is exempt from tax) and the excess of the deductions for depletion over the basis of the property subject to depletion; (2) decreases for noncapital, nondeductible expenses (other than federal taxes attributable to any taxable year in which the corporation was a C corporation and expenses related to income that is exempt from tax); (3) decreases for certain oil and gas depletion deductions; (4) decreases for items of loss or deduction; and (5) the effect of certain redemptions.

Consistent with the proposed amendments to §1.1367–1, the proposed regulations amend §1.1368–2 to provide that for taxable years of the corporation beginning on or after August 18, 1998, the adjustments to the AAA are made in the same order as the adjustments to the basis of a share of stock under §1.1367–1 of the proposed regulations. For purposes of determining the amount of any distribution made from the AAA, decreases to the AAA to reflect distributions are made without taking into account any net negative adjustments as defined in section 1368(e)(1)(C)(ii).

Section 1311(a) of the 1996 Act generally eliminated the S corporation earnings and profits of a corporation accumulated in those taxable years beginning before January 1, 1983, for which the corporation was an electing small business corporation under the provisions of subchapter S of the Code as then in effect, if the corporation was also an S corporation for its first taxable year beginning after December 31, 1996. Several provisions of the existing final regulations under subchapter S, which were adopted before the 1996 Act amendments, refer separately to S corporation earnings and profits and C corporation earnings and profits. See, e.g., §1.1368–1(f)(2)(iii). Treasury and the IRS specifically request comments on the extent, if any, to which these regulations should be amended in view of the general elimination of S corporation earnings and profits. Treasury and the IRS also request comments on whether section 1311(a) of the 1996 Act applies to qualified casualty insurance electing small business corporations and qualified oil corporations, within the meaning of section 6(c) of the 1982 Act.

Proposed Effective Date

The regulations under section 1366 and the amendments to the regulations under sections 1367 and 1368 are proposed to be effective for taxable years of the corporation beginning on or after August 18, 1998.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations do not impose a collection of information that is not already required by the underlying statute or the current regulations and reflected in the appropriate forms. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for Tuesday, December 15, 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 written comments (a signed original and eight (8) copies) by November 16, 1998. The outline of topics to be discussed at the hearing must be received by Tuesday, November 24, 1998.

A period of 10 minutes will be allotted for 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 proposed regulations are Deane M. Burke, Terri A. Belanger, and Brenda Stewart of the Office of Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service. 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 TAX

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

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

§§1.1366–1 and 1.1366–2 [Removed]

Par. 2. Sections 1.1366–1 and 1.1366–2 are removed.

Par. 3. Sections 1.1366–0 through 1.1366–5 are added to read as follows:

§1.1366–0 Table of contents.

The following table of contents is provided to facilitate the use of §§1.1366–1 through 1.1366–5:

§1.1366–1 Shareholder's share of items of an S corporation.

(a) Determination of shareholder's tax liability.
(1) In general.
(2) Separately stated items of income, loss, deduction, or credit.
(3) Nonseparately computed income or loss.
(4) Separate activities requirement.
(5) Aggregation of deductions or exclusions for purposes of limitations.
(b) Character of items constituting pro rata share.
(1) In general.
(2) Exception for contribution of noncapital gain property.
(3) Exception for contribution of capital loss property.
(c) Gross income of a shareholder.
(1) In general.
(2) Gross income for substantial omission of items.
(d) Shareholders holding stock subject to community property laws.
(e) Net operating loss deduction of shareholder of S corporation.
(f) Cross-reference.

§1.1366–2 Limitations on deduction of pass-through items of an S corporation to its shareholders.

(a) In general.
(1) Limitation on losses and deductions.
(2) Carryover of disallowance.
(3) Basis limitation amount.
(i) Stock portion.
(ii) Indebtedness portion.
(4) Limitation on losses and deductions allocated to each item.
(5) Nontransferability of losses and deductions.
(6) Basis of stock acquired by gift.
(b) Special rules for carryover of disallowed losses and deductions to post-termination transition period described in section 1377(b).
(1) In general.
(2) Limitation on losses and deductions.
(3) Limitation on losses and deductions allocated to each item.
(4) Adjustment to the basis of stock.
(c) Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions.
(1) Liquidations and reorganizations.
(2) Corporate separations to which section 368(a)(1)(D) applies.

§1.1366–3 Treatment of family groups.

(a) In general.
(b) Examples.

§1.1366–4 Special rules limiting the pass through of certain items of an S corporation to its shareholders.

(a) Pass through inapplicable to section 34 credit.
(b) Reduction in pass through for tax imposed on built-in gains.
(c) Reduction in pass through for tax imposed on excess net passive income.

§1.1366-5 Effective date.

§1.1366-1 Shareholder's share of items of an S corporation.

(a) *Determination of shareholder's tax*

liability—(1) *In general.* An S corporation must report, and a shareholder is required to take into account in the shareholder's return, the shareholder's pro rata share, whether or not distributed, of the S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2), (3), and (4) of this section. A shareholder's pro rata share is determined in accordance with the provisions of section 1377(a) and the regulations thereunder. The shareholder takes these items into account in determining the shareholder's taxable income and tax liability for the shareholder's taxable year with or within which the taxable year of the corporation ends. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return. For the limitation on allowance of a shareholder's pro rata share of S corporation losses or deductions, see section 1366(d) and §1.1366–2.

(2) *Separately stated items of income, loss, deduction, or credit.* Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately. The separately stated items of the S corporation include, but are not limited to, the following items—

(i) The corporation's combined net amount of gains and losses from sales or exchanges of capital assets grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(ii) The corporation's combined net amount of gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(iii) Charitable contributions, grouped by the percentage limitations of section 170(b), paid by the corporation within the taxable year of the corporation;

(iv) The taxes described in section 901 that have been paid (or accrued) by the corporation to foreign countries or to possessions of the United States;

(v) Each of the corporation's separate items involved in the determination of credits against tax allowable under part IV of subchapter A (section 21 and following) of the Internal Revenue Code, except for any credit allowed under section 34 (relating to certain uses of gasoline and special fuels);

(vi) Each of the corporation's separate items of gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); deduction under an election to expense certain depreciable business expenses (section 179); medical, dental, etc., expenses (section 213); the additional itemized deductions for individuals provided in part VII of subchapter B (section 212 and following) of the Internal Revenue Code; and any other itemized deductions for which the limitations on itemized deductions under sections 67 or 68 applies;

(vii) Any of the corporation's items of portfolio income or loss, and expenses related thereto, as defined under section 469;

(viii) The corporation's tax-exempt income. For purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. For example, income that is excludible from gross income under section 101 (certain death benefits) or section 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under section 108 (income from discharge of indebtedness) or section 109 (improvements by lessee on lessor's property) is not tax-exempt income;

(ix) The corporation's adjustments described in sections 56 and 58, and items of tax preference described in section 57; and

(x) Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

(3) *Nonseparately computed income or loss.* Each shareholder must take into account separately the shareholder's pro rata share of the nonseparately computed income or loss of the S corporation. For this purpose, *nonseparately computed income or loss* means the corporation's gross income less the deductions allowed to the corporation under chapter 1 of the Internal Revenue Code, determined by excluding any item requiring separate computation under paragraph (a)(2) of this section.

(4) *Separate activities requirement.* An S corporation must report, and each shareholder must take into account in the shareholder's return, the shareholder's pro rata share of an S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2) and (3) of this section for each of the corporation's activities as defined in section 469 and the regulations thereunder.

(5) *Aggregation of deductions or exclusions for purposes of limitations*—(i) *In general.* A shareholder aggregates the shareholder's separate deductions or exclusions with the shareholder's pro rata share of the S corporation's separately stated deductions or exclusions in determining the amount of any deduction or exclusion allowable to the shareholder under subtitle A of the Internal Revenue Code as to which a limitation is imposed.

(ii) *Example.* The provisions of paragraph (a)(5)(i) of this section are illustrated by the following example:

Example. In 1999, Corporation M, an S corporation, purchases and places in service section 179 property costing $10,000. Corporation M elects to expense the entire cost of the property. Shareholder A owns 50 percent of the stock of Corporation M. Shareholder A's pro rata share of this item after Corporation M applies the section 179(b) limitations is $5,000. Because the aggregate amount of Shareholder A's pro rata share and separately acquired section 179 expense may not exceed $19,000 (the aggregate maximum cost that may be taken into account under section 179(a) for the applicable taxable year), Shareholder A may elect to expense up to $14,000 of separately acquired section 179 property that is purchased and placed in service in 1999, subject to the limitations of section 179(b).

(b) *Character of items constituting pro rata share*—(1) *In general.* Except as provided in paragraph (b)(2) or (3) of this section, the character of any item of income, loss, deduction, or credit described in section 1366(a)(1)(A) or (B) and para-

graph (a) of this section is determined for the S corporation and retains that character in the hands of the shareholder. For example, if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder's pro rata share of that gain will also be characterized as a capital gain regardless of whether the shareholder is otherwise a dealer in that type of property. Similarly, if an S corporation engages in an activity that is not for profit (section 183), a shareholder's pro rata share of the S corporation's deductions will be characterized as not for profit. Also, if an S corporation makes a charitable contribution to an organization qualifying under section 170(b)(1)(A), a shareholder's pro rata share of the S corporation's charitable contribution will be characterized as made to an organization qualifying under section 170(b)(1)(A).

(2) *Exception for contribution of noncapital gain property.* If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would not have produced capital gain if sold or exchanged by the shareholder or shareholders, then the gain on the sale or exchange of the property recognized by the corporation is not treated as a capital gain.

(3) *Exception for contribution of capital loss property.* If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would have produced capital loss if sold or exchanged by the shareholder or shareholders, then the loss on the sale or exchange of the property recognized by the corporation is treated as a capital loss to the extent that, immediately before the contribution, the adjusted basis of the property in the hands of the shareholder or shareholders exceeded the fair market value of the property.

(c) *Gross income of a shareholder*—(1) *In general.* Where it is necessary to determine the amount or character of the gross income of a shareholder, the shareholder's gross income includes the shareholder's pro rata share of the gross income of the S corporation. The shareholder's pro rata share of the gross income of the S corporation is the amount of gross income of the corporation used in deriving the shareholder's pro rata share of S corporation taxable income or loss (including items described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section). For example, a shareholder is required to include the shareholder's pro rata share of S corporation gross income in computing the shareholder's gross income for the purposes of determining the necessity of filing a return (section 6012(a)) and the shareholder's gross income derived from farming (sections 175 and 6654(i)).

(2) *Gross income for substantial omission of items*—(i) *In general.* For purposes of determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a shareholder's gross income includes the shareholder's pro rata share of S corporation gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of S corporation gross income used in deriving the shareholder's pro rata share of any item of S corporation income, loss, deduction, or credit (as included or disclosed in the shareholder's return) is considered as an amount of gross income stated in the shareholder's return for purposes of section 6501(e).

(ii) *Example.* The following example illustrates the provisions of paragraph (c)(2)(i) of this section:

Example. Shareholder A, an individual, owns 25 percent of the stock of Corporation N, an S corporation that has $10,000 gross income and $2,000 taxable income. A reports only $300 as A's pro rata share of N's taxable income. A should have reported $500 as A's pro rata share of taxable income, derived from $2,500 of N's gross income. Because A's return included only $300 without a disclosure meeting the requirements of section 6501(e)(1)(A)(ii) describing the difference of $200, A is regarded as having reported on the return only $1,500 ($300/$500 of $2,500) as gross income from N.

(d) *Shareholders holding stock subject to community property laws.* If a shareholder holds S corporation stock that is community property, then the shareholder's pro rata share of any item or items listed in paragraphs (a)(2), (3), and (4) of this section with respect to that stock is reported by the husband and wife in accordance with community property rules.

(e) *Net operating loss deduction of shareholder of S corporation.* For purposes of determining a net operating loss deduction under section 172, a shareholder of an S corporation must take into account the shareholder's pro rata share of items of income, loss, deduction, or credit of the corporation. See section 1366(b) and paragraph (b) of this section for rules on determining the character of the items. In determining under section 172(d)(4) the nonbusiness deductions allowable to a shareholder of an S corporation (arising from both corporation sources and any other sources), the shareholder separately takes into account the shareholder's pro rata share of the deductions of the corporation that are not attributable to a trade or business and combines this amount with the shareholder's nonbusiness deductions from any other sources. The shareholder also separately takes into account the shareholder's pro rata share of the gross income of the corporation not derived from a trade or business and combines this amount with the shareholder's nonbusiness income from all other sources. See section 172 and the regulations thereunder.

(f) *Cross-reference.* For rules relating to the consistent tax treatment of subchapter S items, see section 6037(c).

§1.1366–2 Limitations on deduction of pass-through items of an S corporation to its shareholders.

(a) *In general*—(1) *Limitation on losses and deductions.* The aggregate amount of losses and deductions taken into account by a shareholder under §1.1366–1(a)(2), (3), and (4) for any taxable year of an S corporation cannot exceed the sum of—

(i) The adjusted basis of the shareholder's stock in the corporation (as determined under paragraph (a)(3)(i) of this section); and

(ii) The adjusted basis of any indebtedness of the corporation to the shareholder (as determined under paragraph (a)(3)(ii) of this section).

(2) *Carryover of disallowance.* A shareholder's aggregate amount of losses and deductions for a taxable year in excess of the sum of the adjusted basis of the shareholder's stock in an S corporation and of any indebtedness of the S corporation to the shareholder is not allowed

for the taxable year. However, any disallowed loss or deduction is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder to the extent that the shareholder's adjusted basis of stock or indebtedness exceeds zero. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(3)(i) and (ii) of this section.

(3) *Basis limitation amount*—(i) *Stock portion.* A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (2) of this section (limiting losses and deductions) by taking into account only increases in basis under section 1367(a)(1) for the taxable year and decreases in basis under section 1367(a)(2)(A), (D) and (E) (relating to distributions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) for the taxable year. In so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2)(B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the taxable year. However, if the shareholder has in effect for the taxable year an election under §1.1367–1(f) (proposed to be redesignated as §1.1367–1(g)) to decrease basis by items of loss and deduction prior to decreasing basis by noncapital, nondeductible expenses and certain oil and gas depletion deductions, the shareholder also disregards decreases in basis under section 1367(a)(2)(D) and (E). This basis limitation amount for stock is determined at the time prescribed under §1.1367–1(d)(1) for adjustments to the basis of stock.

(ii) *Indebtedness portion.* A shareholder determines the shareholder's adjusted basis in indebtedness of the corporation for purposes of paragraphs (a)(1)(ii) and (2) of this section (limiting losses and deductions) without regard to any adjustment under section 1367(b)(2)(A) for the taxable year. This basis limitation amount for indebtedness is determined at the time prescribed under §1.1367–2(d)(1) for adjustments to the basis of indebtedness.

(4) *Limitation on losses and deductions allocated to each item.* If a shareholder's pro rata share of the aggregate amount of losses and deductions specified in §1.1366–1(a)(2), (3), and (4) exceeds the sum of the adjusted basis of the shareholder's stock in the corporation (determined in accordance with paragraph (a)(3)(i) of this section) and the adjusted basis of any indebtedness of the corporation to the shareholder (determined in accordance with paragraph (a)(3)(ii) of this section), then the limitation on losses and deductions under section 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions. For this purpose, the total of losses and deductions for the taxable year is the sum of the shareholder's pro rata share of losses and deductions for the taxable year, and the losses and deductions disallowed and carried forward from prior years pursuant to section 1366(d)(2).

(5) *Nontransferability of losses and deductions.* Any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

(6) *Basis of stock acquired by gift.* For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (2) of this section, the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss.

(b) *Special rules for carryover of disallowed losses and deductions to post-termination transition period described in section 1377(b)*—(1) *In general.* If, for the last taxable year of a corporation for which it was an S corporation, a loss or deduction was disallowed to a shareholder by reason of the limitation in paragraph (a) of this section, the loss or deduction is treated under section 1366(d)(3) as incurred by that shareholder on the last day of any post-termination transition period (within the meaning of section 1377(b)).

(2) *Limitation on losses and deductions.* The aggregate amount of losses and deductions taken into account by a shareholder under paragraph (b)(1) of this section cannot exceed the adjusted basis of the shareholder's stock in the corporation determined at the close of the last day of the post-termination transition period. For this purpose, the adjusted basis of a shareholder's stock in the corporation is determined at the close of the last day of the post-termination transition period without regard to any reduction required under paragraph (b)(4) of this section. If a shareholder disposes of a share of stock prior to the close of the last day of the post-termination transition period, the adjusted basis of that share is its basis as of the close of the day of disposition. Any losses and deductions in excess of a shareholder's adjusted stock basis are permanently disallowed. For purposes of section 1366(d)(3)(B) and this paragraph (b)(2), the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss.

(3) *Limitation on losses and deductions allocated to each item.* If the aggregate amount of losses and deductions treated as incurred by the shareholder under paragraph (b)(1) of this section exceeds the adjusted basis of the shareholder's stock determined under paragraph (b)(2) of this section, the limitation on losses and deductions under section 1366(d)(3)(B) must be allocated among each loss or deduction. The amount of the limitation allocated to each loss or deduction is an amount that bears the same ratio to the amount of the limitation as the amount of each loss or deduction bears to the total of all the losses and deductions.

(4) *Adjustment to the basis of stock.* The shareholder's basis in the stock of the corporation is reduced by the amount allowed as a deduction by reason of this paragraph (b). For rules regarding adjustments to the basis of a shareholder's stock in an S corporation, see §1.1367–1.

(c) *Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions*—(1) *Liquidations and reorganizations.* If a corporation acquires the assets of an S

corporation in a transaction to which section 381(a) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributor or transferor S corporation is available to that shareholder as a shareholder of the acquiring corporation. Thus, where the acquiring corporation is an S corporation, a loss or deduction of a shareholder of the distributor or transferor S corporation disallowed prior to or during the taxable year of the transaction is treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder of the acquiring S corporation after the transaction. Where the acquiring corporation is a C corporation, a post-termination transition period arises the day after the last day that an S corporation was in existence and the rules provided in paragraph (b) of this section apply with respect to any shareholder of the acquired S corporation that is also a shareholder of the acquiring C corporation after the transaction. See the special rules under section 1377 for the availability of the post-termination transition period if the acquiring corporation is a C corporation.

(2) *Corporate separations to which section 368(a)(1)(D) applies.* If an S corporation transfers a portion of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributing S corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. The amount of disallowed loss or deduction allocated to the distributing (or controlled) corporation with respect to the shareholder is an amount that bears the same ratio to each item of disallowed loss or deduction as the value of the shareholder's stock in the distributing (or controlled) corporation bears to the total value of the shareholder's stock in the distributing and controlled corporations, in each case as determined immediately after the distribution.

§1.1366–3 Treatment of family groups.

(a) *In general.* Under section 1366(e), if an individual, who is a member of the family of one or more shareholders of an S corporation, renders services for, or furnishes capital to, the corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to those items taken into account by the individual and the shareholders as may be necessary to reflect the value of the services rendered or capital furnished. For these purposes, in determining the reasonable value for services rendered, or capital furnished, to the corporation, consideration will be given to all the facts and circumstances, including the amount that ordinarily would be paid in order to obtain comparable services or capital from a person (other than a member of the family) who is not a shareholder in the corporation. In addition, for purposes of section 1366(e), if a member of the family of one or more shareholders of the S corporation holds an interest in a pass-through entity (e.g., a partnership, S corporation, trust, or estate), that performs services for, or furnishes capital to, the S corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to the pass-through entity and the corporation as may be necessary to reflect the value of the services rendered or capital furnished. For purposes of section 1366(e), the term *family* of any shareholder includes only the shareholder's spouse, ancestors, lineal descendants, and any trust for the primary benefit of any of these persons.

(b) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. The stock of an S corporation is owned 50 percent by F and 50 percent by T, the minor son of F. For the taxable year, the corporation has items of taxable income equal to $70,000. Compensation of $10,000 is paid by the corporation to F for services rendered during the taxable year, and no compensation is paid to T, who rendered no services. Based on all the relevant facts and circumstances, reasonable compensation for the services rendered by F would be $30,000. In the discretion of the Internal Revenue Service, up to an additional $20,000 of the $70,000 of the corporation's taxable income, for tax purposes, may be allocated to F as compensation for services rendered. If the Service allocates $20,000 of the corporation's taxable income to F as compensation for services, taxable income of the corporation would be reduced by $20,000 to $50,000, of which F and T each would be allocated $25,000. F would have $30,000 of total compensation paid by the corporation for services rendered.

Example 2. The stock of an S corporation is owned by A and B. For the taxable year, the corporation has paid compensation to a partnership that rendered services to the corporation during the taxable year. The spouse of A is a partner in that partnership. Consequently, if based on all the relevant facts and circumstances the partnership did not receive reasonable compensation for the services rendered to the corporation, the Internal Revenue Service, in its discretion, may make adjustments to those items taken into account by the partnership and the corporation as may be necessary to reflect the value of the services rendered.

§1.1366–4 Special rules limiting the pass through of certain items of an S corporation to its shareholders.

(a) *Pass through inapplicable to section 34 credit.* Section 1.1366–1(a) does not apply to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels).

(b) *Reduction in pass through for tax imposed on built-in gains.* For purposes of §1.1366–1(a), if for any taxable year of the S corporation a tax is imposed on the corporation under section 1374, the amount of the tax imposed is treated as a loss sustained by the S corporation during the taxable year. The character of the deemed loss is determined by allocating the loss proportionately among the recognized built-in gain items giving rise to the tax and attributing the character of each recognized built-in gain item to the allocable portion of the loss.

(c) *Reduction in pass through for tax imposed on excess net passive income.* For purposes of §1.1366–1(a), if for any taxable year of the S corporation a tax is imposed on the corporation under section 1375, each item of passive investment income shall be reduced by an amount that bears the same ratio to the amount of the tax as the amount of the item bears to the total passive investment income for that taxable year.

§1.1366–5 Effective date.

Sections 1.1366–1 through 1.1366–4 apply to taxable years of an S corporation beginning on or after August 18, 1998.

Par. 4. Section 1.1367–0 is amended in the table as follows:

1. The entries for §1.1367–1(e) through (g) are revised.

2. The entries for §1.1367–1(h) through (j) are added.

The additions and revisions read as follows:

§1.1367–0 Table of contents.

* * * * *

§1.1367–1 Adjustments to basis of shareholder's stock in an S corporation.

* * * * *

(e) Ordering rules for taxable years beginning before January 1, 1997.

(f) Ordering rules for taxable years beginning on or after
August 18, 1998.

(g) Elective ordering rule.

(h) Examples.

(i) [Reserved]

(j) Adjustments for items of income in respect of a decedent.

* * * * *

Par. 5. Section 1.1367–1 is amended as follows:

1. The heading and introductory text of paragraph (e) are revised.

2. Paragraphs (f) and (g) are redesignated as paragraphs (g) and (h), respectively.

3. New paragraph (f) is added.

4. The first and second sentences of newly designated paragraph (g) are revised.

5. Newly designated paragraph (h) is amended as follows:

a. The heading for *Example 1* is revised.

b. *Example 2* and *Example 3* are redesignated as *Example 3* and *Example 4*, respectively.

c. New *Example 2* is added.

d. The heading of newly designated *Example 4* is revised.

e. *Example 5* is added.

6. Paragraph (i) is added and reserved and paragraph (j) is added.

The additions and revisions read as follows:

§1.1367–1 Adjustments to basis of shareholder's stock in an S corporation.

* * * * *

(e) *Ordering rules for taxable years beginning before January 1, 1997.* For any taxable year of a corporation beginning before January 1, 1997, except as provided in paragraph (g) of this section, the adjustments required by section 1367(a) are made in the following order—

* * * * *

(f) *Ordering rules for taxable years beginning on or after August 18, 1998.* For any taxable year of a corporation beginning on or after August 18, 1998, except as provided in paragraph (g) of this section, the adjustments required by section 1367(a) are made in the following order—

(1) Any increase in basis attributable to the income items described in section 1367(a)(1)(A) and (B), and the excess of the deductions for depletion described in section 1367(a)(1)(C);

(2) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A);

(3) Any decrease in basis attributable to noncapital, nondeductible expenses described in section 1367(a)(2)(D), and the oil and gas depletion deduction described in section 1367(a)(2)(E); and

(4) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2)(B) and (C).

(g) *Elective ordering rule.* A shareholder may elect to decrease basis under paragraph (e)(3) or (f)(4) of this section, whichever applies, prior to decreasing basis under paragraph (e)(2) or (f)(3) of this section, whichever applies. If a shareholder makes this election, any amount described in paragraph (e)(2) or (f)(3) of this section, whichever applies, that is in excess of the shareholder's basis in stock and indebtedness is treated, solely for purposes of this section, as an amount described in paragraph (e)(2) or (f)(3) of this section, whichever applies, in the succeeding taxable year. * * *

(h) * * *

Example 1. Adjustments to basis of stock for taxable years beginning before January 1, 1997. * * *

Example 2. Adjustments to basis of stock for taxable years beginning on or after August 18, 1998. (i) On December 31, 2001, A owns a block of 50 shares of stock with an adjusted basis per share of $6 in Corporation S. On December 31, 2001, A purchases for $400 an additional block of 50 shares of stock with an adjusted basis of $8 per share. Thus, A holds 100 shares of stock for each day of the 2002 taxable year. For S's 2002 taxable year, A's pro rata share of the amount of items described in section 1367(a)(1)(A) (relating to increases in basis of stock) is $300, A's pro rata share of the amount of the items described in section 1367(a)(2)(B) (relating to decreases in basis of stock attributable to items of loss and deduction) is $300, and A's pro rata share of the amount of the items described in section 1367(a)(2)(D) (relating to decreases in basis of stock attributable to noncapital, nondeductible expenses) is $200. S makes a distribution to A in the amount of $100 during 2002.

(ii) Pursuant to the ordering rules of paragraph (f) of this section, A first increases the basis of each share of stock by $3 ($300/100 shares) and then decreases the basis of each share by $1 ($100/100 shares) for the distribution. A next decreases the basis of each share by $2 ($200/100 shares) for the noncapital, nondeductible expenses and then decreases the basis of each share by $3 ($300/100 shares) for the items of loss. Thus, on January 1, 2003, A has a basis of $3 per share in the original block of 50 shares ($6 + $3 – $1 – $2 – $3) and a basis of $5 per share in the second block of 100 shares ($8 + $3 – $1 – $2 – $3).

* * * * *

Example 4. Effects of section 1377(a)(2) election and distribution on basis of stock for taxable years beginning before January 1, 1997. * * *

Example 5. Effects of section 1377(a)(2) election and distribution on basis of stock for taxable years beginning on or after August 18, 1998. (i) The facts are the same as in *Example 4,* except that all of the events occur in 2001 rather than in 1994 and except as follows: On June 30, 2001, B sells 25 shares of her stock for $5,000 to D and 25 shares back to Corporation S for $5,000. Under section 1377(a)(2)(B) and §1.1377–1(b)(2), B and C are affected shareholders because B has transferred shares to Corporation S. Pursuant to section 1377(a)(2)(A) and §1.1377–1(b)(1), B and C, the affected shareholders, and Corporation S agree to treat the taxable year 2001 as if it consisted of two separate taxable years for all affected shareholders for the purposes set forth in §1.1377–1(b)(3)(i).

(ii) On June 30, 2001, B and C, pursuant to the ordering rules of paragraph (f)(1) of this section, increase the basis of each share by $60 ($6,000/100 shares) for the nonseparately computed income. Then B and C reduce the basis of each share by $120 ($12,000/100 shares) for the distribution. Finally, B and C decrease the basis of each share by $40 ($4,000/100 shares) for the separately stated deduction item.

(iii) The basis of the stock of B is reduced from $120 to $20 per share ($120 + $60 – $120 – $40). Prior to accounting for the separately stated deduction item, the basis of the stock of C is reduced from $80 to $20 ($80 + $60 – $120). Finally, because the period from January 1 through June 30, 2001 is treated under §1.1377–1(b)(3)(i) as a separate taxable year for purposes of making adjustments to the basis of stock, under section 1366(d) and §1.1366– 2(a)(2), C may deduct only $20 per share of the remaining $40 of the separately stated deduction item, and the basis of the stock of C is reduced from $20 per share to $0 per share. Under section 1366 and §1.1366–2(a)(2), C's remaining separately stated deduction item of $20 per share is treated as having been incurred in the first succeeding taxable year of Corporation S, which, for this purpose, begins on July 1, 2001.

(i) [Reserved]

(j) *Adjustments for items of income in respect of a decedent.* The basis deter-

mined under section 1014 of any stock in an S corporation is reduced by the portion of the value of the stock that is attributable to items constituting income in respect of a decedent. For the determination of items realized by an S corporation constituting income in respect of a decedent, see sections 1367(b)(4)(A) and 691 and applicable regulations thereunder. For the determination of the allowance of a deduction for the amount of estate tax attributable to income in respect of a decedent, see section 691(c) and applicable regulations thereunder.

Par. 6. The first sentence of §1.1367–3 is removed and two sentences are added in its place to read as follows:

§1.1367–3 Effective date and transition rule.

Except for §1.1367–1(f), *Example 2* and *Example 5* of §1.1367–1(h), and §1.1367–1(j), §§1.1367–1 and 1.1367–2 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1367–1(f), *Example 2* and *Example 5* of §1.1367–1(h), and §1.1367–1(j) apply only to taxable years of the corporation beginning on or after August 18, 1998. * * *

Par. 7. Section 1.1368–0 is amended in the table as follows:

1. The entry for §1.1368–1(e) is revised and entries for §1.1368–1(e)(1) and (2) are added.
2. The entries for §1.1368–2(a)(4) and (d) are revised.
3. An entry for §1.1368–2(a)(5) is added.

The additions and revisions read as follows:

§1.1368–0 Table of contents.

* * * * *

§1.1368–1 Distributions by S corporations.

* * * * *

(e) Certain adjustments taken into account.

(1) Taxable years beginning before January 1, 1997.

(2) Taxable years beginning on or after August 18, 1998.

* * * * *

§1.1368–2 Accumulated adjustments account (AAA).

(a) Accumulated adjustments account.

* * * * *

(4) Ordering rules for the AAA for taxable years beginning before January 1, 1997.

(5) Ordering rules for the AAA for taxable years beginning on or after August 18, 1998.

* * * * *

(d) Adjustment in the case of redemptions, liquidations, reorganizations, and divisions.

* * * * *

Par. 8. Section 1.1368–1 is amended by revising paragraphs (d)(1) and (e) to read as follows:

§1.1368–1 Distributions by S corporations.

* * * * *

(d) *S corporation with earnings and profits*—(1) *General treatment of distribution.* Except as provided in paragraph (d)(2) of this section, a distribution made with respect to its stock by an S corporation that has accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(c). See section 316 and §1.316–2 for provisions relating to the allocation of earnings and profits among distributions.

* * * * *

(e) *Certain adjustments taken into account*—(1) *Taxable years beginning before January 1, 1997.* For any taxable year of the corporation beginning before January 1, 1997, paragraphs (c) and (d) of this section are applied only after taking into account—

(i) The adjustments to the basis of the shares of a shareholder's stock described in section 1367 (without regard to section 1367(a)(2)(A) (relating to decreases attributable to distributions not includible in income)) for the S corporation's taxable year; and

(ii) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under §1.1368–2(a)(3)(iii)) for the S corporation's taxable year.

(2) *Taxable years beginning on or after August 18, 1998.* For any taxable year of the corporation beginning on or after August 18, 1998, paragraphs (c) and (d) of this section are applied only after taking into account—

(i) The adjustments to the basis of the shares of a shareholder's stock described in section 1367(a)(1) (relating to increases in basis of stock) for the S corporation's taxable year; and

(ii) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under §1.1368–2(a)(3)(iii)) for the S corporation's taxable year. Any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)) for the taxable year shall not be taken into account.

* * * * *

Par. 9. Section 1.1368–2 is amended as follows:

1. Paragraphs (a)(1) and (a)(3)(ii), and the heading and introductory text of paragraph (a)(4) are revised.
2. Paragraph (a)(5) is added.
3. The heading for paragraph (d) is revised.

The additions and revisions read as follows:

§1.1368–2 Accumulated adjustments account (AAA).

(a) *Accumulated adjustments account*—(1) *In general.* The accumulated adjustments account is an account of the S corporation and is not apportioned among shareholders. The AAA is relevant for all taxable years beginning on or after January 1, 1983, for which the corporation is an S corporation. On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero. The AAA is increased in the manner provided in paragraph (a)(2) of this section and is decreased in the manner provided in paragraph (a)(3) of this section. For the adjustments to the AAA in the case of redemptions, liquidations, reorganizations, and corporate separations, see paragraph (d) of this section.

* * * * *

(3) *Decreases to the AAA* * * *

(ii) *Extent of allowable reduction.* The AAA may be decreased under paragraph (a)(3)(i) of this section below zero. The AAA is decreased by noncapital, nonde-

ductible expenses under paragraph (a)(3)(i)(C) of this section even though a portion of the noncapital, nondeductible expenses is not taken into account by a shareholder under §1.1367–1(g) (relating to the elective ordering rule). The AAA is also decreased by the entire amount of any loss or deduction even though a portion of the loss or deduction is not taken into account by a shareholder under section 1366(d)(1) or is otherwise not currently deductible under the Internal Revenue Code. However, in any subsequent taxable year in which the loss, deduction, or noncapital, nondeductible expense is treated as incurred by the corporation with respect to the shareholder under section 1366(d)(2) or §1.1367–1(g) (or in which the loss or deduction is otherwise allowed to the shareholder), no further adjustment is made to the AAA.

* * * * *

(4) *Ordering rules for the AAA for taxable years beginning before January 1, 1997.* For any taxable year beginning before January 1, 1997, the adjustments to the AAA are made in the following order—

* * * * *

(5) *Ordering rules for the AAA for taxable years beginning on or after August 18, 1998.* For any taxable year of the corporation beginning on or after August 18, 1998, the adjustments to the AAA are made in the following order—

(i) The AAA is increased under paragraph (a)(2) of this section before it is decreased under paragraph (a)(3) of this section for the taxable year;

(ii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368(b) or (c)(1) applies (without taking into account any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)) before it is decreased under paragraph (a)(3)(i) of this section;

(iii) The AAA is decreased under paragraph (a)(3)(i)(C) and (D) of this section before it is decreased under paragraph (a)(3)(i)(A) and (B) of this section;

(iv) The AAA is decreased under paragraph (a)(3)(i)(A) and (B) of this section; and

(v) The AAA is adjusted (whether negative or positive) for redemption distributions under paragraph (d)(1) of this section.

* * * * *

(d) *Adjustment in the case of redemptions, liquidations, reorganizations, and divisions* * * *

* * * * *

Par. 10. Section 1.1368–3 is amended as follows:

1. The heading for *Example 1* is revised.

2. *Example 2* through *Example 6* are redesignated as *Example 3* through *Example 7,* respectively.

3. New *Example 2* is added.

The revision and addition read as follows:

§1.1368–3 Examples.

* * * * *

Example 1. Distributions by S corporations without C corporation earnings and profits for taxable years beginning before January 1, 1997. * * *

Example 2. Distributions by S corporations without earnings and profits for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 2001, the first day of its 2001 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of $1 per share as of that date. On March 1, 2001, S makes a distribution of $38 to A. For S's 2001 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is $50. A's pro rata share of the amount of the items described in sections 1367(a)(2)(B) through (D) (relating to decreases in basis of stock for items other than distributions) is $26, $20 of which is attributable to items described in section 1367(a)(2)(B) and (C) and $6 of which is attributable to items described in section 1367(a)(2)(D) (relating to decreases in basis attributable to noncapital, nondeductible expenses).

(ii) Under section 1368(d)(1) and §1.1368–1(e)(1) and (2), the adjustments to the basis of A's stock in S described in sections 1367(a)(1) are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is $6.00 ($1 + [$50/10]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under §1.1367–1(c)(3), the amount of the distribution that is attributable to each share of A's stock is $3.80 ($38 distribution/10 shares). Thus, A's basis per share in the stock is $2.20 ($6.00 – $3.80), after taking into account the distribution. Under section 1367(a)(2)(D), the basis of each share of A's stock in S after taking into account the distribution, $2.20, is decreased by $.60 ($6 noncapital, nondeductible expenses/10). Thus, A's basis per share after taking into account the nondeductible, noncapital expenses is $1.60. Under section 1367(a)(2)(B) and (C), A's basis per share is further decreased by $2 ($20 items described in section 1367(a)(2)(B) and (C)/10 shares). However, basis may not be reduced below zero. Therefore, the basis of each share of A's stock is reduced to zero. As of January 1, 2002, A has a basis of $0 in his shares of S stock. Pursuant to section 1366(d)(2), the $.40 of loss in excess of A's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to A.

* * * * *

Par. 11. The first sentence of §1.1368-4 is removed and two sentences are added in its place to read as follows:

§1.1368–4 Effective date and transition rule.

Except for §§1.1368–1(e)(2), 1.1368–2(a)(5), and *Example 2* of §1.1368–3, §§1.1368–1, 1.1368–2, and 1.1368–3 apply to taxable years of the corporation beginning on or after January 1, 1994. Sections 1.1368–1(e)(2), 1.1368–2(a)(5) and *Example 2* of §1.1368–3 apply only to taxable years of the corporation beginning on or after August 18, 1998. * * *

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

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Announcement 98–81

Pursuant to the authority described in section 9 of Rev. Proc. 95–28, 1995–1 C.B. 704, 705–6, this announcement extends the relief provided in section 5.02 of that revenue procedure to the owner of any project in Nevada County, California that (1) received a 1996 allocation of low-income housing credit under § 42(h)(1)(E) or (F) of the Internal Revenue Code, (2) is located within 20 miles of Yuba County, California, one of the counties included in a major disaster declaration by the President on February 9, 1998, as a result of flooding from the "El Nino" weather pattern, and (3) as required by section 6 of Rev. Proc. 95–28, is determined by the California Tax Credit Allocation Committee to qualify for the relief provided in section 5.02 of that revenue procedure as a result of the flooding herein described. In addition, the compliance monitoring relief provided in section 8 of Rev. Proc. 95–28

will apply to the California Tax Credit Allocation Committee.

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

Changes to Excise Taxes

Announcement 98-83

Purpose

To announce excise tax changes made by recent legislation. The changes include:

- A reduction in the tax rate for diesel fuel used in trains beginning November 1, 1998, and
- New rules for making a claim for refund under sections 6421 and 6427 of the Internal Revenue Code.

Diesel fuel used in trains, IRS No. 71

Beginning November 1, 1998, the tax rate for diesel fuel used in trains is $.044 per gallon.

Claims for fuel tax refunds

Beginning October 1, 1998, persons may file a claim if, at the close of any quarter of the claimant's income tax year, a refund of $750 or more is due. Such a claim now includes amounts for excise taxes on gasoline, aviation gasoline, diesel fuel, aviation fuel (other than gasoline), and kerosene in the quarter or any prior quarter of the taxable year.

Claimants should file **Form 8849,** Claim for Refund of Excise Taxes, or Schedule C of **Form 720,** Quarterly Federal Excise Tax Return, for the listed taxes. However, they should continue to use **Form 4136,** Credit for Federal Tax Paid on Fuels, for:

- Tax on gasoline used on a farm for farming purposes (section 6420); and
- Amounts not included in claims previously filed for the taxable year.

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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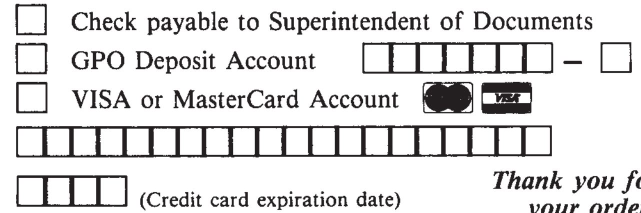

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