Bulletin No. 1997–10
March 10, 1997

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 97–10, page 31.
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 March 1997.

Rev. Rul. 97–11, page 5.
Election in respect of losses attributable to a disaster. This ruling lists the areas declared by the President to qualify as major disaster areas under the Disaster Relief and Emergency Assistance Act since the publication of Rev. Rul. 96–13.

T.D. 8708, page 14.
Final regulations under section 902 of the Code relate to the computation of foreign taxes deemed paid.

REG–208172–91, page 59.
Proposed regulations under sections 108 and 1017 of the Code provide ordering rules for the reduction of bases of property that affect taxpayers who exclude discharge of indebtedness from gross income. A public hearing will be held on April 24, 1997.

Rev. Proc. 97–18, page 53.
This procedure provides guidance for any bank seeking to change its accounting method for bad debts from the section 585 reserve method to the section 166 specific charge-off method in order to elect S corporation status for the 1997 tax year.

Notice 97–20, page 52.
Accounting periods; small business corporations. Procedures are provided under which a taxpayer may automatically change its annual accounting period in order elect to be an S corporation effective for the taxable year beginning January 1, 1997.

EXEMPT ORGANIZATIONS

Announcement 97–18, page 67.
A list is given of organizations now classified as private foundations.

ADMINISTRATIVE

Rev. Proc. 97–19, page 55.
Timely filing or payment; private delivery services. Criteria and application procedures are provided for designation of private delivery services under section 7502(f) of the Code.

Notice 97–17, page 34.
The "differential earnings rate" under section 809 is tentatively determined for 1996 together with the "recomputed differential earnings rate" for 1995.

Notice 97–18, page 35.
This notice provides guidance concerning the application of sections 1491 through 1494 of the Code to certain transfers of property by a U.S. person to a foreign corporation, partnership, trust, or estate. Pursuant to section 1902 of the Small Business Job Protection Act of 1996, failure to report such a transfer made after August 20, 1996, could result in a penalty equal to 35 percent of the value of the property transferred.

Notice 97–19, page 40.
This notice provides guidance under sections 877, 2107, 2501, and 6039F for expatriates who lose U.S. citizenship or cease to be taxed as long-term residents of the United States with a principal purpose to avoid U.S. taxes. This notice also provides guidance on the interaction of section 7701(b)(10) with section 877, as amended by the Health Insurance Portability and Accountability Act of 1996.

(Continued on page 4)

Finding Lists begin on page 71.

HIGHLIGHTS OF THIS ISSUE—Continued

ADMINISTRATIVE—Continued

Announcement 97–10, page 64.
Information on new reporting for medical savings accounts, long-term care accounts, and SIMPLE retirement accounts is provided.

Announcement 97–19, page 68.
The Service will continue, through December 31, 1997, its program to respond to requests for fact-of-filing information from firms in the tax professional community with respect to their employees and associates. The tax professional community consists of all firms that prepare tax returns, offer tax advice, or provide tax services. This includes practitioners governed by Treasury Department Circular 230.

Mission of the Service

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

Statement of Principles of Internal Revenue Tax Administration

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

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

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

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

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

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

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

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1997. See Rev. Rul. 97–10, page 31.

Section 165.—Losses

26 CFR 1.165–11: Election in respect of losses attributable to a disaster.

Election in respect of losses attributable to a disaster. This ruling lists the areas declared by the President to qualify as major disaster areas under the Disaster Relief and Emergency Assistance Act since the publication of Rev. Rul. 96–13.

Rev. Rul. 97–11

Under § 165(i) of the Internal Revenue Code, if a taxpayer suffers a loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. §§ 5121–5204c (1988 & Supp. V 1993) (the Act), the taxpayer may elect to claim a deduction for that loss on the taxpayer's federal income tax return for the taxable year immediately preceding the taxable year in which the disaster occurred.

Section 1.165–11(e) of the Income Tax Regulations provides that the election to deduct a disaster loss for the preceding year must be made by filing a return, an amended return, or a claim for refund on or before the later of (1) the due date of the taxpayer's income tax return (determined without regard to any extension of time to file the return) for the taxable year in which the disaster actually occurred, or (2) the due date of the taxpayer's income tax return (determined with regard to any extension of time to file the return) for the taxable year immediately preceding the taxable year in which the disaster actually occurred.

The provisions of § 165(i) apply only to losses that are otherwise deductible under § 165(a). An individual taxpayer may deduct losses if they are incurred in a trade or business, if they are incurred in a transaction entered into for profit, or if they are casualty losses under § 165(c)(3).

The President has determined that during 1996 the areas listed below have been adversely affected by disasters of sufficient severity and magnitude to warrant assistance by the Federal Government under the Act.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jonathan Strum of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Strum on (202) 622–4960 (not a toll-free call).

Disaster Areas in 1996	Type of Disaster	Date of Disaster
Alabama		
Counties of Blount, Colbert, Cullman, DeKalb, Etowah, Jackson, Lauderdale, Lawrence, Limestone, Madison, Marion, Marshall, Morgan, and Winston	Severe winter storm, ice and flooding	February 1-12, 1996
Counties of Dallas, Macon, and Montgomery	Severe storms, flooding and tornadoes	March 5-6, 1996
Alaska		
The City of Houston; and the Matanuska-Susitna Borough	Wildland fires	June 2-15, 1996
Arkansas		
Counties of Crawford, Franklin, Madison, Marion, Sebastian, and Washington	Severe storms and tornadoes	April 21-22, 1996
California		
Counties of Alameda, Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Fresno, Glenn, Humboldt, Lake, Lassen, Madera, Marin, Mariposa, Mendocino, Merced, Modoc, Mono, Monterey, Napa, Nevada, Placer, Plumas, Sacramento, San Benito, San Francisco, San Joaquin, San Mateo, Santa Clara, Santa Cruz, Shasta, Sierra, Siskiyou, Solano, Sonoma, Stanislaus, Sutter, Tehama, Trinity, Tulare, Tuolumne, Yolo, and Yuba; and the City of Morgan Hill	Severe storms, flooding, mud and land slides	December 28, 1996
Connecticut		
Counties of Fairfield, Hartford, Litchfield, Middlesex, New Haven, New London, Tolland, and Windham	Blizzard of 1996	January 7-13, 1996
Delaware		
Counties of Kent, New Castle, and Sussex	Blizzard of 1996	January 6-12, 1996
District of Columbia	Blizzard of 1996	January 6-12, 1996

Disaster Areas in 1996	Type of Disaster	Date of Disaster
Florida		
Counties of Baker, Citrus, Clay, Dixie, Duval, Hernando, Hillsborough, Levy, Manatee, Nassau, Pasco, Pinellas, Putnam, Sarasota, Taylor, and Volusia	Storm surge, heavy rains, flooding, and wind damage due to Tropical Storm Josephine	October 7, 1996
Hawaii		
Island of Oahu	Prolonged and heavy rains, high surf, flooding, landslides, mudslices and severe storms	November 5-December 9, 1996
Idaho		
Counties of Benewah, Bonner, Boundary, Clearwater, Idaho, Kootenai, Latah, Lewis, Nez Perce, and Shoshone; and the Nez Perce Indian Reservation	Severe storms and flooding	February 6-23, 1996
Counties of Adams, Benewah, Bonner, Boundary, Boise, Clearwater, Elmore, Gem, Idaho, Kootenai, Latah, Nez Perce, Owyhee, Payette, Shoshone, Valley, and Washington	Severe storms, flooding, mud and land slides	November 16, 1996-January 3, 1997
Illinois		
Counties of Champaign, Henry, Lake, Macon, and Marion	Severe storms and tornadoes	April 18-19, 1996
Counties of Adams, Brown, Cass, Champaign, Crawford, Cumberland, Douglas, Effingham, Franklin, Gallatin, Hamilton, Hancock, Jackson, Jasper, Lawrence, Madison, Menard, Monroe, Perry, Richland, Saline, Sangamon, Schuyler, St. Clair, Vermilion, Wabash, White, and Williamson	Severe storms and flooding	April 28-May 17, 1996
Counties of Cook, Dekalb, DuPage, Grundy, Kane, Kendall, LaSalle, Ogle, Stephenson, Will, and Winnebago	Severe storms and flooding	July 17-August 7, 1996
Indiana		
Counties of Bartholomew, Blackford, Boone, Brown, Clark, Clay, Clinton, Crawford, Daviess, Dearborn, Decatur, Delaware, Dubois, Fayette, Floyd, Franklin, Gibson, Greene, Hamilton, Hancock, Harrison, Hendricks, Henry, Jackson, Jay, Jefferson, Jennings, Johnson, Knox, Lawrence, Madison, Marion, Monroe, Montgomery, Morgan, Ohio, Orange, Owen, Parke, Perry, Pike, Posey, Putnam, Randolph, Rush, Scott, Shelby, Spencer, Sullivan, Switzerland, Tipton, Union, Vigo, Warrick, Washington, and Wayne.	Blizzard of 1996	January 6-12, 1996
Counties of Brown, Crawford, Daviess, Dearborn, Dekalb, Dubois, Franklin, Gibson, Harrison, Jefferson, Knox, Lawrence, Martin, Montgomery, Ohio, Orange, Perry, Pike, Posey, Putnam, Ripley, Steuben, Sullivan, Switzerland, Union, Vanderburgh, Warrick, Washington, and Whitley.	Severe storms and flooding	April 28-May 25, 1996
Iowa		
Counties of Adair, Adams, Des Moines, Henry, Iowa, Johnson, Keokuk, Lee, Louisa, Madison, Mahaska, Muscatine, Ringgold, Taylor, Union, and Washington.	Severe storms and flooding	May 8-28, 1996
Counties of Audubon, Boone, Cherokee, Crawford, Hamilton, Hardin, Harrison, Ida, Monona, Plymouth, Pottawattamie, Sac, Shelby, Story, and Woodbury.	Severe storms and flooding	June 15-30, 1996

Disaster Areas in 1996	Type of Disaster	Date of Disaster
Kentucky		
Counties of Adair, Allen, Anderson, Ballard, Barren, Bath, Bell, Boone, Bourbon, Boyd, Boyle, Bracken, Breathitt, Breckinridge, Bullitt, Butler, Caldwell, Calloway, Campbell, Carlisle, Carroll, Carter, Casey, Christian, Clark, Clay, Clinton, Crittenden, Cumberland, Daviess, Edmonson, Elliott, Estill, Fayette, Fleming, Floyd, Franklin, Fulton, Gallatin, Garrard, Grant, Graves, Grayson, Green, Greenup, Hancock, Hardin, Harlan, Harrison, Hart, Henderson, Henry, Hickman, Hopkins, Jackson, Jefferson, Jessamine, Johnson, Kenton, Knott, Knox, Larue, Laurel, Lawrence, Lee, Leslie, Letcher, Lewis, Lincoln, Livingston, Logan, Lyon, McCracken, McCreary, McLean, Madison, Magoffin, Marion, Marshall, Martin, Mason, Meade, Menifee, Mercer, Metcalfe, Monroe, Montgomery, Morgan, Muhlenberg, Nelson, Nicholas, Ohio, Oldham, Owen, Owsley, Pendleton, Perry, Pike, Powell, Pulaski, Robertson, Rockcastle, Rowan, Russell, Scott, Shelby, Simpson, Spencer, Taylor, Todd, Trigg, Trimble, Union, Warren, Washington, Wayne, Webster, Whitley, Wolfe, and Woodford	Blizzard of 1996	January 5-12, 1996
Counties of Bullitt, Owsley, Perry, and Spencer	Severe storms, flooding and tornadoes	May 28, 1996
Maine		
Counties of Androscroggin, Franklin, Oxford, Penobscot, Piscataquis, Somerset, and Waldo	Severe storms, ice jams and flooding	January 19-February 6, 1996
Counties of Androscroggin, Cumberland, Knox, Oxford, and York	Severe storms, mudslides, inland and coastal flooding	April 16-17, 1996
Counties of Cumberland, Oxford, and York	Severe storms, heavy rains, high winds, and inland and coastal flooding	October 20-26, 1996
Maryland		
Counties of Allegany, Anne Arundel, Baltimore, Calvert, Caroline, Carroll, Cecil, Charles, Dorchester, Frederick, Garrett, Harford, Howard, Kent, Montgomery, Prince Georges, Queen Anne's, Somerset, St. Mary's, Talbot, Washington, Wicomico and Worchester; and the Cities of Baltimore and Ocean City.	Blizzard of 1996	January 6-12, 1996
Counties of Allegany, Carroll, Cecil, Frederick, Garrett, and Washington	Flooding and severe storms	January 19-31, 1996
Counties of Allegany and Frederick	Severe storms and flooding associated with Tropical Storm Fran	September 6-9, 1996
Massachusetts		
Counties of Barnstable, Berkshire, Bristol, Dukes, Essex, Franklin, Hampden, Hampshire, Middlesex, Nantucket, Norfolk, Plymouth, Suffolk, and Worcester	Blizzard of 1996	January 7-13, 1996
Counties of Essex, Middlesex, Norfolk, Plymouth, and Suffolk	Extreme weather conditions and flooding	October 20-25, 1996

Disaster Areas in 1996	Type of Disaster	Date of Disaster
Michigan		
Counties of Bay, Lapeer, Midland, Saginaw, Sanilac, St.Clair, and Tuscola	Severe storms and flooding	June 21-July 1, 1996
Minnesota		
Counties of Aitkin, Beltrami, Big Stone, Blue Earth, Chisago, Clay, Clearwater, Dakota, Faribault, Freeborn, Kittson, Koochiching, Lake of the Woods, Marshall, Nicollet, Norman, Pennington, Polk, Pope, Red Lake, Roseau, Steele, Traverse, Wabasha, Waseca, and Washington	Severe storms and flooding	March 14-June 17, 1996
Counties of Cottonwood, Faribault, Freeborn, Jackson, Lincoln, Lyon, Murray, Nobles, Pipestone, Rock, Waseca, and Yellow Medicine	Severe ice storms	November 14-30, 1996
Montana		
Counties of Chouteau, Deer Lodge, Gallatin, Jefferson, Lewis and Clark, Lincoln, Meagher, Mineral, Missoula, Park, Powell, Ravalli, Sanders, and Silver Bow	Severe storms, flooding and ice jams	February 4-29, 1996
Counties of Blain, Flathead, Hill, Liberty, Phillips, and Toole	Severe storms, flooding, ice jams and excessive soil saturation	March 9-June 5, 1996
Nebraska		
Counties of Gage, Johnson, Nemaha, and Otoe	Tornado and severe storms	May 8-28, 1996
Nevada		
Counties of Churchill, Douglas, Lyon, Mineral, Storey and Washoe; and the City of Carson City; and the Walker River Paiute tribal lands located in Churchill, Lyon, and Mineral Counties	Severe storms, flooding, mud and land slides	December 20, 1996—January 17, 1997
New Hampshire		
Counties of Hillsborough, Merrimack, Rockingham, Strafford, and Sullivan	Fall Northeaster rainstorm	October 20-26, 1996
New Jersey		
Counties of Atlantic, Bergen, Burlington, Camden, Cape May, Cumberland, Essex, Gloucester, Hudson, Hunterdon, Mercer, Middlesex, Monmouth, Morris, Ocean, Passaic, Salem, Somerset, Sussex, Union, and Warren	Blizzard of 1996	January 6-12, 1996
Counties of Hudson, Middlesex, Morris, Somerset, and Union	Severe storm and flooding	October 18-23, 1996
New York		
Counties of Albany, Bronx, Columbia, Delaware, Dutchess, Greene, Kings, Nassau, New York, Orange, Putnam, Queens, Rensselaer, Richmond, Rockland, Suffolk, Sullivan, Ulster, and Westchester	Blizzard of 1996	January 6-12, 1996
Counties of Albany, Allegany, Broome, Cattaraugus, Cayuga, Chemung, Chenango, Clinton, Columbia, Cortland, Delaware, Dutchess, Essex, Franklin, Greene, Herkimer, Jefferson, Lewis, Livingston, Madison, Montgomery, Onondaga, Ontario, Orange, Otsego, Putnam, Rensselaer, Saratoga, Schenectady, Schoharie, Schuyler, Steuben, St. Lawrence, Sullivan, Tioga, Tompkins, Ulster, Warren, Washington, Wyoming, and Yates	Severe storms and flooding	January 19-30, 1996
New York City; and the Counties of Nassau, Suffolk, and Westchester	Severe storms and flooding	October 19-20, 1996

Disaster Areas in 1996	Type of Disaster	Date of Disaster
Counties of Chemung, Clinton, Delaware, Essex, Franklin, Fulton, Lewis, Montgomery, Schoharie, Schuyler, Steuben, and Tompkins	Severe thunderstorms, high winds, rain, and flooding	November 8-15, 1996
North Carolina		
Counties of Alamance, Alexander, Alleghany, Ashe, Avery, Bertie, Buncombe, Burke, Cabarrus, Caldwell, Camden, Caswell, Catawba, Chatham, Cherokee, Chowan, Cleveland, Davidson, Davie, Durham, Edgecombe, Forsyth, Franklin, Gaston, Gates, Graham, Granville, Guilford, Halifax, Harnett, Haywood, Henderson, Hertford, High Point, Iredell, Jackson, Johnston, Lee, Lincoln, Macon, Madison, McDowell, Mecklenburg, Mitchell, Montgomery, Moore, Nash, Northampton, Orange, Pasquotank, Person, Pitt, Polk, Randolph, Rockingham, Rowan, Rutherford, Stanley, Stokes, Surry, Swain, Transylvania, Union, Vance, Wake, Warren, Watauga, Wilkes, Wilson, Yadkin, and Yancey; and the Eastern Band of Cherokee Indians Reservation	Blizzard of 1996	January 6-12, 1996
Counties of Alexander, Burke, Caldwell, Caswell, Catawba, Cherokee, Cleveland, Davidson, Davie, Forsyth, Gaston, Gates, Guilford, Halifax, Haywood, Henderson, Hertford, Iredell, Lincoln, Madison, McDowell, Montgomery, Northampton, Polk, Randolph, Rockingham, Rutherford Stokes, Surry, Warren, Watauga, Wilkes, Yadkin, and Yancey	Winter storm	February 2-9, 1996
Counties of Beaufort, Bladen, Brunswick, Cateret, Chowan, Columbus, Craven, Duplin, Greene, Hyde, Jones, Lenoir, New Hanover, Onslow, Pamlico, Pender, and Pitt	Severe storms, high wind, and flooding and related effects of Hurricane Bertha	July 10-13, 1996
All Counties	Hurricane Fran	September 5-7, 1996
Counties of Alamance, Anson, Beaufort, Bertie, Bladen, Brunswick, Buncombe, Caswell, Cateret, Chatham, Chowan, Columbus, Craven, Cumberland, Davidson, Duplin, Durham, Edgecombe, Franklin, Granville, Greene, Guilford, Halifax, Harnett, Henderson, Hertford, Hoke, Hyde, Johnston, Jones, Lee, Lenoir, Martin, Moore, Nash, New Hanover, Onslow, Orange, Pamlico, Pender, Person, Pitt, Polk, Randolph, Richmond, Robeson, Rockingham, Rutherford, Sampson, Scotland, Stanley, Vance, Wake, Warren, Wayne, and Wilson	Hurricane Fran	September 5-October 21, 1996
North Dakota		
Counties of Barnes, Benson, Burleigh, Cass, Cavalier, Dickey, Eddy, Emmons, Foster, Grand Forks, Grant, Griggs, Kidder, LaMoure, Logan, McHenry, McIntosh, McLean, Morton, Nelson, Oliver, Pembina, Pierce, Ramsey, Ransom, Richland, Sargent, Sheridan, Steele, Stutsman, Traill, Walsh, and Wells	Severe storms, flooding, ice jams, and ground saturation due to high water tables	March 12-June 21, 1996
Ohio		
Counties of Adams, Belmont, Brown, Clermont, Columbiana, Gallia, Hamilton, Jefferson, Lawrence, Meigs, Monroe, Scioto, and Washington	Severe storms and flooding	January 20-31, 1996
Counties of Adams, Belmont, Brown, Butler, Clermont, Gallia, Hamilton, Hocking, Jefferson, Lawrence, Meigs, Monroe, Paulding, Scioto, Vinton, and Williams	Flooding	May 2-June 24, 1996

Disaster Areas in 1996	Type of Disaster	Date of Disaster
Oregon		
Counties of Benton, Clackamas, Clatsop, Columbia, Coos, Deschutes, Douglas, Gilliam, Hood River, Jefferson, Josephine, Lane, Lincoln, Linn, Marion, Morrow, Multnomah, Polk, Sherman, Tillamook, Umatilla, Union, Wallowa, Wasco, Washington, Wheeler, and Yamhill; and the lands of the Coquille Indian Tribe, the Confederated Tribes of Umatilla Indian Reservation, and the Warm Springs Indian Reservation.	High winds, severe storms and flooding	February 4-21, 1996
Counties of Coos, Douglas, and Lane	Flooding, land and mud slides, and severe storms	November 17-December 11, 1996
Counties of Baker, Gilliam, Grant, Jackson, Josephine, Klamath, Morrow, and Wheeler	Severe winter storms, land and mudslides and flooding	December 25, 1996-January 6, 1997
Pennsylvania		
Counties of Adams, Allegheny, Armstrong, Bedford, Berks, Blair, Bradford, Bucks, Cambria, Carbon, Centre, Chester, Clearfield, Clinton, Columbia, Cumberland, Dauphin, Delaware, Fayette, Franklin, Fulton, Greene, Huntingdon, Indiana, Juniata, Lackawanna, Lancaster, Lebanon, Lehigh, Luzerne, Lycoming, Mifflin, Monroe, Montgomery, Montour, Northampton, Northumberland, Perry, Philadelphia, Pike, Schuylkill, Snyder, Somerset, Sullivan, Susquehanna, Union, Washington, Wayne, Westmoreland, Wyoming, and York	Blizzard of 1996	January 6-12, 1996
Counties of Adams, Allegheny, Armstrong, Beaver, Bedford, Berks, Blair, Bradford, Bucks, Butler, Cambria, Cameron, Carbon, Centre, Chester, Clarion, Clearfield, Clinton, Columbia, Crawford, Cumberland, Dauphin, Delaware, Elk, Erie, Fayette, Forest, Franklin, Fulton, Greene, Huntingdon, Indiana, Jefferson, Juniata, Lackawanna, Lancaster, Lawrence, Lebanon, Lehigh, Luzerne, Lycoming, Mercer, McKean, Mifflin, Monroe, Montgomery, Montour, Northampton, Northumberland, Philadelphia, Perry, Pike, Potter, Schuylkill, Snyder, Somerset, Sullivan, Susquehanna, Tioga, Union, Venango, Warren, Washington, Wayne, Westmoreland, Wyoming, and York	Severe storms and flooding	January 19-February 1, 1996
Counties of Adams, Beaver, Bedford, Bucks, and Franklin	Severe storms and flooding	June 12-19, 1996
Counties of Armstrong, Blair, Cambria, Clarion, Clearfield, Crawford, Greene, Indiana, Jefferson, and Venango	Severe storms, flooding and tornadoes	July 19, 1996
Counties of Cumberland, Huntingdon, Juniata, Mifflin, Montgomery, and Perry	Flooding associated with Tropical Depression Fran	September 6-8, 1996
County of Tioga	Severe thunderstorms, high winds, rain and flooding	November 8-15, 1996

Disaster Areas in 1996	Type of Disaster	Date of Disaster
Puerto Rico		
Municipalities of Adjuntas, Aguada, Aguadilla, Aibonito, Anasco, Arecibo, Arroyo, Augas Buenas, Barceloneta, Barranquitas, Bayamon, Cabo Rojo, Caguas, Camuy, Canovanas, Carolina, Catano, Cayey, Ceiba, Ciales, Cidra, Coamo, Comerio, Corozal, Dorado, Florida, Guanica, Guayama, Guayanilla, Guaynabo, Gurabo, Hatillo, Humacao, Isabela, Jayuya, Juana Diaz, Juncos, Lares, Las Marias, Las Piedras, Loiza, Manati, Maricao, Maunabo, Mayaguez, Moca, Morovis, Naguabo, Naranjito, Orocovis, Patillas, Penuelas, Ponce, Quebradillas, Rincon, Rio Grande, Salinas, San German, San Juan, San Lorenzo, San Sebastian, Santa Isabel, Toa Alta, Toa Baja, Trujillo Alto, Utuado, Vega Alta, Vega Baja, Villalbo, Yabucoa, and Yauco	Hurricane Hortense	September 9-11, 1996
Rhode Island		
Counties of Bristol, Kent, Newport, Providence, and Washington	Blizzard of 1996	January 7-13, 1996
South Carolina		
Counties of Dillon, Georgetown, Horry, Marion, and Williamsburg	Severe winds and flooding associated with Hurricane Fran	September 4-October 15, 1996
U.S. Virgin Islands		
Islands of St. Croix, St. John, and St. Thomas	Hurricane Bertha	July 8-9, 1996
Vermont		
Counties of Addison, Bennington, Chittenden, Franklin, Lamoille, Orange, Orleans, Rutland, Washington, Windham, and Windsor	Ice jams and flooding	January 19-February 2, 1996
County of Windham	Extreme rainfall and flooding	June 12-14, 1996
Virginia		
Counties of Accomack, Albermarle, Alleghany, Amelia, Amherst, Appomattox, Arlington, Augusta, Bath, Bedford, Bland, Botetourt, Brunswick, Buchanan, Buckingham, Campbell, Caroline, Carroll, Charlotte, Charles City, Chesterfield, Clarke, Craig, Culpeper, Cumberland, Dickenson, Dinwiddie, Essex, Fauquier, Fairfax, Floyd, Fluvanna, Franklin, Frederick, Giles, Gloucester, Goochland, Grayson, Greene, Greensville, Halifax, Hanover, Henrico, Henry, Highland, Isle of Wight, James City, King George, King & Queen, King William, Lancaster, Lee, Loudoun, Louisa, Lunenburg, Madison, Mathews, Mecklenburg, Middlesex, Montgomery, Nelson, New Kent, Northhampton, Northumberland, Nottoway, Orange, Page, Patrick, Pittsylvania, Powhatan, Prince George, Prince William, Pulaski, Rappahannock, Richmond, Roanoke, Rockbridge, Rockingham, Russell, Scott, Shenandoah, Smyth, Southhampton, Spotsylvania, Stafford, Surry, Sussex, Tazewell, Warren, Washington, Westmoreland, Wise, Wythe, and York; and Cities of Alexandria, Bedford, Bristol, Buena Vista, Charlottesville, Chesapeake, Clifton Forge, Colonial Heights, Covington, Danville, Emporia, Fairfax, Falls Church, Franklin, Fredericksberg, Galax, Hampton, Harrisonburg, Hopewell, Lexington, Lynchburg, Manassas, Manassas Park,	Blizzard of 1996	January 6-12, 1996

Disaster Areas in 1996	Type of Disaster	Date of Disaster
Virginia—Continued		
Martinsville, Newport News, Norfolk, Norton, Petersburg, Portsmouth, Poquoson, Radford, Richmond, Roanoke, Salem, South Boston Town, Staunton, Suffolk, Virginia Beach, Waynesboro, Williamsburg, and Winchester	Blizzard of 1996	January 6-12, 1996
Counties of Alleghany, Augusta, Bath, Bland, Botetourt, Clarke, Fauquier, Frederick, Giles, Grayson, Greene, Highland, Loudoun, Page, Pulaski, Rappahanock, Rockbridge, Rockingham, Shenandoah, Warren, Washington, and Wythe; and the Cities of Buena Vista, Clifton Forge, Covington, Harrisonburg, and Waynesboro	Severe storm, high winds, flooding, and wind-driven rain	January 19-February 1, 1996
All Counties	Hurricane Fran	September 5-7, 1996
Counties of Accomack, Albemarle, Alleghany, Amelia, Amherst, Appomattox, Augusta, Bath, Bedford, Botetourt, Brunswick, Buckingham, Campbell, Charles City, Charlotte, Chesterfield, Clarke, Culpeper, Cumberland, Dinwiddie, Essex, Fluvanna, Giles, Gloucester, Goochland, Greene, Greenville, Halifax, Hampton City, Henrico, Henry, Highland, Isle of Wight, James City, King & Queen, King George, King William, Lancaster, Louisa, Lunenburg, Madison, Mathews, Mecklenburg, Middlesex, Montgomery, Nelson, New Kent, Northampton, Northumberland, Nottoway, Orange, Page, Pittsylvania, Powhattan, Prince Edward, Prince George, Prince William, Rappahannock, Richmond, Roanoke, Rockbridge, Rockingham, Shenandoah, Stafford, Surry, Warren, Westmoreland, and York; and the Cities of Bedford, Buena Vista, Charlottesville, Danville, Emporia, Fredericksburg, Hampton, Harrisonburg, Hopewell, Lexington, Lynchburg, Martinsville, Newport News, Poquoson, Staunton, Suffolk, Waynesboro, and Williamsburg	Hurricane Fran and severe storm conditions including high winds, tornadoes, wind-driven rain, and river and flash flooding	September 5-23, 1996
Washington		
Counties of Adams, Asotin, Benton, Clark, Columbia, Cowlitz, Garfield, Grays Harbor, King, Kitsap, Kittitas, Klickitat, Lewis, Lincoln, Pierce, Skagit, Skamania, Snohomish, Spokane, Thurston, Wahkiakum, Walla Walla, Whitman, and Yakima	High winds, severe storms and flooding	January 26-February 23, 1996
Counties of Klickitat, Pend Oreille, and Spokane	Severe ice storms	November 19-December 4, 1996
Counties of Adams, Asotin, Benton, Chelan, Clallam, Clark, Columbia, Cowlitz, Ferry, Garfield, Grant, Grays Harbor, Island, Jefferson, King, Kitsap, Kittitas, Klickitat, Lewis, Lincoln, Mason, Okanogan, Pacific, Pend Oreille, Pierce, San Juan, Skagit, Skamania, Snohomish, Spokane, Stevens, Thurston, Walla Walla, Whatcom, Whitman, and Yakima	Winter storms, land and mudslides and flooding	December 26, 1996
West Virginia		
Counties of Barbour, Berkeley, Boone, Braxton, Brooke, Cabell, Calhoun, Clay, Doddridge, Fayette, Gilmer, Grant, Greenbrier, Hampshire, Hancock, Hardy, Harrison, Jackson, Jefferson, Kanawha, Lewis, Lincoln, Logan, Marion, Marshall, Mason, McDowell, Mercer, Mineral, Mingo, Monongalia, Monroe, Morgan, Nicholas, Ohio, Pendleton, Pleasants, Pocahontas, Preston, Putnam, Raleigh, Randolph, Ritchie, Roane, Summers, Taylor, Tucker, Tyler, Upshur, Wayne, Webster, Wetzel, Wirt, Wood, and Wyoming	Blizzard of 1996	January 6-12, 1996

Disaster Areas in 1996	Type of Disaster	Date of Disaster
West Virginia—Continued		
Counties of Berkeley, Brooke, Grant, Greenbriar, Hampshire, Hancock, Hardy, Jefferson, Marshall, Mason, Mercer, Mineral, Monroe, Morgan, Nicholas, Ohio, Pendleton, Pleasants, Pocahontas, Preston, Raleigh, Randolph, Summers, Tucker, Tyler, Webster, Wetzel, and Wood	Flooding	January 19-February 2, 1996
Counties of Barbour, Boone, Harrison, Lincoln, Logan, McDowell, Mercer, Mingo, Pendleton, Pocahontas, Raleigh, Randolph, Tucker, Upshur, Wayne, Wetzel, and Wyoming	Flooding and heavy winds	May 15-June 10, 1996
Counties of Barbour, Braxton, Clay, Gilmer, Monongalia, Nicholas, Randolph, and Webster	Heavy rains, high winds, flooding, and slides	July 18-31, 1996
Counties of Berkeley, Grant, Hardy, Hampshire, Jefferson, Mineral, Morgan, Pendleton, Randolph, and Tucker	Heavy rain, high wind, flooding and slides due to Hurricane Fran	September 5-8, 1996
Wisconsin		
Counties of Fond du Lac and Green	Tornadoes, severe storms and flooding	July 17-22, 1996

Section 166.—Bad Debts

26 CFR 1.166–4: Bad debts.

How does a bank change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method so that it may elect S corporation status for the 1997 tax year? See Rev. Proc. 97–18, page 53.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of March 1997. See Rev. Rul. 97–10, page 31.

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 March 1997. See Rev. Rul. 97–10, page 31.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1997. See Rev. Rul. 97–10, page 31.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

How does a bank change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method so that it may elect S corporation status for the 1997 tax year? See Rev. Proc. 97–18, page 53.

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 March 1997. See Rev. Rul. 97–10, page 31.

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 March 1997. See Rev. Rul. 97–10, page 31.

Section 481.—Adjustments Required by Changes in Method of Accounting

26 CFR 1.481–1: Adjustments in general.

How does a bank change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method so that it may elect S corporation status for the 1997 tax year? See Rev. Proc. 97–18, page 53.

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 March 1997. See Rev. Rul. 97–10, page 31.

Section 585.—Reserves for Bad Debts

26 CFR 1.585–1: Reserve for losses on loans of banks.

How does a bank change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method so that it may elect S corporation status for the 1997 tax year? See Rev. Proc. 97–18, page 53.

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 March 1997. See Rev. Rul. 97–10, page 31.

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 March 1997. See Rev. Rul. 97–10, page 31.

Section 877.—Expatriation To Avoid Tax

What are the tax consequences under sections 877, 2107, 2501, and 6039F for individuals who lose U.S. citizenship or cease to be taxed as long-term residents of the United States with a principal purpose to avoid U.S. taxes? See Notice 97–19, page 40.

Section 902.—Deemed Paid Credit Where Domestic Corporation Owns 10 Percent or More of Voting Stock of Foreign Corporation

26 CFR 1.902.1: Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

T.D. 8708

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

Computation of Foreign Taxes Deemed Paid Under Section 902 Pursuant to a Pooling Mechanism for Undistributed Earnings and Foreign Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final income tax regulations relating to the computation of foreign taxes deemed paid under section 902. Changes to the applicable law were made by the Tax Reform Act of 1986 and by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). These regulations provide guidance needed to comply with these changes and affect foreign corporations and their United States corporate shareholders.

DATES: These regulations are effective January 7, 1997.

Applicability: For the specific dates of applicability of these regulations, see §§ 1.902–1(g) and 1.902–3(l).

FOR FURTHER INFORMATION CONTACT: Caren S. Shein (202) 622–3850 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545– 1458. Responses to these collections of information are required by the IRS to implement the section 902 pooling regime enacted in the Tax Reform Act of 1986.

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

The burden for the collection of information is reflected in the burden for Form 1118.

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

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

Background

Section 902 (26 CFR part 1) was amended by section 1202(a) of the Tax Reform Act of 1986 (Public Law 99–514, 100 Stat. 1085), and section 1012(b) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) (Public Law 100– 647, 102 Stat. 3242). On January 6, 1995, the IRS published a notice of proposed rulemaking in the **Federal Register** (60 FR 2049 [INTL–933–86 (1995–1 C.B. 959)]). The proposed regulations provide guidance needed to comply with section 902 as amended in 1986 and 1988. No public hearing was requested or held, but numerous written comments were received. The proposed regulations, with certain changes made in response to comments, are adopted in this Treasury decision as final regulations. The principal changes to the regulations, as well as the major comments and suggestions, are discussed below.

Explanation of Provisions

Section 1.902–1

In the preamble to the proposed regulations, the IRS requested comments on whether the holding of Revenue Ruling 71–141 (1971–1 C.B. 211) should be expanded to allow taxes paid by a foreign corporation to be considered deemed paid by domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, beneficiaries of domestic or foreign trusts and estates, or interest holders in other pass-through entities. The revenue ruling held that two 50-percent domestic corporate general partners of a domestic general partnership that owned 40 percent of a foreign corporation were entitled to compute an amount of foreign taxes deemed paid under section 902 with respect to dividends they received from the foreign corporation through the partnership.

The IRS received numerous comments in response to the request in the preamble. The commenters uniformly argue that the aggregate theory of partnerships should apply to allow domestic corporate partners to compute an amount of foreign taxes deemed paid with respect to dividends paid to any partnership by a foreign corporation, provided that the partner owns at least 10 percent of the voting stock of the foreign corporation through the partnership.

The final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity. That issue will be the subject of a future proposed regulations project. However, in recognition of the holding in Revenue Ruling 71–141 (1971–1 C.B. 211) that a general partner of a domestic general partnership may compute an amount of foreign taxes deemed paid with respect to a dividend distribution from a foreign corporation to the partnership, § 1.902–1(a)(1) is amended to define a domestic shareholder as a domestic corporation that ''owns'' the requisite voting stock in a foreign corporation rather than one that ''owns directly'' the voting stock. The IRS is still considering under what other circumstances the revenue ruling should apply.

Section 1.902–1(a)(8) is amended to clarify under what circumstances the pool of post-1986 foreign income taxes must be reduced to account for distributions made in prior post-1986 taxable years. The regulations require a reduction in the taxes pool for taxes attribut-

able to earnings distributed to shareholders ineligible for the deemed paid credit (for example, a foreign shareholder, a U.S. individual shareholder, or a domestic corporate shareholder that owns less than 10 percent of the foreign corporation's voting stock) and to shareholders that are eligible for the credit but that choose to deduct foreign taxes under section 164(a) in the year of the distribution rather than claim a credit.

The IRS understands that some taxpayers have taken the position, contrary to the position taken in § 1.902–1(a)(8) of the proposed regulations, that although post-1986 undistributed earnings must be reduced to account for all distributions out of current or accumulated earnings and profits, post-1986 foreign income taxes should be reduced only to account for taxes attributable to distributions with respect to which a shareholder both is eligible to claim a credit for foreign taxes deemed paid under section 902(a) and in fact elects to credit foreign taxes for the taxable year under section 901(a). These taxpayers argue that only in those circumstances are foreign taxes ''deemed paid'' and thus required to be removed from the taxes pool under a literal reading of sections 902(a) and 902(c)(2)(B).

The IRS has not changed its position as reflected in § 1.902–1(a)(8)(i) of the proposed regulations that the foreign taxes pool must be reduced to account for foreign taxes attributable to all distributions and deemed distributions or inclusions to all shareholders. However, the text of the final regulations has been amended to clarify the rule. The requirement that the foreign taxes pool must be reduced proportionately as the earnings pool is reduced is consistent with the legislative history of the Tax Reform Act of 1986 (Public Law 99–514). The House Report states that under the pooling regime, ''[a] dividend or subpart F inclusion is considered to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary.'' H.R. Rep. No. 426, 99th Cong., 1st Sess. 357 (1985). In addition, removing taxes attributable to distributions to ineligible shareholders and eligible shareholders that choose to deduct foreign taxes is supported by the general matching principles of section 902, which presume that a dividend distribution will carry with it a ratable share of the foreign corporation's taxes. If taxes paid with respect to distributed earnings remained in the pool, eligible shareholders eventually could receive credits for more than their ratable share of the foreign corporation's taxes, a result at odds with the statutory scheme.

Section 1.902–1(a)(8)(i) is amended to correct an oversight in the proposed regulation. In the case of a distribution out of current earnings and profits that is treated as a ''nimble'' dividend under section 316(a)(2) when there is a deficit in accumulated earnings and profits, post-1986 foreign income taxes are not reduced. This rule is not inconsistent with the general rule of paragraph (a)(8)(i) that the foreign taxes pool must be reduced to account for taxes attributable to all distributions and deemed distributions out of post-1986 undistributed earnings. Rather, it reflects the fact that under section 902 and these regulations, no taxes are deemed paid with respect to a nimble dividend under section 316(a)(2) because the post-1986 undistributed earnings pool is zero or less than zero.

Section 1.902–1(a)(9), defining post-1986 undistributed earnings, is amended to clarify that the earnings pool is reduced only to account for distributions or deemed distributions that reduce earnings and profits and inclusions that result in previously-taxed amounts described in sections 959(c)(1) and (c)(2) or 1293(c). Thus, for example, in the case of a controlled foreign corporation owned 60 percent by a domestic corporate shareholder and 40 percent by a foreign shareholder, the earnings and taxes pools are reduced only to account for 60 percent of the foreign corporation's subpart F income.

The rules precluding special allocations of earnings and taxes in § 1.902–1(a)(9)(iv) and (10)(ii) of the proposed regulations have been retained in the final regulations. These regulations are intended to reverse the result in *Vulcan v. Commissioner*, 96 T.C. 410 (1991), aff'd per curiam, 959 F.2d 973 (11th Cir. 1992), nonacq. 1995–1 C.B. 1, for post-1986 taxable years. Several commenters argued that the *Vulcan* decision was correct and should be applied to both pre-1987 and post-1986 taxable years, and the regulations should be revised to reflect the decision. For the reasons stated in the preamble to the proposed regulations, the IRS declines to do so.

Commenters also argued that the rule precluding special allocations of earnings and taxes is inconsistent with § 1.904–6(a)(2). Section 1.904–6(a)(2) is an anti-abuse rule designed to prevent the use of accommodation parties to improve a United States taxpayer's foreign tax credit position. The rule states that if a taxpayer receives or accrues a dividend from a noncontrolled section 902 corporation and the Commissioner establishes the existence of an express or implied agreement that the dividend is paid out of the foreign corporation's passive or high withholding tax interest earnings, then only taxes imposed on passive or high withholding tax interest earnings will be considered related to the dividend. The IRS may invoke this rule to prevent a shareholder from sheltering investment income from tax by investing it through a noncontrolled section 902 corporation that distributes only the investment earnings to the shareholder, which then treats the distribution as a dividend sheltered by taxes paid on the corporation's high-taxed active business income. The IRS believes that this narrowly defined anti-abuse rule is an appropriate exception to the general rule of § 1.902–1(a)(9)(iv) and (a)(10)(ii) barring special allocations of earnings and taxes.

Section 1.902–1(a)(11) has been amended to clarify that the definition of a dividend in section 316(a) applies for purposes of section 902, and that the section 902 definition of a dividend also includes deemed dividends under sections 551 and 1248. Deemed inclusions under sections 951(a) and 1293 are not dividends for purposes of section 902. However, sections 960(a)(1) and 1293(f) provide that deemed paid taxes with respect to inclusions under sections 951(a) and 1293 are determined under section 902 in the same manner as if a dividend was paid.

Paragraph (a)(11) also has been amended to add a cross-reference to section 1291 and § 1.1291–5 of the proposed regulations, which provide special rules for computing foreign taxes deemed paid with respect to distributions from section 1291 funds. These distributions are treated as dividends solely for foreign tax credit purposes, but the general section 902 computational rules do not apply.

A commenter correctly pointed out that the regulation's inclusion of deemed distributions under section 551 as dividends for purposes of section 902 is contrary to the holding in Revenue Ruling 74–59 (1974–1 C.B. 183) that an amount includible in gross income under section 551 is not considered a dividend received for purposes of the allowance of a foreign tax credit under section 902. The holding of the revenue ruling

is based on language in the 1937 legislative history of the foreign personal holding company provisions. The Report of the Joint Committee on Tax Evasion and Avoidance of the Congress of the United States, H.R. Doc. No. 337, 75th Cong., 1st Sess. 18 (1937), recommended that shareholders of foreign personal holding companies not be allowed a credit for foreign income taxes paid by the foreign corporation with respect to amounts deemed distributed. The Report goes on to state that the committee recommended against allowing a credit because ''it is not administratively feasible, although it might seem equitable under the circumstances.''

Section 551(b) provides that amounts required to be included in the gross income of a U.S. shareholder under section 551(a) are treated as dividends, and under current law it is administratively feasible to allow deemed paid taxes to be computed with respect to deemed dividends. In addition, the Code now includes other anti-deferral regimes, e.g., the subpart F and passive foreign investment company provisions, the application of which may overlap with the foreign personal holding company rules. Shareholders are permitted to compute deemed paid taxes with respect to subpart F and passive foreign investment company inclusions.

The IRS, therefore, has concluded the revenue ruling is not supported by current law. A shareholder of a foreign personal holding company should be entitled to compute deemed paid taxes with respect to amounts required to be included in gross income as dividends under section 551(a). Revenue Ruling 74–59 (1974–1 C.B. 183) is hereby revoked effective as of the date these regulations are published in the **Federal Register**.

A commenter argued that the rule in § 1.902–1(b)(4), providing that no taxes are deemed paid with respect to dividends out of current earnings and profits when the foreign corporation has no post-1986 undistributed earnings and no accumulated earnings and profits (so-called ''nimble'' dividends) conflicts with the general purpose of the foreign tax credit to prevent double taxation. The rule is retained in the final regulations for two reasons. First, the legislative history of the Tax Reform Act of 1986 (Public Law 99–514) clearly indicates that Congress was aware of the issue and agreed with the position stated in the regulation. See S. Rep. No. 313, 99th Cong., 2d Sess. 321 (1986). Second, because no taxes can be deemed paid under the computational rules of section 902 when post-1986 undistributed earnings are zero or less than zero, no taxes are removed from the post-1986 foreign income taxes pool. Thus, all of the foreign corporation's taxes remain in its post-1986 foreign income taxes pool and are available to be credited if the corporation pays another dividend in a later year in which the post-1986 undistributed earnings pool is positive.

Section 1.902–1(c)(8) of the proposed regulations reserved on the application of section 902 in section 304 exchanges. Commenters suggested that the regulations should address this area by incorporating the holdings in Revenue Ruling 91–5 (1991–1 C.B. 114), and Revenue Ruling 92–86 (1992–1 C.B. 199). In addition, the commenters argued that the regulations should state that a deemed paid credit is available in a section 304 exchange involving a foreign parent corporation. The IRS is still studying the area and the regulations thus continue to reserve on the application of section 902 in a section 304 exchange.

Section 1.902–1(c)(9) of the proposed regulations is reserved in these final regulations. The proposed regulation provided a cross-reference to regulations under section 905(c) with respect to adjustments to post-1986 undistributed earnings and taxes that result from a section 482 allocation of income. There currently are no regulations under section 905(c) addressing section 482 allocations and the IRS, therefore, has reserved this paragraph pending issuance of final regulations under section 905(c).

Section 1.902–1(d)(3)(ii) through (iv) of the proposed regulations is not included in the final regulations. Paragraph (d)(3) set out rules and examples exercising a grant of regulatory authority under the last sentence of section 904(d)(2)(E)(i) to limit beyond the statute the circumstances under which a dividend paid to a new U.S. shareholder by a controlled foreign corporation out of earnings accumulated while it was a controlled foreign corporation will be treated as dividends from a noncontrolled section 902 corporation. Identical rules were proposed in 1992 under section 904(d). See § 1.904–4(g)(3)(ii) through (iv) of the proposed regulations. The rules address the character of a dividend distribution under section 904(d) and are more appropriately placed in the regulations under that section. After considering the comments received, the rule will be finalized as part of the section 904 regulations.

Section 1.902–2

A commenter suggested that the deficit carryback rules in § 1.902–2(a)(1) should be amended to provide that a deficit in post-1986 undistributed earnings will not be carried back to pre-1987 years on a return of capital or capital gain distribution. The rule states that a deficit will be carried back when ''* * * a corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, * * * .'' The commenter suggests that the rule in the proposed regulation can result in ''locked-in'' taxes when earnings attributable to one or more pre-1987 years are eliminated by the deficit carryback. If the deficit stays in the post-1986 pool there is a chance it can be absorbed by future earnings, leaving the pre-1987 earnings and taxes intact. In support of its position, the commenter argues that section 902 establishes rules that minimize double taxation by allowing a taxpayer to compute a deemed paid credit on a taxable dividend. The legislative history indicates that the pooling provisions of section 902 are to apply solely for purposes of computing the deemed paid credit. Because a return of capital or capital gain distribution is not a taxable dividend and no section 902 credit is allowable, the commenter argues that the pooling rules (including the deficit carryback rules) should not apply.

The IRS declines to adopt the commenter's suggestion. When an amount is distributed in a post-1986 taxable year and there is a deficit in post-1986 undistributed earnings, the deficit must be carried back and reduce earnings and profits in pre-1987 years to determine whether any earnings remain to support treatment of the distribution as a dividend. To the extent there are earnings remaining in one or more pre-1987 years after a deficit is carried back, the distribution is a dividend. Any remaining amount is a return of capital and capital gain. It would be incongruous to adopt a rule providing a different result if a single dollar of pre-1987 accumulated profits remains in a pre-1987 year after a post-1986 deficit is carried back than if the deficit carryback eliminated all pre-1987 accumulated profits and the entire distribution were treated as a return of capital.

Another commenter argued that the interplay among § 1.902–2(b)(1) (pre-1987 accumulated deficit carries over to become the opening balance of post-1986 undistributed earnings pool) and § 1.902–1(b)(4) (no taxes deemed paid if a dividend is a nimble dividend) of the proposed regulations, and section 960 (incorporating the section 902 rules with respect to deemed inclusions under subpart F) results in a denial of deemed paid taxes to a U.S. shareholder if a controlled foreign corporation has both a pre-1987 accumulated deficit and post-1986 earnings and profits that are entirely subpart F income. The commenter suggests that regulations be issued under section 960 to provide, solely for purposes of that section, that accumulated deficits in pre-1987 accumulated profits will not carry over into the post-1986 pool.

The IRS cannot adopt the rule the commenter suggests. Congress amended sections 902 and 960 in 1986 specifically to eliminate different earnings and profits and deemed paid taxes computations for purposes of sections 902 and 960. Further, in the situation the commenter posits, the credits are deferred but not permanently disallowed. If the controlled foreign corporation earns enough post-1986 income to eliminate the accumulated deficit, any distribution or deemed distribution will carry with it a ratable share of post-1986 foreign income taxes.

A commenter argued that § 1.902–2(b)(2) and (3), Example 1, are incorrect because they imply that annual deficits in pre-1987 accumulated profits were required to be carried back under pre-1987 section 902 regardless of how foreign income taxes were determined. The commenter argues that pre-1987 section 902 requires a ''correlation'' between accumulated profits as determined under U.S. law and the foreign law method by which foreign taxes were determined.

The IRS disagrees with the comment and the proposed regulation has not been amended. The regulation reflects the IRS' longstanding position that in the case of a deficit in accumulated profits of a foreign corporation for a particular pre-1987 year, the deficit first reduces prior years' accumulated profits on a LIFO basis to the extent thereof, and then the remaining deficit reduces accumulated profits in subsequent years. That rule applies regardless of whether foreign law permits or requires the carryback or carryforward of losses. See Revenue Ruling 74–550 (1974–2 C.B. 209) and Revenue Ruling 87–72 (1987–2 C.B. 170).

Effect on Other Documents

The following revenue ruling is revoked as of January 7, 1997.

Revenue Ruling 74–59, 1974–1 C.B. 183.

Special Analyses

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

Drafting Information

The principal author of these final regulations is Caren Silver Shein of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.902–1 also issued under 26 U.S.C. 902(c)(7).

Section 1.902–2 also issued under 26 U.S.C. 902(c)(7). * * *

Par. 2. Sections 1.902–1 and 1.902–2 are redesignated §§ 1.902–3 and 1.902–4, respectively.

Par. 3. Sections 1.902–0, 1.902–1 and 1.902–2 are added to read as follows:

§ 1.902–0 Outline of regulations provisions for section 902.

This section lists the provisions under section 902.

§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) Definitions and special effective date.
(1) Domestic shareholder.
(2) First-tier corporation.
(3) Second-tier corporation.
(4) Third-tier corporation.
(5) Example.
(6) Upper- and lower-tier corporations.
(7) Foreign income taxes.
(8) Post-1986 foreign income taxes.
(i) In general.
(ii) Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.
(iii) Foreign income taxes paid or accrued with respect to high withholding tax interest.
(9) Post-1986 undistributed earnings.
(i) In general.
(ii) Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.
(iii) Reduction for foreign income taxes paid or accrued.
(iv) Special allocations.
(10) Pre-1987 accumulated profits.
(i) Definition.
(ii) Computation of pre-1987 accumulated profits.
(iii) Foreign income taxes attributable to pre-1987 accumulated profits.
(11) Dividend.
(12) Dividend received.
(13) Special effective date.
(i) Rule.
(ii) Example.
(b) Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, and second-tier corporation.
(1) General rule.
(2) Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits.

§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

(a) *Definitions and special effective date*. For purposes of section 902, this section, and § 1.902–2, the definitions provided in paragraphs (a)(1) through (12) of this section and the special effective date of paragraph (a)(13) of this section apply.

(1) *Domestic shareholder*. In the case of dividends received by a domestic corporation from a foreign corporation after December 31, 1986, the term domestic shareholder means a domestic corporation, other than an S corporation as defined in section 1361(a), that owns at least 10 percent of the voting stock of the foreign corporation at the time the domestic corporation receives a dividend from that foreign corporation.

(2) *First-tier corporation*. In the case of dividends received by a domestic shareholder from a foreign corporation in a taxable year beginning after December 31, 1986, the term first-tier corporation means a foreign corporation, at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time the domestic shareholder receives a dividend from that foreign corporation. The term first-tier corporation also includes a DISC or former DISC, but only with respect to dividends from the DISC or former DISC that are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the United States.

(3) *Second-tier corporation*. In the case of dividends paid to a first-tier corporation by a foreign corporation in a taxable year beginning after December

31, 1986, the foreign corporation is a second-tier corporation if, at the time a first-tier corporation receives a dividend from that foreign corporation, the first-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation.

(4) Third-tier corporation. In the case of dividends paid to a second-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, a foreign corporation is a third-tier corporation if, at the time a second-tier corporation receives a dividend from that foreign corporation, the second-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation; multiplied by

(iii) The percentage of voting stock owned by the second-tier corporation in the third-tier corporation.

(5) *Example*. The following example illustrates the ownership requirements of paragraphs (a)(1) through (4) of this section:

Example. (i) Domestic corporation M owns 30 percent of the voting stock of foreign corporation A on January 1, 1991, and for all periods thereafter. Corporation A owns 40 percent of the voting stock of foreign corporation B on January 1, 1991, and continues to own that stock until June 1, 1991, when Corporation A sells its stock in Corporation B. Both Corporation A and Corporation B use the calendar year as the taxable year. Corporation B pays a dividend out of its post-1986 undistributed earnings to Corporation A, which Corporation A receives on February 16, 1991. Corporation A pays a dividend out of its post-1986 undistributed earnings to Corporation M, which Corporation M receives on January 20, 1992. Corporation M uses a fiscal year ending on June 30 as the taxable year.

(ii) On February 16, 1991, when Corporation B pays a dividend to Corporation A, Corporation M satisfies the 10-percent stock ownership requirement of paragraphs (a)(1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder of Corporation A within the meaning of paragraph (a)(1) of this section. Also on February 16, 1991, Corporation B is a second-tier corporation within the meaning of paragraph (a)(3) of this section because Corporation A owns at least 10 percent of its voting stock, and the percentage of voting stock owned by Corporation M in Corporation A on February 16, 1991 (30 percent) multiplied by the percentage of voting stock owned by Corporation A in Corporation B on February 16, 1991 (40 percent) equals 12 percent. Corporation A shall be deemed to have paid foreign income taxes of Corporation B with respect to the dividend received from Corporation B on February 16, 1991.

(iii) On January 20, 1992, Corporation M satisfies the 10-percent stock ownership requirement of paragraphs (a)(1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder within the meaning of paragraph (a)(1) of this section. Accordingly, for its taxable year ending on June 30, 1992, Corporation M is deemed to have paid a portion of the post-1986 foreign income taxes paid, accrued, or deemed to be paid, by Corporation A. Those taxes will include taxes paid by Corporation B that were deemed paid by Corporation A with respect to the dividend paid by Corporation B to Corporation A on February 16, 1991, even though Corporation B is no longer a second-tier corporation with respect to Corporations A and M on January 20, 1992, and has not been a second-tier corporation with respect to Corporations A and M at any time during the taxable years of Corporations A and M that include January 20, 1992.

(6) *Upper- and lower-tier corporations*. In the case of a third-tier corporation, the term upper-tier corporation means a first- or second-tier corporation. In the case of a second-tier corporation, the term upper-tier corporation means a first-tier corporation. In the case of a first-tier corporation, the term lower-tier corporation means a second- or third-tier corporation. In the case of a second-tier corporation, the term lower-tier corporation means a third-tier corporation.

(7) *Foreign income taxes*. The term foreign income taxes means income, war profits, and excess profits taxes as defined in § 1.901–2(a), and taxes included in the term income, war profits, and excess profits taxes by reason of section 903, that are imposed by a foreign country or a possession of the United States, including any such taxes deemed paid by a foreign corporation under this section. Foreign income, war profits, and excess profits taxes shall not include amounts excluded from the definition of those taxes pursuant to section 901 and the regulations under that section. See also paragraphs (c)(4) and (5) of this section (concerning foreign taxes paid with respect to foreign mineral income and in connection with the purchase or sale of oil and gas).

(8) *Post-1986 foreign income taxes*—(i) *In general*. Except as provided in paragraphs (a)(10) and (13) of this section, the term post-1986 foreign income taxes of a foreign corporation means the sum of the foreign income taxes paid, accrued, or deemed paid in the taxable year of the foreign corporation in which it distributes a dividend plus the foreign income taxes paid, accrued, or deemed paid in the foreign corporation's prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not paid or deemed paid by the foreign corporation on or with respect to earnings that in prior taxable years were distributed to, or otherwise included (e.g., under sections 304, 367(b), 551, 951(a), 1248 or 1293) in the income of, a foreign or domestic shareholder. Except as provided in paragraph (b)(4) of this section, foreign taxes paid or deemed paid by the foreign corporation on or with respect to earnings that were distributed or otherwise removed from post-1986 undistributed earnings in prior post-1986 taxable years shall be removed from post-1986 foreign income taxes regardless of whether the shareholder is eligible to compute an amount of foreign taxes deemed paid under section 902, and regardless of whether the shareholder in fact chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion. Thus, if an amount is distributed or deemed distributed by a foreign corporation to a United States person that is not a domestic shareholder within the meaning of paragraph (a)(1) of this section (e.g., an individual or a corporation that owns less than 10% of the foreign corporation's voting stock), or to a foreign person that does not meet the definition of a first- or second-tier corporation under paragraph (a)(2) or (3) of this section, then although no foreign income taxes shall be deemed paid under section 902, foreign income taxes attributable to the distribution or deemed distribution that would have been deemed paid had the shareholder met the ownership requirements of paragraphs (a)(1) through (4) of this section shall be removed from post-1986 foreign income taxes. Further, if a domestic shareholder chooses to deduct foreign taxes paid or accrued for the taxable year of the distribution or inclusion, it shall nonetheless be deemed to have paid a proportionate share of the foreign corporation's post-1986 foreign income taxes under section 902(a), and the foreign taxes deemed paid must be removed from post-1986 foreign income taxes. In the case of a foreign corporation the foreign income taxes of which are determined based on an accounting period of less than one year, the term

year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986*. Post-1986 foreign income taxes shall include foreign income taxes that are deemed paid by an upper-tier corporation with respect to distributions from a lower-tier corporation out of non-previously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, provided the upper-tier corporation's earnings and profits in that year are included in its post-1986 undistributed earnings under paragraph (a)(9) of this section. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the lower-tier corporation into dollars at the spot exchange rate in effect on the date of the distribution. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904–7(a).

(iii) *Foreign income taxes paid or accrued with respect to high withholding tax interest*. Post-1986 foreign income taxes shall not include foreign income taxes paid or accrued by a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)(i)) with respect to high withholding tax interest (as defined in section 904(d)(2)(B)) to the extent the foreign tax rate imposed on such interest exceeds 5 percent. See section 904(d)(2)(E)(ii) and § 1.904–4(g)(2)(iii). The reduction in foreign income taxes paid or accrued by the amount of tax in excess of 5 percent imposed on high withholding tax interest income must be computed in functional currency before foreign income taxes are translated into U.S. dollars and included in post-1986 foreign income taxes.

(9) *Post-1986 undistributed earnings*—(i) *In general*. Except as provided in paragraphs (a)(10) and (13) of this section, the term post-1986 undistributed earnings means the amount of the earnings and profits of a foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years of the foreign corporation beginning after December 31, 1986, determined as of the close of the taxable year of the foreign corporation in which it distributes a dividend. Post-1986 undistributed earnings shall not be reduced by reason of any earnings distributed or otherwise included in income, for example under section 304, 367(b), 551, 951(a), 1248 or 1293, during the taxable year. Post-1986 undistributed earnings shall be reduced to account for distributions or deemed distributions that reduced earnings and profits and inclusions that resulted in previously-taxed amounts described in section 959(c)(1) and (2) or section 1293(c) in prior taxable years beginning after December 31, 1986. Thus, post-1986 undistributed earnings shall not be reduced to the extent of the ratable share of a controlled foreign corporation's subpart F income, as defined in section 952, attributable to a shareholder that is not a United States shareholder within the meaning of section 951(b) or section 953(c)(1)(A), because that amount has not been included in a shareholder's gross income. Post-1986 undistributed earnings shall be reduced as provided herein regardless of whether any shareholder is deemed to have paid any foreign taxes, and regardless of whether any domestic shareholder chose to claim a foreign tax credit under section 901(a) for the year of the distribution. For rules on carrybacks and carryforwards of deficits and their effect on post-1986 undistributed earnings, see § 1.902–2. In the case of a foreign corporation the foreign income taxes of which are computed based on an accounting period of less than one year, the term year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986*. Distributions by a lower-tier corporation out of non-previously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, shall be treated as post-1986 undistributed earnings of the upper-tier corporation, provided the upper-tier corporation's earnings and profits for that year are included in its post-1986 undistributed earnings under paragraph (a)(9)(i) of this section. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904–7(a).

(iii) *Reduction for foreign income taxes paid or accrued*. In computing post-1986 undistributed earnings, earnings and profits shall be reduced by foreign income taxes paid or accrued regardless of whether the taxes are creditable. Thus, earnings and profits shall be reduced by foreign income taxes paid with respect to high withholding tax interest even though a portion of the taxes is not creditable pursuant to section 904(d)(2)(E)(ii) and is not included in post-1986 foreign income taxes under paragraph (a)(8)(iii) of this section. Earnings and profits of an upper-tier corporation, however, shall not be reduced by foreign income taxes paid by a lower-tier corporation and deemed to have been paid by the upper-tier corporation.

(iv) *Special allocations*. The term post-1986 undistributed earnings means the total amount of the earnings of the corporation determined at the corporate level. Special allocations of earnings and taxes to particular shareholders, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. If, however, the Commissioner establishes that there is an agreement to pay dividends only out of earnings in the separate categories for passive or high withholding tax interest income, then only taxes imposed on passive or high withholding tax interest earnings shall be treated as related to the dividend. See § 1.904–6(a)(2).

(10) *Pre-1987 accumulated profits*—(i) *Definition*. The term pre-1987 accumulated profits means the amount of the earnings and profits of a foreign corporation computed in accordance with section 902 and attributable to its taxable years beginning before January 1, 1987. If the special effective date of paragraph (a)(13) of this section applies, pre-1987 accumulated profits also includes any earnings and profits (computed in accordance with sections 964(a) and 986) attributable to the foreign corporation's taxable years beginning after December 31, 1986, but before the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to that corporation.

(ii) *Computation of pre-1987 accumulated profits*. Pre-1987 accumulated profits must be computed under United

States principles governing the computation of earnings and profits. Pre-1987 accumulated profits are determined at the corporate level. Special allocations of accumulated profits and taxes to particular shareholders with respect to distributions of pre-1987 accumulated profits in taxable years beginning after December 31, 1986, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. Pre-1987 accumulated profits of a particular year shall be reduced by amounts distributed from those accumulated profits or otherwise included in income from those accumulated profits, for example under sections 304, 367(b), 551, 951(a), 1248 or 1293. If a deficit in post-1986 undistributed earnings is carried back to offset pre-1987 accumulated profits, pre-1987 accumulated profits of a particular taxable year shall be reduced by the amount of the deficit carried back to that year. See § 1.902–2. The amount of a distribution out of pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under section 902, shall be determined and translated into United States dollars by applying the law as in effect prior to the effective date of the Tax Reform Act of 1986. See §§ 1.902–3, 1.902–4 and 1.964–1.

(iii) *Foreign income taxes attributable to pre-1987 accumulated profits*. The term pre-1987 foreign income taxes means any foreign income taxes paid, accrued, or deemed paid by a foreign corporation on or with respect to its pre-1987 accumulated profits. Pre-1987 foreign income taxes of a particular year shall be reduced by the amount of taxes paid or deemed paid by the foreign corporation on or with respect to amounts distributed or otherwise included in income from pre-1987 accumulated profits of that year. Thus, pre-1987 foreign income taxes shall be reduced by the amount of taxes deemed paid by a domestic shareholder (regardless of whether the shareholder chose to credit foreign income taxes under section 901 for the year of the distribution or inclusion) or a first-tier or second-tier corporation, and by the amount of taxes that would have been deemed paid had any other shareholder been eligible to compute an amount of foreign taxes deemed paid under section 902. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the distributing corporation into United States dollars at the spot exchange rate in effect on the date of the distribution.

(11) *Dividend*. For purposes of section 902, the definition of the term dividend in section 316 and the regulations under that section applies. Thus, for example, distributions and deemed distributions under sections 302, 304, 305(b) and 367(b) that are treated as dividends within the meaning of section 301(c)(1) also are dividends for purposes of section 902. In addition, the term dividend includes deemed dividends under sections 551 and 1248, but not deemed inclusions under sections 951(a) and 1293. For rules concerning excess distributions from section 1291 funds that are treated as dividends solely for foreign tax credit purposes, (see Regulation Project INTL–656–87 published in 1992–1 C.B. 1124; see § 601.601(d)(2)(ii)(*b*) of this chapter).

(12) *Dividend received*. A dividend shall be considered received for purposes of section 902 when the cash or other property is unqualifiedly made subject to the demands of the distributee. See § 1.301–1(b). A dividend also is considered received for purposes of section 902 when it is deemed received under section 304, 367(b), 551, or 1248.

(13) *Special effective date*—(i) *Rule*. If the first day on which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to a foreign corporation, without regard to whether a dividend is distributed, is in a taxable year of the foreign corporation beginning after December 31, 1986, then—

(A) The post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation shall be determined by taking into account only taxable years beginning on and after the first day of the first taxable year of the foreign corporation in which the ownership requirements are met, including subsequent taxable years in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met; and

(B) Earnings and profits accumulated prior to the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met shall be considered pre-1987 accumulated profits.

(ii) *Example*. The following example illustrates the special effective date rules of this paragraph (a)(13):

Example. As of December 31, 1991, and since its incorporation, foreign corporation A has owned 100 percent of the stock of foreign corporation B. Corporation B is not a controlled foreign corporation. Corporation B uses the calendar year as its taxable year, and its functional currency is the u. Assume 1u equals $1 at all relevant times. On April 1, 1992, Corporation B pays a 200u dividend to Corporation A and the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met at that time. On July 1, 1992, domestic corporation M purchases 10 percent of the Corporation B stock from Corporation A and, for the first time, Corporation B meets the ownership requirements of section 902(c)(3)(B) and paragraph (a)(2) of this section. Corporation M uses the calendar year as its taxable year. Corporation B does not distribute any dividends to Corporation M during 1992. For its taxable year ending December 31, 1992, Corporation B has 500u of earnings and profits (after foreign taxes but before taking into account the 200u distribution to Corporation A) and pays 100u of foreign income taxes that is equal to $100. Pursuant to paragraph (a)(13)(i) of this section, Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes will include earnings and profits and foreign income taxes attributable to Corporation B's entire 1992 taxable year and all taxable years thereafter. Thus, the April 1, 1992, dividend to Corporation A will reduce post-1986 undistributed earnings to 300u (500u – 200u) under paragraph (a)(9)(i) of this section. The foreign income taxes attributable to the amount distributed as a dividend to Corporation A will not be creditable because Corporation A is not a domestic shareholder. Post-1986 foreign income taxes, however, will be reduced by the amount of foreign taxes attributable to the dividend. Thus, as of the beginning of 1993, Corporation B has $60 ($100 – [$100 x 40% (200u/500u)]) of post-1986 foreign income taxes. See paragraphs (a)(8)(i) and (b)(1) of this section.

(b) *Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, and second-tier corporation*—(1) *General rule*. If a foreign corporation pays a dividend in any taxable year out of post-1986 undistributed earnings to a shareholder that is a domestic shareholder or an upper-tier corporation at the time it receives the dividend, the recipient shall be deemed to have paid the same proportion of any post-1986 foreign income taxes paid, accrued or deemed paid by the distributing corporation on or with respect to post-1986 undistributed earnings which the amount of the dividend out of post-1986 undistributed earnings (determined without regard to the gross-up under section 78) bears to the amount of the distributing corporation's post-1986 undistributed earnings. An upper-tier corporation shall not be entitled to compute an amount of foreign taxes deemed paid on a dividend from a lower-tier corporation, however, unless

the ownership requirements of paragraphs (a)(1) through (4) of this section are met at each tier at the time the upper-tier corporation receives the dividend. Foreign income taxes deemed paid by a domestic shareholder or an upper-tier corporation must be computed under the following formula:

$$\text{Foreign income taxes deemed paid by domestic shareholder (or upper-tier corporation)} = \text{Post-1986 foreign income taxes of first-tier corporation (or lower-tier corporation)} \times \frac{\text{Dividend paid to domestic shareholder (or upper-tier corporation) by first-tier corporation (or lower-tier) corporation)}}{\text{Post-1986 undistributed earnings of first-tier corporation (or lower-tier corporation)}}$$

(2) *Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits*—(i) *Portion of dividend out of post-1986 undistributed earnings*. Dividends will be deemed to be paid first out of post-1986 undistributed earnings to the extent thereof. If dividends exceed post-1986 undistributed earnings and dividends are paid to more than one shareholder, then the dividend to each shareholder shall be deemed to be paid pro rata out of post-1986 undistributed earnings, computed as follows:

$$\text{Portion of Dividend to a Shareholder Attributable to Post-1986 Undistributed Earnings} = \text{Post-1986 Undistributed Earnings} \times \frac{\text{Dividend to Shareholder}}{\text{Total Dividends Paid To all Shareholders}}$$

(ii) *Portion of dividend out of pre-1987 accumulated profits*. After the portion of the dividend attributable to post-1986 undistributed earnings is determined under paragraph (b)(2)(i) of this section, the remainder of the dividend received by a shareholder is attributable to pre-1987 accumulated profits to the extent thereof. That part of the dividend attributable to pre-1987 accumulated profits will be treated as paid first from the most recently accumulated earnings and profits. See § 1.902–3. If dividends paid out of pre-1987 accumulated profits are attributable to more than one pre-1987 taxable year and are paid to more than one shareholder, then the dividend to each shareholder attributable to earnings and profits accumulated in a particular pre-1987 taxable year shall be deemed to be paid pro rata out of accumulated profits of that taxable year, computed as follows:

$$\text{Portion of Dividend to a Shareholder Attributable to Accumulated Profits of a Particular Pre-1987 Taxable Year} = \text{Divident Paid Out of Pre-1987 Accumulated Profits with Respect to the Particular Pre-1987 Taxable Year} \times \frac{\text{Dividend to Shareholder}}{\text{Total Dividends Paid to all Shareholders}}$$

(3) *Dividends paid out of pre-1987 accumulated profits*. If dividends are paid by a first-tier corporation or a lower-tier corporation out of pre-1987 accumulated profits, the domestic shareholder or upper-tier corporation that receives the dividends shall be deemed to have paid foreign income taxes to the extent provided under section 902 and the regulations thereunder as in effect prior to the effective date of the Tax Reform Act of 1986. See paragraphs (a)(10) and (13) of this section and §§ 1.902–3 and 1.902–4.

(4) *Deficits in accumulated earnings and profits.* No foreign income taxes shall be deemed paid with respect to a distribution from a foreign corporation out of current earnings and profits that is treated as a dividend under section 316(a)(2), and post-1986 foreign income taxes shall not be reduced, if as of the end of the taxable year in which the dividend is paid or accrued, the corporation has zero or a deficit in post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits is zero or less than zero. The dividend shall reduce post-1986 undistributed earnings and accumulated earnings and profits.

(5) *Examples*. The following examples illustrate the rules of this paragraph (b):

Example 1. Domestic corporation M owns 100 percent of foreign corporation A. Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. All of Corporation A's pre-1987 accumulated profits and post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). As of December 31, 1992, Corporation A has 100u of post-1986 undistributed earnings and $40 of post-1986 foreign income taxes. For its 1986 taxable year, Corporation A has accumulated profits of 200u (net of foreign taxes) and paid 60u of foreign income taxes on those earnings. In 1992, Corporation A distributes 150u to Corporation M. Corporation A has 100u of post-1986 undistributed earnings and the dividend, therefore, is treated as paid out of post-1986 undistributed earnings to the extent of 100u. The first 100u distribution is from post-1986 undistributed earnings, and, because the distribution exhausts those earnings, Corporation M is deemed to have paid the entire amount of post-1986 foreign income taxes of Corporation A ($40). The remaining 50u dividend is treated as a dividend out of 1986 accumulated profits under paragraph (b)(2) of this section. Corporation M is deemed to have paid $15 (60u x 50u/200u, translated at the appropriate exchange rates) of Corporation A's foreign income taxes for 1986. As of January 1, 1993, Corporation A's post-1986 undistributed earnings and post-1986 foreign income taxes are 0. Corporation A has 150u of accumulated profits and 45u of foreign income taxes remaining in 1986.

Example 2. Domestic corporation M (incorporated on January 1, 1987) owns 100 percent of foreign corporation A (incorporated on January 1, 1987). Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. Corporation A has no pre-1987 accumulated profits. All of Corporation A's post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). On January 1, 1992, Corporation A has a deficit in accumulated earnings and profits and a deficit in post-1986 undistributed earnings of (200u). No foreign taxes have been paid with respect to post-1986 undistributed earnings. During 1992, Corporation A earns 100u (net of foreign taxes), pays $40 of foreign taxes on those earnings and distributes 50u to Corporation M. As of the end of 1992, Corporation A has a deficit of (100u) ((200u) post-1986 undistributed earnings + 100u current earnings and profits) in post-1986 undistributed earnings. Corporation A, however, has current earnings and profits of 100u. Therefore, the 50u distribution is treated as a dividend in its entirety under section 316(a)(2). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign taxes paid by Corporation A because post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits are (100u). The dividend reduces both post-1986 undistributed earnings and accumulated earnings and profits. Therefore, as of January 1, 1993, Corporation A's post-1986 undistributed earnings are (150u) and its accumulated earnings and profits are (150u). Corporation A's post-1986 foreign income taxes at the start of 1993 are $40.

(c) *Special rules*—(1) *Separate computations required for dividends from each first-tier and lower-tier corporation*—(i) *Rule*. If in a taxable year dividends are received by a domestic shareholder or an upper-tier corporation from two or more first-tier corporations or two or more lower-tier corporations, the foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under sections 902(a) and (b) and paragraph (b) of this section shall be computed separately with respect to the dividends received from each first-tier corporation or lower-tier corporation. If a domestic shareholder receives dividend distributions from one or more first-tier corporations and in the same taxable year the first-

tier corporation receives dividends from one or more lower-tier corporations, then the amount of foreign income taxes deemed paid shall be computed by starting with the lowest-tier corporation and working upward.

(ii) *Example*. The following example illustrates the application of this paragraph (c)(1):

Example. P, a domestic corporation, owns 40 percent of the voting stock of foreign corporation S. S owns 30 percent of the voting stock of foreign corporation T, and 30 percent of the voting stock of foreign corporation U. Neither S, T, nor U is a controlled foreign corporation. P, S, T and U all use the calendar year as their taxable year. In 1993, T and U both pay dividends to S and S pays a dividend to P. To compute foreign taxes deemed paid, paragraph (c)(1) of this section requires P to start with the lowest tier corporations and to compute foreign taxes deemed paid separately for dividends from each first-tier and lower-tier corporation. Thus, S first will compute foreign taxes deemed paid separately on its dividends from T and U. The deemed paid taxes will be added to S's post-1986 foreign income taxes, and the dividends will be added to S's post-1986 undistributed earnings. Next, P will compute foreign taxes deemed paid with respect to the dividend from S. This computation will take into account the taxes paid by T and U and deemed paid by S.

(2) *Section 78 gross-up*—(i) *Foreign income taxes deemed paid by a domestic shareholder*. Except as provided in section 960(b) and the regulations under that section (relating to amounts excluded from gross income under section 959(b)), any foreign income taxes deemed paid by a domestic shareholder in any taxable year under section 902(a) and paragraph (b) of this section shall be included in the gross income of the domestic shareholder for the year as a dividend under section 78. Amounts included in gross income under section 78 shall, for purposes of section 904, be deemed to be derived from sources within the United States to the extent the earnings and profits on which the taxes were paid are treated under section 904(g) as United States source earnings and profits. Section 1.904–5(m)(6). Amounts included in gross income under section 78 shall be treated for purposes of section 904 as income in a separate category to the extent that the foreign income taxes were allocated and apportioned to income in that separate category. See section 904(d)(3)(G) and § 1.904–6(b)(3).

(ii) *Foreign income taxes deemed paid by an upper-tier corporation*. Foreign income taxes deemed paid by an upper-tier corporation on a distribution from a lower-tier corporation are not included in the earnings and profits of the upper-tier corporation. For purposes of section 904, foreign income taxes shall be allocated and apportioned to income in a separate category to the extent those taxes were allocated to the earnings and profits of the lower-tier corporation in that separate category. See section 904(d)(3)(G) and § 1.904–6(b)(3). To the extent that section 904(g) treats the earnings of the lower-tier corporation on which those foreign income taxes were paid as United States source earnings and profits, the foreign income taxes deemed paid by the upper-tier corporation on the distribution from the lower-tier corporation shall be treated as attributable to United States source earnings and profits. See section 904(g) and § 1.904–5(m)(6).

(iii) *Example*. The following example illustrates the rules of this paragraph (c)(2):

Example. P, a domestic corporation, owns 100 percent of the voting stock of controlled foreign corporation S. Corporations P and S use the calendar year as their taxable year, and S uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. As of January 1, 1992, S has -0- post-1986 undistributed earnings and -0- post-1986 foreign income taxes. In 1992, S earns 150u of non-subpart F general limitation income net of foreign taxes and pays 60u of foreign income taxes. As of the end of 1992, but before dividend payments, S has 150u of post-1986 undistributed earnings and $60 of post-1986 foreign income taxes. Assume that 50u of S's earnings for 1992 are from United States sources. S pays P a dividend of 75u which P receives in 1992. Under § 1.904–5(m)(4), one-third of the dividend, or 25u (75u x 50u/150u), is United States source income to P. P computes foreign taxes deemed paid on the dividend under paragraph (b)(1) of this section of $30 ($60 x 50%[75u/150u]) and includes that amount in gross income under section 78 as a dividend. Because 25u of the 75u dividend is United States source income to P, $10 ($30 x 33.33%[25u/75u]) of the section 78 dividend will be treated as United States source income to P under this paragraph (c)(2).

(3) *Creditable foreign income taxes*. The amount of creditable foreign income taxes under section 901 shall include, subject to the limitations and conditions of sections 902 and 904, foreign income taxes actually paid and deemed paid by a domestic shareholder that receives a dividend from a first-tier corporation. Foreign income taxes deemed paid by a domestic shareholder under paragraph (b) of this section shall be deemed paid by the domestic shareholder only for purposes of computing the foreign tax credit allowed under section 901.

(4) *Foreign mineral income*. Certain foreign income, war profits and excess profits taxes paid or accrued with respect to foreign mineral income will not be considered foreign income taxes for purposes of section 902. See section 901(e) and § 1.901–3.

(5) *Foreign taxes paid or accrued in connection with the purchase or sale of certain oil and gas*. Certain income, war profits, or excess profits taxes paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in that country will not be considered foreign income taxes for purposes of section 902. See section 901(f).

(6) *Foreign oil and gas extraction income*. For rules relating to reduction of the amount of foreign income taxes deemed paid with respect to foreign oil and gas extraction income, see section 907(a) and the regulations under that section.

(7) *United States shareholders of controlled foreign corporations*. See paragraph (d) of this section and sections 960 and 962 and the regulations under those sections for special rules relating to the application of section 902 in computing foreign income taxes deemed paid by United States shareholders of controlled foreign corporations.

(8) *Credit for foreign taxes deemed paid in a section 304 transaction*. [Reserved].

(9) *Effect of section 482 adjustments on post-1986 foreign income taxes and post-1986 undistributed earnings.* [Reserved].

(d) *Dividends from controlled foreign corporations*— (1) *General rule*. Except as provided in paragraph (d)(3) of this section, if a dividend is received by a domestic shareholder that is a United States shareholder (as defined in section 951(b) or section 953(c)(1)(A)) from a first-tier corporation that is a controlled foreign corporation (as defined in section 957(a) or section 953(c)(1)(B)), or by an upper-tier corporation from a lower-tier corporation if the corporations are related look-through entities within the meaning of § 1.904–5(i), the following rule applies. If a dividend is paid out of post-1986 undistributed earnings or pre-1987 accumulated profits of the upper- or lower-tier controlled foreign corporation attributable to more than one separate category under section 904(d), the amount of foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under section 902 and paragraph (b) of this section shall be computed separately with respect to the post-1986 undistributed earnings or pre-1987 accumulated

profits in each separate category out of which the dividend is paid. See § 1.904–5(c)(4) and paragraph (d)(2) of this section. The separately computed deemed paid taxes shall be added to other taxes paid by the U.S. shareholder or upper-tier corporation with respect to income in the appropriate separate category.

(2) *Look-through*—(i) *Dividends*. Except as otherwise provided in paragraph (d)(3) of this section, any dividend distribution out of post-1986 undistributed earnings of a look-through entity to a related look-through entity shall be deemed to be paid pro rata out of each separate category of income. See §§ 1.904–5(c)(4) and 1.904–7. The portion of the foreign income taxes attributable to a particular separate category that shall be deemed paid by the domestic shareholder or upper-tier corporation must be computed under the following formula:

$$\text{Foreign taxes deemed paid by domestic shareholder or upper-tier corporation with respect to a separate category under section 904(d)} = \text{Post-1986 foreign income taxes of first-tier or lower-tier corporation allocated and apportioned to a separate category under § 1.904–6} \times \frac{\text{Dividend amount attributable to a separate category}}{\text{Post-1986 undistributed earnings of first-tier or lower-tier corporation attributable to the separate category}}$$

(ii) *Coordination with section 960*. For rules coordinating the computation of foreign taxes deemed paid with respect to amounts included in gross income under section 951(a) and dividends distributed by a controlled foreign corporation, see section 960 and the regulations under that section.

(3) *Dividends distributed out of earnings accumulated before a controlled foreign corporation became a controlled foreign corporation*—(i) *General rule*. Any dividend distributed by a controlled foreign corporation out of earnings accumulated before the controlled foreign corporation became a controlled foreign corporation shall be treated as a dividend from a noncontrolled section 902 corporation regardless of whether the earnings were accumulated in a taxable year beginning before January 1, 1987, or after December 31, 1986.

(ii) *Dividend distributions out of earnings and profits for a year during which a shareholder that is currently a more-than-90-percent United States shareholder of a controlled foreign corporation was not a United States shareholder of the controlled foreign corporation.* [Reserved].

(e) *Information to be furnished*. If the credit for foreign income taxes claimed under section 901 includes foreign income taxes deemed paid under section 902 and paragraph (b) of this section, the domestic shareholder must furnish the same information with respect to the foreign income taxes deemed paid as it is required to furnish with respect to the foreign income taxes it directly paid or accrued and for which the credit is claimed. See § 1.905–2. For other information required to be furnished by the domestic shareholder for the annual accounting period of certain foreign corporations ending with or within the shareholder's taxable year, and for reduction in the amount of foreign income taxes paid, accrued, or deemed paid for failure to furnish the required information, see section 6038 and the regulations under that section.

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

Example 1. Since 1987, domestic corporation M has owned 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation. Corporation A uses the u as its functional currency, and 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. In 1992, Corporation A pays a 30u dividend out of post-1986 undistributed earnings, 3u to Corporation M and 27u to Corporation Z. Corporation M is deemed, under paragraph (b) of this section, to have paid a portion of the post-1986 foreign income taxes paid by Corporation A and includes the amount of foreign taxes deemed paid in gross income under section 78 as a dividend. Both the foreign taxes deemed paid and the dividend would be subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Under paragraph (a)(9)(i) of this section, Corporation A must reduce its post-1986 undistributed earnings as of January 1, 1993, by the total amount of dividends paid to Corporation M and Corporation Z in 1992. Under paragraph (a)(8)(i) of this section, Corporation A must reduce its post-1986 foreign income taxes as of January 1, 1993, by the amount of foreign income taxes that were deemed paid by Corporation M and by the amount of foreign income taxes that would have been deemed paid by Corporation Z had Corporation Z been eligible to compute an amount of foreign income taxes deemed paid with respect to the dividend received from Corporation A. Foreign income taxes deemed paid by Corporation M and Corporation A's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

1.	Assumed post-1986 undistributed earnings of Corporation A at start of 1992	25u
2.	Assumed post-1986 foreign income taxes of Corporation A at start of 1992	$25
3.	Assumed pre-tax earnings and profits of Corporation A for 1992	50u
4.	Assumed foreign income taxes paid or accrued by Corporation A in 1992	15u
5.	Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	60u
6.	Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates)	$40
7.	Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1992	3u
8.	Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M (Line 7 divided by Line 5)	5%
9.	Foreign income taxes of Corporation A deemed paid by Corporation M under section 902 (a) (Line 6 multiplied by Line 8)	$2
10.	Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992	30u
11.	Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5)	50%
12.	Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11)	$20
13.	Corporation A's post-1986 undistributed earnings at the start of 1993 (Line 5 minus Line 10)	30u
14.	Corporation A's post-1986 foreign income taxes at the start of 1993 (Line 6 minus Line 12)	$20

Example 2. (i) The facts are the same as in *Example 1*, except that Corporation M has also owned 10 percent of the one class of stock of foreign corporation B since 1987. Corporation B uses the calendar year as the taxable year. The remaining 90 percent of Corporation B's stock is owned by Corporation Z. Corporation B is not a controlled foreign corporation. Corporation B uses the u as its functional currency, and 1u equals $1 at all relevant times. In 1992, Corporation B has earnings and profits and pays foreign income taxes, a portion of which are attributable to high withholding tax interest, as defined in section 904(d)(2)(B)(i). Corporation B must reduce its pool of post-1986 foreign income taxes by the amount of tax imposed on high withholding tax interest in excess of 5 percent because that amount is not treated as a tax for purposes of section 902. See section 904(d)(2)(E)(ii) and paragraph (a)(8)(iii) of this section. Corporation B pays 50u in dividends in 1992, 5u to Corporation M and 45u to Corporation Z. Corporation M must compute its section 902(a) deemed paid taxes separately for the dividends it receives in 1992 from

Corporation A (as computed in *Example 1*) and from Corporation B. Foreign income taxes of Corporation B deemed paid by Corporation M, and Corporation B's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

1.	Assumed post-1986 undistributed earnings of Corporation B at start of 1992	(100u)
2.	Assumed post-1986 foreign income taxes of Corporation B at start of 1992	$0
3.	Assumed pre-tax earnings and profits of Corporation B for 1992 (including 50u of high withholding tax interest on which 5u of tax is withheld)	302.50u
4.	Assumed foreign income taxes paid or accrued by Corporation B in 1992	102.50u
5.	Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	100u
6.	Amount of foreign income tax of Corporation B imposed on high withholding tax interest in excess of 5% (5u withholding tax - [5% x 50u high withholding tax interest])	2.50u
7.	Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus [Line 4 minus Line 6 translated at the appropriate exchange rate])	$100
8.	Dividends paid out of post-1986 undistributed earnings to Corporation M in 1992	5u
9.	Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation M (Line 8 divided by Line 5)	5%
10.	Foreign income taxes of Corporation B deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9)	$5
11.	Total dividends paid out of post-1986 undistributed earnings of Corporation B to all shareholders in 1992	50u
12.	Percentage of Corporation B's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 5)	50%
13.	Post-1986 foreign income taxes of Corporation B paid on or with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12)	$50
14.	Corporation B's post-1986 undistributed earnings at start of 1993 (Line 5 minus Line 11)	50u
15.	Corporation B's post-1986 foreign income taxes at start of 1993 (Line 7 minus Line 13)	$50

(ii) For 1992, as computed in Example 1, Corporation M is deemed to have paid $2 of the post-1986 foreign income taxes paid by Corporation A and includes $2 in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Corporation M also is deemed to have paid $5 of the post-1986 foreign income taxes paid by Corporation B and includes $5 in gross income as a deemed dividend under section 78. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation B, a noncontrolled section 902 corporation.

Example 3. (i) Since 1987, domestic corporation M has owned 50 percent of the one class of stock of foreign corporation A. The remaining 50 percent of Corporation A is owned by foreign corporation Z. For the same time period, Corporation A has owned 40 percent of the one class of stock of foreign corporation B, and Corporation B has owned 30 percent of the one class of stock of foreign corporation C. The remaining 60 percent of Corporation B is owned by foreign corporation Y, and the remaining 70 percent of Corporation C is owned by foreign corporation X. Corporations A, B, and C are not controlled foreign corporations. Corporations A, B, and C use the u as their functional currency, and 1u equals $1 at all relevant times. Corporation B uses a fiscal year ending June 30 as its taxable year; all other corporations use the calendar year as the taxable year. On February 1, 1992, Corporation C pays a 500u dividend out of post-1986 undistributed earnings, 150u to Corporation B and 350u to Corporation X. On February 15, 1992, Corporation B pays a 300u dividend out of post-1986 undistributed earnings computed as of the close of Corporation B's fiscal year ended June 30, 1992, 120u to Corporation A and 180u to Corporation Y. On August 15, 1992, Corporation A pays a 200u dividend out of post-1986 undistributed earnings, 100u to Corporation M and 100u to Corporation Z. In computing foreign taxes deemed paid by Corporations B and A, section 78 does not apply and Corporations B and A thus do not have to include the foreign taxes deemed paid in earnings and profits. See paragraph (c)(2)(ii) of this section. Foreign income taxes deemed paid by Corporations B, A and M, and the foreign corporations' opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation B's fiscal year beginning July 1, 1992, and Corporation C's and Corporation A's 1993 calendar years are computed as follows:

A. *Corporation C (third-tier corporation)*:

1.	Assumed post-1986 undistributed earnings in Corporation C at start of 1992	1300u
2.	Assumed post-1986 foreign income taxes in Corporation C at start of 1992	$500
3.	Assumed pre-tax earnings and profits of Corporation C for 1992	500u
4.	Assumed foreign income taxes paid or accrued in 1992	300u
5.	Post-1986 undistributed earnings in Corporation C for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	1500u
6.	Post-1986 foreign income taxes in Corporation C for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates)	$800
7.	Dividends paid out of post-1986 undistributed earnings of Corporation C to Corporation B in 1992	150u
8.	Percentage of Corporation C's post-1986 undistributed earnings paid to Corporation B (Line 7 divided by Line 5)	10%
9.	Foreign income taxes of Corporation C deemed paid by Corporation B under section 902(b)(2) (Line 6 multiplied by Line 8)	$80
10.	Total dividends paid out of post-1986 undistributed earnings of Corporation C to all shareholders in 1992	500u
11.	Percentage of Corporation C's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5)	33.33%
12.	Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11)	$266.66
13.	Post-1986 undistributed earnings in Corporation C at start of 1993 (Line 5 minus Line 10)	1000u
14.	Post-1986 foreign income taxes in Corporation C at start of 1993 (Line 6 minus Line 12)	$533.34

B. *Corporation B (second-tier corporation):*

1.	Assumed post-1986 undistributed earnings in Corporation B as of July 1, 1991	0
2.	Assumed post-1986 foreign income taxes in Corporation B as of July 1, 1991	0
3.	Assumed pre-tax earnings and profits of Corporation B for fiscal year ended June 30, 1992, (including 150u dividend from Corporation B)	1000u
4.	Assumed foreign income taxes paid or accrued by Corporation B in fiscal year ended June 30, 1992	200u
5.	Foreign income taxes of Corporation C deemed paid by Corporation B in its fiscal year ended June 30, 1992 (Part A, Line 9 of paragraph (i) of this *Example 3*)	$80
6.	Post-1986 undistributed earnings in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4)	800u
7.	Post-1986 foreign income taxes in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5)	$280
8.	Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A on February 15, 1992	120u
9.	Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to Corporation A (Line 8 divided by Line 6)	15%

10. Foreign income taxes paid and deemed paid by Corporation B as of June 30, 1992, deemed paid by Corporation A under section 902(b)(1) (Line 7 multiplied by Line 9) $42
11. Total dividends paid out of post-1986 undistributed earnings of Corporation B for fiscal year ended June 30, 1992 . . . . . 300u
12. Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to all shareholders (Line 11 divided by Line 6) 37.5%
13. Post-1986 foreign income taxes paid and deemed paid with respect to post-1986 undistributed earnings distributed to all shareholders during Corporation B's fiscal year ended June 30, 1992 (Line 7 multiplied by Line 12) $105
14. Post-1986 undistributed earnings in Corporation B as of July 1, 1992 (Line 6 minus Line 11) . 500u
15. Post-1986 foreign income taxes in Corporation B as of July 1, 1992 (Line 7 minus Line 13) . $175

C. *Corporation A (first-tier corporation)*:

1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992 . . . . . 250u
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992 . . . . . $100
3. Assumed pre-tax earnings and profits of Corporation A for 1992 (including 120u dividend from Corporation B) 250u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992 . . . . . 100u
5. Foreign income taxes paid or deemed paid by Corporation B as of June 30, 1992, that are deemed paid by Corporation A in 1992 (Part B, Line 10 of paragraph (i) of this Example 3) $42
6. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) 400u
7. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5) $242
8. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M on August 15, 1992 . . . . . 100u
9. Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M in 1992 (Line 8 divided by Line 6) 25%
10. Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9) $60.50
11. Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992 . . . . . 200u
12. Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 6) 50%
13. Post-1986 foreign income taxes paid and deemed paid by Corporation A with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12) $121
14. Post-1986 undistributed earnings in Corporation A at start of 1993 (Line 6 minus Line 11) . 200u
15. Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 13) . $121

(ii) Corporation M is deemed, under section 902(a) and paragraph (b) of this section, to have paid $60.50 of post-1986 foreign income taxes paid, or deemed paid, by Corporation A on or with respect to its post-1986 undistributed earnings (Part C, Line 10) and Corporation M includes that amount in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation.

Example 4. (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A, and Corporation A has owned 100 percent of the voting stock of controlled foreign corporation B. Corporations M, A and B use the calendar year as the taxable year. Corporations A and B are organized in the same foreign country and use the u as their functional currency. 1u equals $1 at all relevant times. Assume that all of the earnings of Corporations A and B are general limitation earnings and profits within the meaning of section 904(d)(2)(I), and that neither Corporation A nor Corporation B has any previously taxed income accounts. In 1992, Corporation B pays a dividend of 150u to Corporation A out of post-1986 undistributed earnings, and Corporation A computes an amount of foreign taxes deemed paid under section 902(b)(1). The dividend is not subpart F income to Corporation A because section 954(c)(3)(B)(i) (the same country dividend exception) applies. Pursuant to paragraph (c)(2)(ii) of this section, Corporation A is not required to include the deemed paid taxes in earnings and profits. Corporation A has no pre-1987 accumulated profits and a deficit in post-1986 undistributed earnings for 1992. In 1992, Corporation A pays a dividend of 100u to Corporation M out of its earnings and profits for 1992 (current earnings and profits). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign income taxes paid or deemed paid by Corporation A because Corporation A has a deficit in post-1986 undistributed earnings as of December 31, 1992, and the sum of its current plus accumulated profits is less than zero. Note that if instead of paying a dividend to Corporation A in 1992, Corporation B had made an additional investment of $150 in United States property under section 956, that amount would have been included in gross income by Corporation M under section 951(a)(1)(B) and Corporation M would have been deemed to have paid $50 of foreign income taxes paid by Corporation B. See sections 951(a)(1)(B) and 960. Foreign income taxes of Corporation B deemed paid by Corporation A and the opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation A and Corporation B for 1993 are computed as follows:

A. *Corporation B (second-tier corporation)*:

1. Assumed post-1986 undistributed earnings in Corporation B at start of 1992 200u
2. Assumed post-1986 foreign income taxes in Corporation B at start of 1992 . . . . . $50
3. Assumed pre-tax earnings and profits of Corporation B for 1992 . . . . . 150u
4. Assumed foreign income taxes paid or accrued in 1992 . . . . . 50u
5. Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) 300u
6. Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates) $100
7. Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A in 1992 . . . . . 150u
8. Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation A (Line 7 divided by Line 5) . . 50%
9. Foreign income taxes of Corporation B deemed paid by Corporation A under section 902(b)(1) (Line 6 multiplied by Line 8) $50
10. Post-1986 undistributed earnings in Corporation B at start of 1993 (Line 5 minus Line 7) . . 150u
11. Post-1986 foreign income taxes in Corporation B at start of 1993 (Line 6 minus Line 9) . . $50

B. *Corporation A (first-tier corporation):*

1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992 . . . . . (200u)
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992 0
3. Assumed pre-tax earnings and profits of Corporation A for 1992 (including 150u dividend from Corporation B) 200u
4. Assumed foreign income taxes paid or accrued by Corporation A in 1992 . . . . . 40u
5. Foreign income taxes paid by Corporation B in 1992 that are deemed paid by Corporation A (Part A, Line 9 of paragraph (i) of this *Example 4*) $50
6. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) . . . . . (40u)
7. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5) $90

8. Dividends paid out of current earnings and profits of Corporation A for 1992 . . . . . 100u
9. Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1992 (Line 8 divided by the greater of Line 6 or zero) . . . 0
10. Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9). 0
11. Post-1986 undistributed earnings in Corporation A at start of 1993 (line 6 minus line 8) . . . (140u)
12. Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 10) . $90

(ii) For 1993, Corporation A has 500u of earnings and profits on which it pays 160u of foreign income taxes. Corporation A receives no dividends from Corporation B, and pays a 100u dividend to Corporation M. The 100u dividend to Corporation M carries with it some of the foreign income taxes paid and deemed paid by Corporation A in 1992, which were not deemed paid by Corporation M in 1992 because Corporation A had no post-1986 undistributed earnings. Thus, for 1993, Corporation M is deemed to have paid $125 of post-1986 foreign income taxes paid and deemed paid by Corporation A and includes that amount in gross income as a dividend under section 78, determined as follows:

1. Post-1986 undistributed earnings in Corporation A at start of 1993. . . . . (140u)
2. Post-1986 foreign income taxes in Corporation A at start of 1993 . . . . . $90
3. Pre-tax earnings and profits of Corporation A for 1993 . . . . . 500u
4. Foreign income taxes paid or accrued by Corporation A in 1993. . . . . 160u
5. Post-1986 undistributed earnings in Corporation A for 1993 (pre-dividend) (Line 1 plus Line 3 minus Line 4) 200u
6. Post-1986 foreign income taxes in Corporation A for 1993 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates) $250
7. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1993 . . . . . 100u
8. Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1993 (Line 7 divided by Line 5) 50%
9. Foreign income taxes paid and deemed paid by Corporation A that are deemed paid by Corporation M in 1993 (Line 6 multiplied by Line 8) $125
10. Post-1986 undistributed earnings in Corporation A at start of 1994 (Line 5 minus Line 7) . . 100u
11. Post-1986 foreign income taxes in Corporation A at start of 1994 (Line 6 minus Line 9) . . $125

Example 5. (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A. Corporation M also conducts operations through a foreign branch. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A uses the u as its functional currency and 1u equals $1 at all relevant times. Corporation A has no subpart F income, as defined in section 952, and no increase in earnings invested in United States property under section 956 for 1992. Corporation A also has no previously taxed income accounts. Corporation A has general limitation income and high withholding tax interest income that, by operation of section 954(b)(4), does not constitute foreign base company income under section 954(a). Because Corporation A is a controlled foreign corporation, it is not required to reduce post-1986 foreign income taxes by foreign taxes paid or accrued with respect to high withholding tax interest in excess of 5 percent. See § 1.902–1(a)(8)(iii). Corporation A pays a 60u dividend to Corporation M in 1992. For 1992, Corporation M is deemed, under paragraph (b) of this section, to have paid $24 of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend, determined as follows:

1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992 attributable to:
   (a) Section 904(d)(1)(B) high withholding tax interest 20u
   (b) Section 904(d)(1)(I) general limitation income. 55u
2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992 attributable to:
   (a) Section 904(d)(1)(B) high withholding tax interest. $5
   (b) Section 904(d)(1)(I) general limitation income. $20
3. Assumed pre-tax earnings and profits of Corporation A for 1992 attributable to:
   (a) Section 904(d)(1)(B) high withholding tax interest. 20u
   (b) Section 904(d)(1)(I) general limitation income 20u
4. Assumed foreign income taxes paid or accrued in 1992 on or with respect to:
   (a) Section 904(d)(1)(B) high withholding tax interest. 10u
   (b) Section 904(d)(1)(I) general limitation income 5u
5. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) attributable to:
   (a) Section 904(d)(1)(B) high withholding tax interest (Line 1(a) + Line 3(a) minus Line 4(a)) 30u
   (b) Section 904(d)(1)(I) general limitation income (Line 1(b) + Line 3(b) minus Line 4(b)) 70u
   (c) Total . . . . . ~~100u~~
6. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) attributable to:
   (a) Section 904(d)(1)(B) high withholding tax interest (Line 2(a) + Line 4(a) translated at the appropriate exchange rates). $15
   (b) Section 904(d)(1)(I) general limitation income (Line 2(b) + Line 4(b) translated at the appropriate exchange rates) . $25
7. Dividends paid to Corporation M in 1992 . . . . . 60u
8. Dividends paid to Corporation M in 1992 attributable to section 904(d) separate categories pursuant to § 1.904–5(d):
   (a) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(B) high withholding tax interest (Line 7 multiplied by Line 5(a) divided by Line 5(c)). 18u
   (b) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(I) general limitation income (Line 7 multiplied by Line 5(b) divided by Line 5(c)) 42u
9. Percentage of Corporation A's post-1986 undistributed earnings for 1992 paid to Corporation M attributable to:
   (a) Section 904(d)(1)(B) high withholding tax interest (Line 8(a) divided by Line 5(a)) . . 60%
   (b) Section 904(d)(1)(I) general limitation income (Line 8(b) divided by Line 5(b)) 60%
10. Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) attributable to:
   (a) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(B) high withholding tax interest (Line 6(a) multiplied by Line 9(a)) $9
   (b) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(I) general limitation income (Line 6(b) multiplied by Line 9(b)) . . . $15
11. Post-1986 undistributed earnings in Corporation A at start of 1993 attributable to:
   (a) Section 904(d)(1)(B) high withholding tax interest (Line 5(a) minus Line 8(a)) 12u
   (b) Section 904(d)(1)(I) general limitation income (Line 5(b) minus Line 8(b)) 28u
12. Post-1986 foreign income taxes in Corporation A at start of 1989 allocable to:
   (a) Section 904(d)(1)(B) high withholding tax interest (Line 6(a) minus Line 10(a)) $6
   (b) Section 904(d)(1)(I) general limitation income (Line 6(b) minus Line 10(b)) $10

(ii) For purposes of computing Corporation M's foreign tax credit limitation, the post-1986 foreign income taxes of Corporation A deemed paid by Corporation M with respect to income in separate categories will be added to the foreign income taxes paid or accrued by Corporation M associated with income derived from Corporation M's branch operation in the same separate categories. The dividend (and the section 78 inclusion with respect

to the dividend) will be treated as income in separate categories and added to Corporation M's other income, if any, attributable to the same separate categories. See section 904(d) and § 1.904–6.

(g) *Effective date*. This section applies to any distribution made in and after a foreign corporation's first taxable year beginning on or after January 1, 1987.

§ 1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first-, second-, or third-tier corporation for purposes of computing an amount of foreign taxes deemed paid under § 1.902–1.

(a) *Carryback of deficits in post-1986 undistributed earnings of a first-, second-, or third-tier corporation to pre-effective date taxable years*—(1) *Rule*. For purposes of computing foreign income taxes deemed paid under § 1.902–1(b) with respect to dividends paid by a first-, second-, or third-tier corporation, when there is a deficit in the post-1986 undistributed earnings of that corporation and the corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, then the post-1986 deficit shall be carried back to the most recent pre-effective date taxable year of the first-, second-, or third-tier corporation with positive accumulated profits computed under section 902. See § 1.902–3(e). For purposes of this § 1.902–2, a pre-effective date taxable year is a taxable year beginning before January 1, 1987, or a taxable year beginning after December 31, 1986, if the special effective date of § 1.902–1(a)(13) applies. The deficit shall reduce the section 902 accumulated profits in the most recent pre-effective date year to the extent thereof, and any remaining deficit shall be carried back to the next preceding year or years until the deficit is completely allocated. The amount carried back shall reduce the deficit in post-1986 undistributed earnings. Any foreign income taxes paid in a post-effective date year will not be carried back to pre-effective date taxable years or removed from post-1986 foreign income taxes. See section 960 and the regulations under that section for rules governing the carryback of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations.

(2) *Examples*. The following examples illustrate the rules of this paragraph (a):

Example 1. (i) From 1985 through 1990, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable Year	1985	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A	150u	150u	(100u)	100u	-0-	-0-
Current Plus Accumulated E & P of Corp. A	150u	300u	200u	250u	250u	200u
Post-'86 Undistributed Earnings of Corp. A		(100u)	100u	100u	50u	
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback)		-0-	100u	50u	50u	
Foreign Income Taxes of Corp. A (Annual)	120u	120u	$10	$50	-0-	-0-
Post-'86 Foreign Income Taxes of Corp. A			$10	$60	$60	$30
12/31 Distributions to Corp. M	-0-	-0-	5u	-0-	5u	-0-
12/31 Distributions to Corp. Z	-0-	-0-	45u	-0-	45u	-0-

(ii) On December 31, 1987, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has a deficit of (100u) in post-1986 undistributed earnings and $10 of post-1986 foreign income taxes. The (100u) deficit (but not the post-1986 foreign income taxes) is carried back to offset the accumulated profits of 1986 and removed from post-1986 undistributed earnings. The accumulated profits for 1986 are reduced to 50u (150u - 100u). The dividend is paid out of the reduced 1986 accumulated profits. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are 12u (120u x (5u/50u)). See § 1.902–1(b)(3). Corporation M must include 12u in gross income (translated under the rule applicable to foreign income taxes paid on earnings accumulated in pre-effective date years) under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. No accumulated profits remain in Corporation A with respect to 1986 after the carryback of the 1987 deficit and the December 31, 1987, dividend distributions to Corporations M and Z.

(iii) On December 31, 1989, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 100u of post-1986 undistributed earnings and $60 of post-1986 foreign income taxes. Therefore, the dividend is considered paid out of Corporation A's post-1986 undistributed earnings. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are $3 ($60 x 5%[5u/100u]). Corporation M must include $3 in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1990, are 50u (100u - 50u). Corporation A's post-1986 foreign income taxes must be reduced by the amount of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes. Section 1.902–1(a)(8)(i). The amount of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend distributed by Corporation A is $30 ($60 x 50%[50u/100u]). Thus, post-1986 foreign income taxes as of January 1, 1990, are $30 ($60 - $30).

Example 2. The facts are the same as in *Example 1*, except that Corporation A has a deficit in its post-1986 undistributed earnings of (150u) on December 31, 1987. The deficit is carried back to 1986 and reduces accumulated profits for that year to -0-. Thus, the foreign income taxes paid with respect to the 1986 accumulated profits will never be deemed paid. The 1987 dividend is deemed to be out of Corporation A's 1985 accumulated profits. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend paid on December 31, 1987, are 4u (120u x 5u/150u). See § 1.902–1(b)(3). As a result of the December 31, 1987, dividend distributions, 100u (150u - 50u) of accumulated profits and 80u (120u reduced by 40u[120u x 50u/150u] of foreign taxes that would have been deemed paid had all of Corporation A's shareholders been eligible to compute an amount of foreign taxes deemed paid with respect to the dividend paid out of 1985 accumulated profits) remain in Corporation A with respect to 1985.

Example 3. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining

90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pay dividends as summarized below:

Taxable Year	1986	1987	1988	1989	1990	1991
Current E & P (Deficits) of Corp. A	100u	(50u)	150u	75u	25u	-0-
Current Plus Accumulated E & P of Corp. A	100u	50u	200u	175u	200u	80u
Post-'86 Undistributed Earnings of Corp. A		(50u)	100u	75u	100u	-0-
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback)		(50u)	-0-	75u	-0-	-0-
Foreign Income Taxes (Annual) of Corp. A	80u	-0-	$120	$20	$20	-0-
Post-'86 Foreign Income Taxes of Corp. A		-0-	$120	$20	$40	-0-
12/31 Distributions to Corp. M	-0-	-0-	10u	-0-	12u	-0-
12/31 Distributions to Corp. Z	-0-	-0-	90u	-0-	108u	-0-

(ii) On December 31, 1988, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and $120 in its post-1986 foreign income taxes. Corporation M is deemed, under § 1.902–1(b)(1), to have paid $12 ($120 x 10%[10u/100u]) of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1989, are -0- (100u - 100u). Its post-1986 foreign taxes as of January 1, 1989, also are -0-, $120 reduced by $120 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of foreign taxes deemed paid on the dividend from Corporation A ($120 x 100%[100u/100u]).

(iii) On December 31, 1990, Corporation A distributes a 12u dividend to Corporation M and a 108u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and $40 in its post-1986 foreign income taxes. The dividend is paid out of post-1986 undistributed earnings to the extent thereof (100u), and the remainder of 20u is paid out of 1986 accumulated profits. Under § 1.902–1(b)(2), the 12u dividend to Corporation M is deemed to be paid out of post-1986 undistributed earnings to the extent of 10u (100u x 12u/120u) and the remaining 2u is deemed to be paid out of Corporation A's 1986 accumulated profits. Similarly, the 108u dividend to Corporation Z is deemed to be paid out of post-1986 undistributed earnings to the extent of 90u (100u x 108u/120u) and the remaining 18u is deemed to be paid out of Corporation A's 1986 accumulated profits. Foreign income taxes deemed paid by Corporation M under section 902 with respect to the portion of the dividend paid out of post-1986 undistributed earnings are $4 ($40 x 10%[10u/100u]), and foreign taxes deemed paid by Corporation M with respect to the portion of the dividend deemed paid out of 1986 accumulated profits are 1.6u (80u x 2u/100u). Corporation M must include $4 plus 1.6u translated under the rule applicable to foreign income taxes paid on earnings accumulated in taxable years prior to the effective date of the Tax Reform Act of 1986 in gross income as a dividend under section 78. The income inclusion and the foreign income taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 Corporation A. As of January 1, 1991, Corporation A's post-1986 undistributed earnings are -0- (100u - 100u). 80u (100u - 20u) of accumulated profits remain with respect to 1986. Post-1986 foreign income taxes as of January 1, 1991, are -0-, $40 reduced by $40 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post- 1986 undistributed earnings ($40 x 100%[100u/100u]). Corporation A has 64u of foreign income taxes remaining with respect to 1986, 80u reduced by 16u [80u x 20u/100u] of foreign income taxes that would have been deemed paid if Corporations M and Z both were eligible to compute an amount of deemed paid taxes on the 20u dividend distributed by Corporation A out of 1986 accumulated profits.

(b) *Carryforward of deficits in pre-1987 accumulated profits of a first-, second-, or third-tier corporation to post-1986 undistributed earnings for purposes of section 902*—(1) *General rule.* For purposes of computing foreign income taxes deemed paid under § 1.902–1(b) with respect to dividends paid by a first-, second-, or third-tier corporation out of post-1986 undistributed earnings, the amount of a deficit in accumulated profits of the foreign corporation determined under section 902 as of the end of its last pre-effective date taxable year is carried forward and reduces post-1986 undistributed earnings on the first day of the foreign corporation's first taxable year beginning after December 31, 1986, or on the first day of the first taxable year in which the ownership requirements of section 902(c)(3)(B) and § 1.902–1(a)(1) through (4) are met if the special effective date of § 1.902–1(a)(13) applies. Any foreign income taxes paid with respect to a pre-effective date year shall not be carried forward and included in post-1986 foreign income taxes. Post-1986 undistributed earnings may not be reduced by the amount of a pre-1987 deficit in earnings and profits computed under section 964(a). See section 960 and the regulations under that section for rules governing the carryforward of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations. For translation rules governing carryforwards of deficits in pre-1987 accumulated profits to post-1986 taxable years of a foreign corporation with a dollar functional currency, see § 1.985–6(d)(2).

(2) *Effect of pre-effective date deficit.* If a foreign corporation has a deficit in accumulated profits as of the end of its last pre-effective date taxable year, then the foreign corporation cannot pay a dividend out of pre-effective date years unless there is an adjustment made (for example, a refund of foreign taxes paid) that restores section 902 accumulated profits to a pre-effective date taxable year or years. Moreover, if a foreign corporation has a deficit in section 902 accumulated profits as of the end of its last pre-effective date taxable year, then no deficit in post-1986 undistributed earnings will be carried back under paragraph (a) of this section. For rules concerning carrybacks of eligible deficits from post-1986 undistributed earnings to reduce pre-1987 earnings and profits computed under section 964(a), see section 960 and the regulations under that section.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. (i) From 1984 through 1988, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation

A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable Year	1984	1985	1986	1987	1988
Current E & P (Deficits) of Corp. A	25u	(100u)	(25u)	200u	100u
Current Plus Accumulated E & P (Deficits) of Corp. A	25u	(75u)	(100u)	100u	50u
Post-'86 Undistributed Earnings of Corp. A				100u	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward)				(50u)	50u
Foreign Income Taxes (Annual) of Corp. A	20u	5u	-0-	$100	$50
Post-'86 Foreign Income Taxes of Corp. A				$100	$50
12/31 Distributions to Corp. M	-0-	-0-	-0-	15u	-0-
12/31 Distributions to Corp. Z	-0-	-0-	-0-	135u	-0-

(ii) On December 31, 1987, Corporation A distributes a 150u dividend, 15u to Corporation M and 135u to Corporation Z. Corporation A has 200u of current earnings and profits for 1987, but its post-1986 undistributed earnings are only 100u as a result of the reduction for pre-1987 accumulated deficits required under paragraph (b)(1) of this section. Corporation A has $100 of post-1986 foreign income taxes. Only 100u of the 150u distribution is a dividend out of post-1986 undistributed earnings. Foreign income taxes deemed paid by Corporation M in 1987 with respect to the 10u dividend attributable to post-1986 undistributed earnings, computed under § 1.902–1(b), are $10 ($100 x 10%[10u/100u]). Corporation M includes this amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. After the distribution, Corporation A has (50u) of post-1986 undistributed earnings (100u - 150u) and -0- post-1986 foreign income taxes, $100 reduced by $100 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986 undistributed earnings ($100 x 100%[100u/100u]).

(iii) The remaining 50u of the 150u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. The 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902–1(b)(4).

Example 2. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable Year	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A	(100u)	150u	(150u)	100u	250u
Current Plus Accumulated E & P (Deficits) of Corp. A	(100u)	50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A		50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward)		(50u)	(200u)	(200u)	-0-
Foreign Income Taxes (Annual) of Corp. A	-0-	$120	-0-	$50	$100
Post-'86 Foreign Income Taxes of Corp. A		$120	-0-	$50	$150
12/31 Distributions to Corp. M	-0-	10u	-0-	10u 5u	
12/31 Distributions to Corp. Z	-0-	90u	-0-	90u	45u

(ii) On December 31, 1987, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At the time of the distribution, Corporation A has 50u of post-1986 undistributed earnings and 150u of current earnings and profits. Thus, 50u of the dividend distribution (5u to Corporation M and 45u to Corporation Z) is a dividend out of post-1986 undistributed earnings. The remaining 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902–1(b)(4). Note that even if there were no current earnings and profits in Corporation A, the remaining 50u of the 100u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. Corporation A has $120 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend out of post-1986 undistributed earnings are $12 ($120 x 10%[5u/50u]). Corporation M includes this amount in gross income as a dividend under section 78. Both the foreign taxes deemed paid and the deemed dividend are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. As of January 1, 1988, Corporation A has (50u) in its post-1986 undistributed earnings (50u - 100u) and -0- in its post-1986 foreign income taxes, $120 reduced by $120 of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the dividend distributed by Corporation A out of post-1986 undistributed earnings ($120 x 100%[50u/50u]).

(iii) On December 31, 1989, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. Although the distribution is considered a dividend in its entirety out of 1989 earnings and profits pursuant to section 316(a)(2), post-1986 undistributed earnings are (100u). Accordingly, for purposes of section 902, Corporation M is deemed to have paid no post-1986 foreign income taxes. See § 1.902–1(b)(4). Corporation A's post-1986 undistributed earnings as of January 1, 1990, are (200u) ((100u) - 100u). Corporation A's post-1986 foreign income

taxes are not reduced because no taxes were deemed paid.

(iv) On December 31, 1990, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 50u of post-1986 undistributed earnings, and $150 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend are $15 ($150 x 10%[5u/50u]). Post-1986 undistributed earnings as of January 1, 1991, are -0- (50u - 50u). Post-1986 foreign income taxes as of January 1, 1991, also are -0-, $150 reduced by $150 ($150 x 100%[50u/50u]) of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend.

Par. 4. Newly designated § 1.902–3 is amended by revising the section heading and paragraph (a) introductory text, and by designating the last paragraph as paragraph (l) and revising it to read as follows:

§ 1.902–3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.

(a) *Definitions*. For purposes of section 902 and §§ 1.902–3 and 1.902–4:

* * * * *

(l) *Effective date*. Except as provided in § 1.902–4, this section applies to any distribution received from a first-tier corporation by its domestic shareholder after December 31, 1964, and before the beginning of the foreign corporation's first taxable year beginning after December 31, 1986. If, however, the first day on which the ownership requirements of section 902(c)(3)(B) and § 1.902–1(a)(1) through (4) are met with respect to the foreign corporation is in a taxable year of the foreign corporation beginning after December 31, 1986, then this section shall apply to all taxable years beginning after December 31, 1964, and before the year in which the ownership requirements are first met. See § 1.902–1(a)(13)(iii). For corresponding rules applicable to distributions received by the domestic shareholder prior to January 1, 1965, see § 1.902–5 as contained in the 26 CFR part 1 edition revised April 1, 1976.

Par. 5. Newly designated § 1.902–4, paragraph (b), in the last sentence, the language ''§ 1.902–1'' is removed and ''§ 1.902–3'' is added in its place.

PART 602—OMB CONTROL NUMBERS UNDER

THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In § 602.101, paragraph (c) is amended by adding entries in numerical order to the table to read as follows:

§ 602.101 OMB Control Numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.902–1	1545–1458
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 12, 1996.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 6, 1997, 8:45 a.m., and published in the issue of the Federal Register on January 6, 1997, 62 F.R. 923)

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, 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 March 1997.

Rev. Rul. 97–10

This revenue ruling provides various prescribed rates for federal income tax purposes for March 1997 (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. 97–10 TABLE 1

Applicable Federal Rates (AFR) for March 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.83%	5.75%	5.71%	5.68%
110% AFR	6.43%	6.33%	6.28%	6.25%
120% AFR	7.02%	6.90%	6.84%	6.80%
130% AFR	7.62%	7.48%	7.41%	7.37%

REV. RUL. 97–10 TABLE 1—Continued

Applicable Federal Rates (AFR) for March 1997

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Mid-Term				
AFR	6.42%	6.32%	6.27%	6.24%
110% AFR	7.07%	6.95%	6.89%	6.85%
120% AFR	7.72%	7.58%	7.51%	7.46%
130% AFR	8.39%	8.22%	8.14%	8.08%
150% AFR	9.70%	9.48%	9.37%	9.30%
175% AFR	11.37%	11.06%	10.91%	10.81%
Long-Term				
AFR	6.86%	6.75%	6.69%	6.66%
110% AFR	7.57%	7.43%	7.36%	7.32%
120% AFR	8.26%	8.10%	8.02%	7.97%
130% AFR	8.97%	8.78%	8.69%	8.62%

REV. RUL. 97–10 TABLE 2

Adjusted AFR for March 1997

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.77%	3.74%	3.72%	3.71%
Mid-term adjusted AFR	4.62%	4.57%	4.54%	4.53%
Long-term adjusted AFR	5.50%	5.43%	5.39%	5.37%

REV. RUL. 97–10 TABLE 3

Rates Under Section 382 for March 1997

Adjusted federal long-term rate for the current month	5.50%
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.)	5.50%

REV. RUL. 97–10 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for March 1997

Appropriate percentage for the 70% present value low-income housing credit	8.56%
Appropriate percentage for the 30% present value low-income housing credit	3.67%

REV. RUL. 97–10 TABLE 5

Rate Under Section 7520 for March 1997

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	7.8%

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 March 1997. See Rev. Rul. 97–10, page 31.

Section 1362.—Election, Revocation, Termination

26 CFR 1.1362–1: Election to be an S corporation.

What are the procedures for a taxpayer to request to change its annual accounting period and elect to be an S corporation effective for the taxable year beginning January 1, 1997? See Notice 97–20, page 52.

26 CFR 1.1362–6: Elections and consents.

How does a bank change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method so that it may elect S corporation status for the 1997 tax year? See Rev. Proc. 97–18, page 53.

Section 1374.—Tax Imposed on Certain Built-In Gains

26 CFR 1.1374–4(d): Section 481(a) adjustments.

How does a bank change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method so that it may elect S corporation status for the 1997 tax year? See Rev. Proc. 97–18, page 53.

Section 2107.—Expatriation To Avoid Tax

What are the tax consequences under sections 877, 2107, 2501, and 6039F for individuals who lose U.S. citizenship or cease to be taxed as long-term residents of the United States with a principal purpose to avoid U.S. taxes? See Notice 97–19, page 40.

Section 2501.—Imposition of Tax

What are the tax consequences under sections 877, 2107, 2501, and 6039F for individuals who lose U.S. citizenship or cease to be taxed as long-term residents of the United States with a principal purpose to avoid U.S. taxes? See Notice 97–19, page 40.

Section 6039F.—Notice of Large Gifts Received From Foreign Persons

What are the tax consequences under sections 877, 2107, 2501, and 6039F for individuals who lose U.S. citizenship or cease to be taxed as long-term residents of the United States with a principal purpose to avoid U.S. taxes? See Notice 97–19, page 40.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 1997. See Rev. Rul. 97–10, page 31.

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 March 1997. See Rev. Rul. 97–10, page 31.

Part III. Administrative, Procedural, and Miscellaneous

Differential Earnings Rate for Mutual Life Insurance Companies

Notice 97–17

This notice publishes a tentative determination under § 809 of the Internal Revenue Code of the ''differential earnings rate'' for 1996 and the rate that is used to calculate the ''recomputed differential earnings amount'' for 1995. (The latter rate is referred to in this notice as the ''recomputed differential earnings rate'' for 1995.) These rates are used by mutual life insurance companies to calculate their federal income tax liability for taxable years beginning in 1996.

BACKGROUND

Section 809(a) provides that, in the case of any mutual life insurance company, the amount of the deduction allowable under § 808 for policyholder dividends is reduced (but not below zero) by the ''differential earnings amount.'' Any excess of the differential earnings amount over the amount of the deduction allowable under § 808 is taken into account as a reduction in the closing balance of reserves under subsections (a) and (b) of § 807. The ''differential earnings amount'' for any taxable year is the amount equal to the product of (a) the life insurance company's average equity base for the taxable year multiplied by (b) the ''differential earnings rate'' for that taxable year. The ''differential earnings rate'' for the taxable year is the excess of (a) the ''imputed earnings rate'' for the taxable year over (b) the ''average mutual earnings rate'' for the second calendar year preceding the calendar year in which the taxable year begins. The ''imputed earnings rate'' for any taxable year is the amount that bears the same ratio to 16.5 percent as the ''current stock earnings rate'' for the taxable year bears to the ''base period stock earnings rate.''

Section 809(f) provides that, in the case of any mutual life insurance company, if the ''recomputed differential earnings amount'' for any taxable year exceeds the differential earnings amount for that taxable year, the excess is included in life insurance gross income for the succeeding taxable year. If the differential earnings amount for any taxable year exceeds the recomputed differential earnings amount for that taxable year, the excess is allowed as a life insurance deduction for the succeeding taxable year. The ''recomputed differential earnings amount'' for any taxable year is an amount calculated in the same manner as the differential earnings amount for that taxable year, except that the average mutual earnings rate for the calendar year in which the taxable year begins is substituted for the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

The stock earnings rates and mutual earnings rates taken into account under § 809 generally are determined by dividing statement gain from operations by the average equity base. For this purpose, the term ''statement gain from operations'' means ''the net gain or loss from operations required to be set forth in the annual statement, determined without regard to Federal income taxes, and ... properly adjusted for realized capital gains and losses....'' *See* § 809(g)(1). The term ''equity base'' is defined as an amount determined in the manner prescribed by regulations equal to surplus and capital increased by the amount of nonadmitted financial assets, the excess of statutory reserves over the amount of tax reserves, the sum of certain other reserves, and 50 percent of any policyholder dividends (or other similar liability) payable in the following taxable year. *See* § 809(b)(2), (3), (4), (5) and (6). Section 1.809–10 of the Income Tax Regulations provides that the equity base includes both the asset valuation reserve and the interest maintenance reserve for taxable years ending after December 31, 1991.

Section 1.809–9(a) of the regulations provides that neither the differential earnings rate under § 809(c) nor the recomputed differential earnings rate that is used in computing the recomputed differential earnings amount under § 809(f)(3) may be less than zero.

As described above, the differential earnings rate for 1996 and the recomputed differential earnings rate for 1995 affect the income and deductions reported by mutual life insurance companies on their federal income tax returns for the 1996 taxable year.

Data necessary to determine the tentative differential earnings rate for 1996 and the tentative recomputed differential earnings rate for 1995 have been compiled from returns filed by mutual life insurance companies and certain stock life insurance companies. The Internal Revenue Service is currently examining these returns. This examination will not be completed before the March 17, 1997, due date for filing 1996 calendar year returns.

NOTICE OF TENTATIVE RATES

This notice publishes a tentative determination of the differential earnings rate for 1996 and of the recomputed differential earnings rate for 1995. This notice also publishes a tentative determination of the rates on which the calculation of the differential earnings rate for 1996 and the recomputed differential earnings rate for 1995 are based. The final determination of these rates is expected to be published before September 1, 1997.

The tentative determination of the differential earnings rate for 1996 and the tentative determination of the recomputed differential earnings rate for 1995 that are published in this notice should be used by mutual life insurance companies to calculate the amount of tax liability for taxable years beginning in 1996 (in the case of companies that file returns before publication of the final determination of these rates) or to calculate the amount of estimated unpaid tax liability for taxable years beginning in 1996 (in the case of companies that are allowed an extension of time to file returns). Companies that file returns before publication of the final determination of these rates should file amended returns after the final determination of these rates is published. If there is a failure to pay tax for a taxable year beginning in 1996 and the failure is attributable to a difference between (a) the tentative determination of the differential earnings rate for 1996 and recomputed differential earnings rate for 1995 and (b) the final determination of these rates, then any such failure through September 15, 1997, will be treated as due to reasonable cause and will not give rise to any addition to tax under § 6651.

The tentative determination of the rates is set forth in Table 1.

Notice 97–17 Table 1

Tentative Determination of Rates To Be Used For Taxable Years Beginning in 1996

Differential earnings rate for 1996	6.555
Recomputed differential earnings rate for 1995	0
Imputed earnings rate for 1995	12.625
Imputed earnings rate for 1996	15.777
Base period stock earnings rate	18.221
Current stock earnings rate for 1996	17.422
Stock earnings rate for 1993	23.385
Stock earnings rate for 1994	11.437
Stock earnings rate for 1995	17.445
Average mutual earnings rate for 1994	9.222
Average mutual earnings rate for 1995	16.477

Transfers to Foreign Entities Under Sections 1491 Through 1494

Notice 97–18

This notice provides guidance with respect to certain transfers of property to foreign corporations, partnerships, trusts, or estates as described in section 1491 of the Internal Revenue Code (the ''Code''). This notice also provides guidance concerning the penalty imposed by section 1494(c) (''section 1494(c) penalty'') for failure to file a return reporting a transfer described in section 1491 (''section 1491 transfer''). Sections 1491 and 1494 were amended by the Small Business Job Protection Act of 1996 (the ''Act'').

The Act provides that the section 1494(c) penalty applies to transfers made after August 20, 1996. However, Notice 96–60, 1996–49 I.R.B. 7, announced that no section 1494(c) penalty would be imposed if a section 1491 transfer is reported no later than 60 days after issuance of forthcoming guidance. This notice provides the guidance referred to in Notice 96–60.

This notice is divided into eight sections. Section I provides background on the relationship of the new section 1494(c) penalty with sections 1491 through 1494, 6048, and 6677. Section II sets forth the section 1491 transfers that are reportable under section 1494. Section III explains various changes to the time and manner for reporting section 1491 transfers, including certain transfers by domestic trusts described in Notice 96–65, 1996–52 I.R.B. 28. Section IV contains examples illustrating the section 1494 reporting requirements. Section V provides guidance with respect to the section 1494(c) penalty. Section VI clarifies the application of section 1491 to organizations that have made an election under section 761(a). Section VII announces that no reporting is required under section 1494 on certain distributions from a corporation or partnership while Treasury and the Service study the appropriate treatment of such transfers under section 1491. Section VIII sets forth the effective date of this notice.

SECTION I. BACKGROUND

A. *Sections 1491 through 1494*

Section 1491 of the Code imposes a 35 percent excise tax on the transfer of property by a citizen or resident of the United States, or by a domestic corporation or partnership, or by an estate or trust that is not a foreign estate or a trust (''U.S. transferor'') to a foreign corporation if the transfer is made as paid-in surplus or as a contribution to capital. The excise tax is also imposed on any transfer of property by a U.S. transferor to a foreign partnership, estate or trust. Tax-free exchanges, gifts, sales in which any portion of the gain realized is deferred, and private annuity transactions are examples of transactions that are within the scope of section 1491. S. Rep. No. 938, 94th Cong. 2d Sess. 223 (1976), 1976–3 C.B. 49, 261. *See also* Rev. Rul. 78–357, 1978–2 C.B. 227. The excise tax is 35 percent of the excess of the fair market value of the property transferred over the transferor's adjusted basis in such property plus any gain recognized to the transferor at the time of the transfer.

Under section 1492, the excise tax imposed by section 1491 does not apply to: transfers to certain exempt organizations (section 1492(1)); transfers described in section 367 (section 1492(2)(A)); transfers with respect to which an election has been made to apply principles similar to the principles of section 367 (section 1492(2)(B)); or transfers with respect to which an election has been made under section 1057 (section 1492(3)).

Section 1494(a) provides that the excise tax is due and payable by the transferor at the time of the transfer, and shall be assessed, collected and paid under regulations prescribed by the Secretary. Under Treas. Reg. § 1.1494–1(a), a U.S. transferor is required to report a section 1491 transfer on Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership*, on the day the transfer is made. Any excise tax due must also be paid on the day of the transfer.

B. *Sections 1494(c), 6048 and 6677*

Section 6048(a), which requires a U.S. person to report certain transfers of property (including money) to foreign trusts, was amended by the Act to broaden the scope of reportable transactions between U.S. persons and foreign trusts. The Act also amended section 6677, which provides for a penalty equal to 35 percent of the gross value of the property transferred to a foreign trust if a U.S. person fails to comply with the reporting requirements of section 6048(a). Additional penalties are imposed if the failure to file continues after the Service mails notice of such failure to the person required to pay the penalty. The section 6677 penalty applies even if the transfer is to a foreign trust with respect to which the transferor is treated as the owner of the transferred property under sections 671 through

679. Congress imposed a significant penalty for failure to report such a transfer, even though there are no tax consequences resulting from the transfer, because of the need to trace transfers of property to a foreign trust to ensure that any subsequent income earned on the transferred property is correctly reported on the income tax return of a U.S. taxpayer. See H.R. Rep. No. 542, 104th Cong., 2d Sess., pt. 2, at 25 (1996).

The Act also adds new section 1494(c) to the Code, which imposes a penalty for failure to file a return required by the Secretary with respect to a section 1491 transfer. Section 1494(c) provides that a U.S. transferor shall be liable for the penalties provided in section 6677 as if such failure were a failure to file a notice under section 6048(a) (*i.e.*, a penalty equal to 35 percent of the gross value of the property transferred plus additional penalties for continuing failure to comply).

SECTION II. TRANSFERS SUBJECT TO REPORTING UNDER SECTION 1494

A. *Reportable section 1491 transfers*

Section 1491 applies to a broad range of transactions. Moreover, existing regulations require a U.S. transferor to report on the day of the transfer any transaction described in section 1491. *See* Treas. Reg. § 1.1494–1(a).

In order to administer section 1494(c) in a manner that is not overly burdensome, Treasury and the Service intend to amend the existing regulations to narrow the scope of transfers subject to reporting under section 1494. Until the regulations are amended, a U.S. transferor is required to report a section 1491 transfer only if it would be reportable under the guidance provided by this notice. Thus, no section 1494(c) penalty will be imposed on a transfer that is not reportable under this notice.

Treasury and the Service believe that a section 1491 transfer should be reported under section 1494 only if the United States has a significant tax interest in obtaining the required information. The United States has a significant tax interest in obtaining information on transfers of appreciated property to a foreign entity if the entire amount of gain is not immediately recognized by the U.S. transferor. In addition, the United States has a significant tax interest in obtaining information on transfers of any property to a foreign entity if the U.S. transferor may be required to pay U.S. tax on the income or gain generated by that property after the transfer. The new foreign trust reporting provisions identify these types of transfers to foreign trusts. This notice identifies these types of transfers to other foreign entities. Finally, Treasury and the Service believe that reporting should not be required under section 1494 with respect to certain transfers that are adequately reported pursuant to another Code section.

Thus, this notice announces that a U.S. transferor is not required to report a section 1491 transfer if:

(i) The U.S. transferor immediately recognizes gain (if any) on the transfer equal to the difference between the fair market value of the property and the U.S. transferor's adjusted basis in such property; and

(ii) The U.S. transferor does not have a significant interest in the transferee immediately after the transfer.

Thus, a U.S. transferor must report any transfer if the entire gain is not immediately recognized, even if the U.S. transferor does not have a significant interest in the transferee after the transfer. In addition, a transfer of property must be reported if the U.S. transferor has a significant interest in the transferee after the transfer, even if the property transferred consists of money or other unappreciated property. However, even if the transfer would otherwise be reportable under this notice, such reporting will be deemed satisfied if the transfer is adequately reported by the U.S. transferor pursuant to a section of the Code specified in section II.B of this notice.

1. *Taxable transfers for fair market value*

If the U.S. transferor immediately recognizes gain (if any) on the transfer equal to the difference between the fair market value of the property and the U.S. transferor's adjusted basis in such property, no excise tax is imposed and reporting is not required unless the U.S. transferor has a significant interest in the transferee, as discussed in Section II.A.2 of this notice. Therefore, unless the U.S. transferor has a significant interest in the transferee, fair market value sales of property by a U.S. person to a foreign partnership, trust or estate on which gain is immediately recognized are not required to be reported. However, if any portion of the gain realized on a transfer is not recognized or is deferred (e.g., installment sales or private annuity transactions), the transfer must be reported. Thus, for example, a U.S. person who contributes appreciated property to a foreign partnership in a transaction in which gain is not recognized generally must report the transfer under section 1494.

Certain transfers by U.S. transferors (described below) would not result in an income tax liability regardless of the method of the transfers. Thus, solely for purposes of section 1491, Treasury and the Service believe it is appropriate to treat such transferors as having immediately recognized the full amount of gain with respect to these transfers. Hence, an excise tax will not be imposed on the following transfers and such transfers will not be subject to reporting:

(i) A transfer by a U.S. transferor who is exempt from federal income taxation under section 501(a) or section 664(c), unless a sale of the transferred property would be subject to tax under section 511 as unrelated business taxable income;

(ii) A transfer to a foreign partnership, trust or estate by a domestic corporation, of stock (including treasury stock) in exchange for money or other property if the domestic corporation is not required to recognize gain on the transfer under section 1032; or

(iii) A transfer to a foreign partnership, trust or estate by a domestic partnership, of an interest in the domestic partnership in exchange for property if the domestic partnership is not required to recognize gain on the transfer under section 721.

2. *Transfers where the U.S. transferor has a significant interest in the transferee*

To obtain information on transfers of property by U.S. persons who may be required to pay U.S. tax on income or gain generated by that property, transfers of property (whether or not appreciated) to a foreign transferee must be reported if the U.S. transferor has a significant interest in the transferee after the transfer. Thus, this notice requires U.S. transferors to report section 1491 transfers of all types of property, including the taxpayer's functional currency (''money''), whenever the U.S. transferor has a significant interest in the transferee after the transfer, regardless of whether the transfers are fair market value sales in which all of the gain is recognized immediately.

For purposes of this notice, a U.S. transferor is treated as having a significant interest in a foreign transferee if the U.S. transferor and the foreign transferee are related persons within the meaning of section 643(i)(2)(B), with the following modifications:

(i) For purposes of applying section 267 (other than section 267(f)) and section 707(b)(1), ''at least 10 percent'' shall be substituted for ''more than 50 percent'' each place it appears;

(ii) The principles of section 267(b)(10), substituting ''at least 10 percent'' for ''more than 50 percent,'' shall apply to determine whether two corporations are related; and

(iii) The principles applicable to trusts shall apply to determine whether an estate is related to another person. For example, a U.S. transferor who owns a 10-percent interest in a foreign partnership immediately after the transfer will have a significant interest in the partnership.

B. *Duplicative reporting*

A U.S. transferor otherwise required to report a section 1491 transfer will be deemed to have satisfied the section 1494 reporting requirement without having to file Form 926 if the transferor complies with the reporting requirements described in one of the four sections below.

1. *Transactions with certain foreign corporations (section 6038)*

Section 6038 requires reporting of certain transactions between a U.S. person and foreign corporations controlled by the U.S. person. A U.S. person generally satisfies the reporting requirements of section 6038 by filing Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*. Capital contributions to foreign corporations that are subject to reporting under section 6038 are also section 1491 transfers.

To the extent section 6038 adequately addresses the reporting requirements with respect to transfers to these foreign corporations, it is not necessary to require additional reporting under section 1494. Therefore, a U.S. transferor that transfers money or other unappreciated property (or appreciated property where the full amount of the gain is recognized immediately) to a foreign corporation described in section 6038(a) is not required to report such transfer on Form 926 provided the U.S. transferor has otherwise complied with the reporting requirements of section 6038.

The reporting requirements of section 6038 do not provide sufficient information to determine the amount of excise tax due upon the transfer of appreciated property if the full amount of gain is not recognized immediately on the transaction. Therefore, a U.S. transferor is required to file Form 926 to report a section 1491 transfer of appreciated property in that case, even if the U.S. transferor has filed a Form 5471 with respect to the foreign transferee. See Section II.B.3, below, if a transfer of appreciated property is reported under sections 367 and 6038B.

2. *Transactions with certain foreign-owned corporations (section 6038A)*

Section 6038A requires reporting of certain transactions between U.S. corporations and related foreign parties if the U.S. corporation is 25-percent foreign owned. U.S. persons generally satisfy the reporting requirements of section 6038A by filing Form 5472, *Information Return of 25% Foreign-Owned U.S. Corporation or Foreign Corporation Engaged in a U.S. Trade or Business.* A transaction with a foreign entity that is subject to reporting under section 6038A may also be a section 1491 transfer.

To the extent section 6038A adequately addresses the reporting requirements with respect to transfers between a U.S. corporation and certain related foreign entities, it is not necessary to require additional reporting under section 1494. Therefore, a U.S. transferor that transfers money or other unappreciated property (or appreciated property where the full amount of the gain is recognized immediately) to a foreign entity described in section 6038A is not required to report such transfer on Form 926 provided the U.S. transferor reports the transfer on Form 5472 in compliance with the reporting requirements of section 6038A.

The reporting requirements of section 6038A do not provide sufficient information to determine the amount of excise tax due upon the transfer of appreciated property if the full amount of gain is not recognized immediately on the transaction. Therefore, a U.S. transferor is required to file Form 926 to report a section 1491 transfer of appreciated property in that case, even if the U.S. transferor has reported such transfer on Form 5472 with respect to the foreign transferee.

3. *Certain transactions involving foreign corporations (sections 367 and 6038B)*

Section 1492(2)(A) provides that to the extent a section 1491 transfer is described in section 367, such transfer is exempt from the section 1491 excise tax. For example, a transfer of property by a U.S. person to a wholly-owned foreign corporation as paid-in surplus or as a contribution to capital is a transfer described in both section 367 and section 1491. Existing regulations require U.S. persons to report transfers of property described in section 367(a) or (d) on Form 926 and to attach such information as is required under section 6038B. Temp. Treas. Reg. § 1.6038B–1T(b).

Because section 6038B addresses the reporting requirements for transfers of property described in section 367(a) and (d), it is not necessary to require additional reporting under section 1494. Therefore, a U.S. transferor that makes a transfer of property (either appreciated or unappreciated) described in both section 367 and section 1491 will satisfy the section 1494 reporting requirements to the extent the U.S. transferor reports the property transferred under section 6038B. If money or other unappreciated property is not reported under section 6038B such property must be reported under section 1494 unless the property is adequately reported under Section II.B.1 of this notice.

4. *Transactions with foreign trusts (section 6048)*

The Act amended section 6048(a) to require enhanced reporting of transfers of property, including money, between U.S. persons and foreign trusts. U.S. persons generally satisfy the reporting requirements of section 6048(a) by filing Form 3520. A transfer of property to a foreign trust for which reporting is required under section 6048(a) may also be a section 1491 transfer.

Because section 6048 adequately addresses the reporting requirements for transfers to foreign trusts, it is not necessary to require additional reporting under section 1494. Therefore, a U.S. transferor that makes a transfer of property (either appreciated or unappreciated) described in both sections 6048 and 1491 is not required to report such transfer on Form 926 provided the U.S. transferor complies with the reporting requirements of section 6048 and the U.S. transferor does not owe excise tax

under section 1491. Form 3520 will be revised to accommodate elections under section 1492(2)(B) or 1492(3) to avoid the section 1491 excise tax.

A U.S. transferor that makes a transfer of property described in both sections 6048 and 1491 is required to report such transfer on Form 926 only if the U.S. transferor owes excise tax under section 1491 on the transfer or fails to comply with the reporting requirements of section 6048.

SECTION III. CHANGES TO TIME AND MANNER FOR REPORTING TRANSFERS DESCRIBED IN SECTION 1491

Existing regulations require that every person making a section 1491 transfer make a return on Form 926 on the day of the transfer and pay any excise tax due at that time. Treas. Reg. § 1.1494–1(a). Treasury and the Service will amend the regulations to change the time and manner for reporting section 1491 transfers and paying any excise tax due. Until the regulations are amended, U.S. transferors who are required to file Form 926 with respect to section 1491 transfers made after August 20, 1996, must file Form 926 and pay any excise tax due in accordance with the procedures set forth in this notice.

A. *Time for filing*

Regulations under section 1494 will be amended to allow a U.S. transferor to file information regarding section 1491 transfers on an annual basis instead of at the time of the transfer. Until the regulations are amended, a U.S. transferor may either file Form 926 with the U.S. transferor's annual tax return or information return for the taxable year that includes the date of the transfer or may file Form 926 on the day the transfer is made. *See* Section III.D of this notice. *See also* Section VII of this notice for relief from penalties under section 1494(c) in certain cases.

B. *Elections made pursuant to section 1492*

A U.S. transferor can avoid the section 1491 excise tax by making certain elections under section 1492. One election allows a U.S. transferor to avoid the excise tax by electing, before the transfer, to apply principles similar to the principles of section 367. Section 1492(2)(B). A U.S. transferor that makes an election to apply principles similar to the principles of section 367 must comply with the reporting requirements of section 6038B.

Regulations will be issued under section 1494 to allow such election to be made with the U.S. transferor's annual tax return or information return for the taxable year that includes the date of the transfer. Until regulations are issued, an election to apply principles similar to the principles of section 367 must be made on Form 926. Further, provided the U.S. transferor indicates on Form 926 that such an election is being made, the information required by the regulations under section 6038B is attached to Form 926, and Form 926 accompanies the U.S. transferor's tax return for the taxable year that includes the date of the transfer, the U.S. transferor will be deemed to have made the election before the transfer.

Alternatively, a U.S. transferor can avoid the section 1491 excise tax by electing to treat the transfer as a taxable exchange under section 1057. Section 1492(3). This election must also be made on Form 926. A Form 926 that accompanies the U.S. transferor's tax return for the taxable year that includes the date of the transfer will satisfy the requirements in Treas. Reg. § 301.9100–12T that specify the time and manner for making an election under section 1057.

As described in Notice 96–65, 1996–52 I.R.B. 28, the Act amended section 7701(a)(30) and (31) to set forth new criteria that must be met to qualify as a domestic trust. Certain domestic trusts will be treated as making section 1491 transfers on January 1, 1997 as a result of becoming foreign trusts under the new law. If a domestic trust relies in good faith on Notice 96–65 to continue to file tax returns as a domestic trust, but is unable to meet the new domestic trust criteria by the end of the two-year period set forth in the notice, the trust may avoid the section 1491 excise tax by making a section 1057 election on the Form 3520 which must be attached to the domestic trust's 1997 amended tax return. Such election will be considered timely for purposes of section 1494(c) and Treas. Reg. § 301.9100–12T if Form 3520 is attached to the domestic trust's 1997 amended tax return that is filed by the due date of the trust's tax return for the taxable year that includes the date that is two years from the due date of the trust's 1997 tax return (including extensions).

C. *Manner of reporting transactions*

A U.S. transferor who transfers appreciated property that is reportable on Form 926 under this notice must separately identify the property on Form 926 if the full amount of gain is not recognized immediately on the transfer. *See* Form 926, Part III. In contrast, to the extent the transfer consists of money or other unappreciated property (or appreciated property in which the full amount of gain is recognized immediately) to a transferee in which the U.S. transferor has a significant interest immediately after the transfer, the value of transferred property may be aggregated by category on a statement attached to Form 926. The categories referred to in the preceding sentence, which are based on the categories of transactions listed on Form 5471, Schedule M, are:

(i) Sales of stock in trade (inventory);

(ii) Sales of tangible property other than stock in trade;

(iii) Sales of property rights (patents, trademarks, etc.);

(iv) Purchases of stock in trade (inventory);

(v) Purchases of tangible property, other than stock in trade;

(vi) Purchases of property rights (patents, trademarks, etc.);

(vii) Compensation paid for technical, managerial, engineering, construction, or like services;

(viii) Commissions paid;

(ix) Rents, royalties, and license fees paid;

(x) Interest paid;

(xi) Contributions to corporations, partnerships, trusts or estates (attach a brief description of the property transferred); and

(xii) All other transfers not required to be separately identified (attach a brief description of the type of transfer and property transferred).

If the transferee is a foreign corporation the U.S. transferor is only required to report transfers described in paragraph (xi) (relating to contributions to capital or paid-in surplus).

D. *Payment of tax*

Any excise tax due on a transfer of assets to a foreign transferee may be paid by attaching Form 926 (with the tax due) to the U.S. transferor's income tax return for the taxable year in which the transfer occurs. Interest must be paid on the amount of excise tax due at the underpayment rate determined under

section 6621 with respect to the period between the date on which the transfer occurred and the date on which the excise tax is actually paid. To avoid paying interest in the case of a transfer for which the excise tax is due, a U.S. transferor may instead file Form 926 and pay any excise tax due on the day of the transfer.

E. *Revisions to forms*

Form 926 and Form 3520 are being revised to reflect the guidance set forth in this notice. Until the revised forms are issued, U.S. transferors should continue to use existing Form 926 to report section 1491 transfers, adjusted as necessary to conform with the new reporting requirements set forth in this notice.

SECTION IV. EXAMPLES

The following examples illustrate the rules of this notice. In these examples UST is a U.S. transferor, FC is a foreign corporation, FP is a foreign partnership, and FT is a foreign trust.

Example 1. Transfer of appreciated property to a foreign corporation. UST transfers appreciated property to FC as a contribution to capital in a transfer described in section 351. The section 351 transfer is described in both section 367(a) and section 1491. UST is not required to report the transfer under section 1494 if the transfer is reported under section 6038B.

Example 2. Transfer of money to a foreign corporation. UST transfers money to FC as a contribution to capital. Immediately after the transfer UST owns 60 percent of the stock of FC. FC is not required to report the transfer on Form 926 provided UST files Form 5471 reflecting the transfer to FC for the taxable year in which the transfer took place.

Example 3. Transfer of appreciated property to a foreign partnership. UST transfers appreciated property to FP in a transaction described in section 721. UST must separately identify the property transferred on Form 926 and pay any excise tax due. UST may file Form 926 with its tax return for the taxable year in which the transfer took place and can make an election under section 1492 at that time to avoid the excise tax. (In contrast, under prior law UST would have been required to file Form 926 on the day of the transfer.)

Example 4. Transfer of money to a foreign partnership. UST makes several transfers of money to FP during a taxable year in transactions described in section 721. Immediately after each transfer UST has more than a 10 percent interest in the capital of FP. UST is required to report the transfers on Form 926. However, UST may aggregate the transfers of money into a single amount on Form 926.

Example 5. Transfer to a foreign trust. UST transfers appreciated property to FT. UST reports the transfer on Form 3520 under section 6048(a). UST is not required to report the transfer on Form 926 unless UST is liable for the section 1491 excise tax. UST can avoid any excise tax by making a section 1057 election directly on Form 3520.

SECTION V. SECTION 1494(c) PENALTY

Section 1494(c) imposes a penalty on a U.S. transferor who fails to report a section 1491 transfer for which reporting is required to the extent the transfer is not reported or is reported inaccurately. *See* sections 1494(c), 6677(a). Thus, if a U.S. person makes a section 1491 transfer of property worth $1,000,000 to a foreign transferee, but reports only $400,000 of that amount, the section 1494(c) penalty is imposed only on the $600,000 unreported amount. Further, the section 1494(c) penalty does not apply if failure to report a transfer is shown to be due to reasonable cause and not willful neglect. *See* sections 1494(c), 6677(d). For example, if an audit results in an allocation of income under section 482, and such allocation results in an adjustment treated as a capital contribution by a U.S. transferor to a foreign corporation, reasonable cause exists for failure to report such capital contribution under section 1494(c) if reasonable cause prevents the imposition of accuracy-related penalties under section 6662 in connection with the section 482 allocation.

Under Section II.B of this notice, a U.S. transferor is not required to report a section 1491 transfer on Form 926 if such transfer is subject to the reporting requirements of certain other Code sections. However, if the U.S. transferor has not complied with the reporting requirements of that section, the U.S. transferor will not be treated as having satisfied its reporting obligation under section 1494 and will be subject to penalties under section 1494(c). The amount of the penalty imposed under section 1494(c) will be reduced, however, by the amount of the penalty imposed for failing to comply with the reporting requirements of that other section.

SECTION VI. ORGANIZATIONS ELECTING UNDER SECTION 761(a)

Section 761(a) allows certain organizations that would otherwise be treated as partnerships to elect not to be treated as partnerships for purposes of subchapter K of the Code. Treasury and the Service believe that it is inappropriate to apply section 1491 to a foreign partnership that has made a section 761(a) election. Thus, a transfer to a foreign partnership with a valid section 761(a) election in effect will not be considered a transfer to that foreign partnership for purposes of section 1491.

SECTION VII. DISTRIBUTIONS FROM CORPORATIONS AND PARTNERSHIPS

Treasury and the Service are studying the appropriate scope of section 1491, including the treatment of corporate distributions described in section 301, 302 or 305, and partnership distributions described in section 731. Notwithstanding any other provision of this notice, until further guidance is issued taxpayers are not required to report such distributions, whether or not they constitute transfers described in section 1491. In addition, if further guidance requires that these transactions be reported, no penalty will be imposed under section 1494(c) on the failure to report any such distribution as long as a return reporting these transfers is filed no later than sixty days after the issuance of that guidance (or such later date as may be specified in that guidance). Moreover, any applicable election with respect to such distribution will be considered timely for purposes of Treas. Reg. § 301.9100–12T if such an election is filed in the manner required no later than sixty days after the issuance of that guidance (or such later date as may be specified in that guidance).

SECTION VIII. EFFECTIVE DATE

This Notice is effective for transfers of property occurring after August 20, 1996. No penalties will be imposed under section 1494(c) if a Form 926 reporting the section 1491 transfer (or other adequate reporting described in Section II.B of this notice) is filed by the due date of the U.S. transferor's income tax return, including extensions, for the taxable year in which the transfer occurred, or the date that is 60 days after the date this notice is published in the Internal Revenue Bulletin, whichever is later. See Notice 96–60.

PUBLIC COMMENT INVITED

Treasury and the Service invite comments on the guidance provided by this notice. Written comments should be submitted by June 10, 1997 to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:CORP:T:R (Notice 97–18)
Room 5228
Washington, D.C. 20044;

or, alternatively, via the internet at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

The comments you submit will be available for public inspection and copying.

DRAFTING INFORMATION

The principal authors of this notice are Wendy Stanley and Michael Kirsch of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Stanley or Mr. Kirsch on (202) 622–3860 (not a toll-free call).

Guidance for Expatriates Under Sections 877, 2501, 2107 and 6039F

Notice 97–19

PURPOSE

The Health Insurance Portability and Accountability Act of 1996 (the ''Act'') recently amended sections 877, 2107 and 2501 of the Internal Revenue Code (''Code''), and added new information reporting requirements under section 6039F.[1] This notice provides guidance regarding certain federal tax consequences under these sections and section 7701(b)(10) for certain individuals who lose U.S. citizenship, cease to be taxed as U.S. lawful permanent residents, or are otherwise subject to tax in the manner provided by section 877.

This notice has eleven sections. Section I provides background regarding the general application of sections 877, 2107 and 2501. Section II explains how to compute tax under section 877. Section III explains how an individual must determine his or her tax liability and net worth for purposes of sections 877, 2107 and 2501. Section IV explains the procedures that an individual must use to request a private letter ruling that the individual's loss of U.S. citizenship did not have for one of its principal purposes the avoidance of U.S. taxes. Section IV also provides that certain former long-term U.S. residents may use this ruling procedure to request a ruling that cessation of long-term U.S. residency did not have for one of its principal purposes the avoidance of U.S. taxes. Section V provides that certain transactions are treated as exchanges of property under section 877 and explains how to enter into a gain recognition agreement to avoid the immediate recognition of gain on exchanges of property. Section VI provides anti-abuse rules that apply to contributions made to certain foreign corporations. Section VII sets forth annual filing requirements for certain individuals subject to section 877. Section VIII explains how new section 877 interacts with certain U.S. income tax treaties. Section IX explains how to file information statements in accordance with section 6039F and describes the information that must be included on such statements. Section X explains how the transition provision of the Act affects certain individuals who performed an expatriating act prior to February 6, 1995. Section XI explains the application of section 7701(b)(10) and how that section interacts with section 877, as amended by the Act.

Treasury and the Service expect to issue regulations under sections 877 and 6039F, and amend regulations under sections 2107 and 2501, to incorporate the guidance set forth in this notice. Until regulations are issued, taxpayers must comply with the guidance set forth in this notice.

SECTION I. GENERAL APPLICATION OF SECTIONS 877, 2107 and 2501

Section 877 generally provides that a citizen who loses U.S. citizenship or a long-term resident who ceases to be taxed as a U.S. resident (collectively, individuals who ''expatriate'') within the 10-year period immediately preceding the close of the taxable year will be taxed on all of his or her U.S. source income (as modified by section 877(d)) for such taxable year, unless such loss or cessation did not have for one of its principal purposes the avoidance of U.S. taxes.

Section 877(a)(2) provides that a former citizen is considered to have lost U.S. citizenship with a principal purpose to avoid U.S. taxes if the former citizen's tax liability or net worth exceeded certain amounts on the date of expatriation. However, a former citizen will not be considered to have expatriated with a principal purpose to avoid U.S. taxes as a result of the individual's tax liability or net worth if he or she qualifies for an exception under section 877(c). To qualify for an exception, a former citizen must be described in certain statutory categories and submit a ruling request for a determination by the Secretary as to whether the individual's expatriation had for one of its principal purposes the avoidance of U.S. taxes. Section 877(c).

Section 2107(a)(1) generally provides that U.S. estate tax will be imposed on the transfer of the taxable estate of every nonresident decedent if, within the 10-year period ending with the date of death, the decedent lost U.S. citizenship, unless such loss did not have for one of its principal purposes the avoidance of U.S. taxes. Unless a former citizen qualifies for an exception as provided by section 877(c), such individual will be considered to have expatriated with a principal purpose to avoid U.S. taxes for purposes of section 2107 if the individual's tax liability or net worth exceeded certain amounts on the date of expatriation. Sections 2107(a)(2)(A) and (a)(2)(B).

Section 2501(a)(1) generally provides that a tax will be imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident. Section 2501(a)(2) provides that section 2501(a)(1) will not apply to the transfer of intangible property made by a nonresident not a citizen of the United States. Section 2501(a)(3)(A) provides that this exception does not apply in the case of a donor who, within the 10-year period ending with the date of a transfer, lost U.S. citizenship, unless such loss did not have for one of its principal purposes the avoidance of U.S. taxes. Unless a former citizen qualifies for an exception as provided by section 877(c), such individual shall be treated as having a principal purpose to avoid U.S. taxes for purposes of section 2501 if the individual's tax liability or net worth exceeded certain amounts on the date of expatriation. Sections 2501(a)(3)(B) and (a)(3)(C).

Section 877(e) provides comparable treatment for long-term residents. A long-term resident of the United States will be treated as if such resident lost U.S. citizenship for purposes of sections 877, 2107, 2501 and 6039F if the resident (i) ceases to be a lawful permanent resident of the United States, or (ii) commences to be treated as a foreign resident under the provisions of an income tax treaty between the United States and a foreign country and does

[1] There are currently two provisions of the Internal Revenue Code designated as section 6039F. Treasury intends to seek a technical correction to the Act to redesignate section 6039F, as added by the Act, as section 6039G. All subsequent references to section 6039F in this notice relate to section 6039F as contained in the Act.

not waive the benefits of such treaty applicable to residents of the foreign country.

Section 877(e)(1) defines a long-term resident as a non-U.S. citizen who was a lawful permanent resident of the United States in at least 8 taxable years during the period of 15 taxable years, ending with the taxable year in which such individual ceases to be a lawful permanent resident of the United States or commences to be treated as a resident of another country under an income tax treaty and does not waive the benefits of such treaty applicable to residents of the foreign country. For purposes of section 877, an individual is considered a lawful permanent resident in a taxable year if he or she is a lawful permanent resident during any portion of that year.

Section 877(e)(3)(B) provides that property held by a long-term resident on the date that such individual first became a resident of the United States (whether or not a lawful permanent resident) shall be treated for purposes of section 877 as having a basis of not less than the fair market value of the property on such date. A long-term resident may elect not to have this treatment apply. Such an election, once made, is irrevocable.

Sections 877, 2107 and 2501, as amended by the Act, apply to individuals who expatriate after February 5, 1995, and to individuals subject to section 511(g)(3)(A) of the Act (see section X of this notice).

SECTION II. COMPUTING TAX UNDER SECTION 877

Individuals who expatriate with a principal purpose to avoid U.S. taxes will be subject to tax on U.S. source income (as modified by section 877(d)) under sections 1, 55 or 402(d)(1)[2] of the Code (the ''alternative tax''), or under section 871 of the Code, depending on which method results in the highest total tax. Sections 877(a)(1) and (b).

An expatriate is subject to the alternative tax under section 877 only if the total tax imposed thereunder on all items of income for the taxable year exceeds the total tax under section 871 for those same items of income. The following example illustrates how to compute tax under section 877.

Example 1. A, a former U.S. citizen, expatriated with a principal purpose to avoid U.S. taxes on December 31, 1996. In 1997, A earns $100,000 of U.S. source dividend income and $50,000 of U.S. source interest income that qualifies as portfolio interest under section 871(h). After taking into account the deductions and credits allowed under section 877(b)(2), A's net tax liability under section 1 on the dividend and portfolio interest income is $40,000.

The tax imposed under section 871 on A's dividend income is $30,000 (30 percent of $100,000). Section 871(a)(1)(A). No tax is imposed on A's portfolio interest under section 871 because section 871(h)(1) exempts portfolio interest received by a nonresident alien from U.S. tax. Thus, A's tax liability under section 871 is $30,000.

Since A's total tax liability computed under section 1 exceeds A's total tax liability computed under section 871, A must pay the higher tax. Thus, A must report $40,000 of U.S. tax on his 1997 U.S. income tax return (Form 1040NR) as a result of section 877.

SECTION III. TAX LIABILITY AND NET WORTH TESTS

Background. Section 877(a)(2) provides that a former citizen is considered to have expatriated with a principal purpose to avoid U.S. taxes if (i) the individual's average annual net U.S. income tax (as defined in section 38(c)(1)) for the five taxable years prior to expatriation is greater than $100,000 (the ''tax liability test''), or (ii) the individual's net worth on the date of expatriation is $500,000 or more (the ''net worth test''). The $100,000 and $500,000 amounts are subject to cost-of-living adjustments determined under section 1(f)(3) for calendar years after 1996. An individual who does not satisfy the tax liability or net worth test, but expatriates with a principal purpose to avoid U.S. taxes, is also subject to section 877.

Section 2107(a)(2)(A) provides that an individual shall be treated as having a principal purpose to avoid U.S. taxes for purposes of section 2107 if such individual satisfies either the tax liability test or the net worth test under section 877(a)(2). Likewise, section 2501(a)(3)(B) provides that an individual shall be treated as having a principal purpose to avoid U.S. taxes for purposes of section 2501 if such individual satisfies either the tax liability test or the net worth test under section 877(a)(2). The tax liability and net worth tests also apply for purposes of determining whether a former long-term resident is subject to sections 877, 2107, and 2501. Section 877(e)(1).

Determination of tax liability. For purposes of the tax liability test, an individual's net U.S. income tax is determined under section 38(c)(1). An individual who files a joint income tax return must take into account the net income tax that is reflected on the joint income tax return for purposes of the tax liability test.

Determination of net worth. For purposes of the net worth test, an individual is considered to own any interest in property that would be taxable as a gift under Chapter 12 of Subtitle B of the Code if the individual were a citizen or resident of the United States who transferred the interest immediately prior to expatriation. For this purpose, the determination of whether a transfer by gift would be taxable under Chapter 12 of Subtitle B of the Code must be determined without regard to sections 2503(b) through (g), 2513, 2522, 2523, and 2524.

An interest in property includes money or other property, regardless of whether it produces any income or gain. In addition, an interest in the right to use property will be treated as an interest in such property. Thus, a nonexclusive license to use property is treated as an interest in the underlying property attributable to the value of the use of such property.

Valuation of interests in property. In determining the values of interests in property for purposes of the net worth test, individuals must use the valuation principles of section 2512 and the regulations thereunder without regard to any prohibitions or restrictions on such interest. Although individuals must use good faith estimates of values, formal appraisals are not required.

Special rules for determining beneficial interests in trusts. An individual's beneficial interest in a trust must be included in the calculation of that individual's net worth. For this purpose, the value of an individual's beneficial interest in a trust will be determined using a two-step process. First, all interests in property held by the trust must be allocated to beneficiaries (or potential beneficiaries) of the trust based on all relevant facts and circumstances, including the terms of the trust instrument, letter of wishes (and any similar document), historical patterns of trust distributions, and any functions performed by a trust protector or similar advisor. Interests in property held by the trust that cannot be allocated based on the factors described in the previous sentence shall

[2] Section 402(d)(1) of the Code generally provides for 5-year income averaging with respect to certain lump-sum distributions from qualified retirement plans. Section 1401(b)(1) of the Small Business Job Protection Act of 1996 amended section 877(b) by striking ''section 1, 55, and section 402(d)(1)'' and inserting ''section 1 or 55.'' This amendment applies to taxable years beginning after December 31, 1999.

be allocated to the beneficiaries of the trust under the principles of intestate succession (determined by reference to the settlor's intestacy) as contained in the Uniform Probate Code, as amended. Second, interests in property held by a trust that are allocated to the expatriate must be valued under the principles of section 2512 and the regulations thereunder without regard to any prohibitions or restrictions on such interest. The following example illustrates this special rule.

Example 2. B, a former long-term resident, expatriated on December 31, 1996. B is a potential beneficiary of two trusts during his lifetime. Trust 1's sole asset is an apartment building. Under the terms of Trust 1, B is entitled to receive 100 percent of the income generated by the apartment building during B's life. B's brother, C, is the remainderman. For purposes of computing B's net worth, Trust 1's interest in the apartment building is allocated between B and C. B is treated as owning a life interest in the apartment building. The value of the life interest must be determined under the principles of section 2512 and the regulations thereunder.

Trust 2 was established by B's father for the benefit of B and C. Under the terms of Trust 2, the trust income and corpus may be distributed at the trustee's discretion to either B or C. For purposes of determining B's net worth, all of the interests in property owned by Trust 2 must first be allocated to either B or C based on all relevant facts and circumstances. If the facts and circumstances do not indicate how the interest in the trust's property should be allocated between B and C, the trust property will be allocated under the rules of intestate succession (determined by reference to B's father's intestacy) as contained in the Uniform Probate Code. If B's father had died intestate, the Uniform Probate Code would have allocated his property equally between B and C. Thus, for purposes of determining B's net worth, B will be treated as owning half of the interests in property owned by Trust 2. The value of these interests in property will be determined under the principles of section 2512.

SECTION IV. RULING REQUESTS

Background. Section 877(c) provides that a former U.S. citizen who satisfies either the tax liability test or the net worth test will not be considered to have a principal purpose of tax avoidance as a result of one of those tests if that former citizen submits a request for a ruling within one year of the date of loss of U.S. citizenship for the Secretary's determination as to whether such loss had for one of its principal purposes the avoidance of U.S. taxes. To be eligible to request a ruling, an individual must be within one of the following categories: (1) the individual became at birth a citizen of the United States and a citizen of another country and continues to be a citizen of such other country, (2) the individual becomes (not later than the close of a reasonable period after loss of U.S. citizenship) a citizen of the country in which the individual, the individual's spouse or one of the individual's parents was born, (3) the individual was present in the United States for no more than 30 days during each year of the 10-year period ending on the date of expatriation, (4) the individual lost U.S. citizenship before reaching age 18 1/2, or (5) the individual is described in a category prescribed by regulation. For purposes of sections 2107 and 2501, a former citizen who meets the requirements of section 877(c)(1) will not be considered to have expatriated with a principal purpose to avoid U.S. taxes. Sections 2107(a)(2)(B) and 2501(a)(3)(C).

Section 877(e)(3)(A) provides that the exception set forth in section 877(c) with respect to U.S. citizens shall not apply to former long-term residents. However, section 877(e)(4) gives the Secretary the authority to exempt categories of former long-term residents from section 877. In addition, section 877(e)(5) authorizes the Secretary to prescribe appropriate regulations to carry out the purposes of section 877(e).

Additional categories of individuals eligible to submit ruling requests. Treasury and the Service expect to issue regulations that will permit a former long-term resident who is within certain categories to request a ruling under sections 877, 2107 and 2501 as to whether the individual's expatriation had for one of its principal purposes the avoidance of U.S. taxes. Until such regulations are issued, a former long-term resident may request a ruling if:

(1) on the date of expatriation, the individual is a citizen of:

(a) the country in which the individual was born,

(b) the country where the individual's spouse was born, or

(c) the country where either of the individual's parents was born, and

the individual becomes (not later than the close of a reasonable period after the individual's expatriation) fully liable to tax in such country by reason of the individual's residence;

(2) the individual was present in the United States for no more than 30 days during each year of the 10-year period prior to expatriation; or

(3) the individual ceases to be taxed as a lawful permanent resident, or commences to be treated as a resident of another country under an income tax treaty and does not waive the benefits of such treaty applicable to residents of the foreign country, before the individual reaches age 18 1/2.

In addition, former long-term residents and former citizens who narrowly fail to satisfy the criteria of an enumerated category may also submit ruling requests. The Secretary, in his or her sole discretion, may decline to rule on any request if the Secretary determines that the individual does not narrowly fail to satisfy the criteria of one of those categories. If the Secretary declines to rule on an individual's ruling request for this reason, the individual will not be considered to have ''submitted'' a ruling request within the meaning of section 877(c)(1)(B). Accordingly, if that individual satisfies either the tax liability or net worth test, the individual will be considered to have expatriated with a principal purpose to avoid U.S. taxes under section 877(a)(2).

Examples. The following examples illustrate circumstances in which an individual narrowly fails to satisfy the criteria of an enumerated category, and thus eligible to request a ruling.

Example 3. D, a former citizen of the United States by birth, expatriated on February 15, 1997. D satisfied the tax liability test on the date of her expatriation and thus, will be considered to have expatriated with a principal purpose to avoid U.S. taxes unless she qualifies for an exception under section 877(c). D has resided in the United Kingdom since 1985. D is not a citizen by birth of another country and does not plan to become a citizen of a country in which one of her parents or her spouse was born. D did not spend any time in the United States during the 10-year period prior to her expatriation, except for one year when she vacationed in Hawaii for 35 days. D narrowly fails to satisfy the criteria of section 877(c)(2)(B) because she spent only 35 days in the United States during one year of the 10-year period ending on the date of her expatriation. Thus, D is eligible to submit a ruling request.

Example 4. E is a citizen of France and a long-term resident of the United States. E's parents emigrated from Africa to France in 1950 and acquired French citizenship in 1960. E's parents were employed by the French government and often travelled outside of France. In 1965, E was born while E's parents were stationed outside of France on a short-term assignment. By virtue of his parents' French citizenship, E became a citizen of France at birth. E resided in France from age 1 until age 21. E became a lawful permanent resident of the United States at age 21. E is now 31 years old and wishes to relinquish his green card and return to France. E will satisfy the net worth test on the date of his expatriation.

Although E is not a citizen of France by virtue of being born in France, E narrowly fails to satisfy the criteria of an enumerated category because he was born outside of France only because his parents were temporarily absent from France during an overseas assignment for the French government. E is a citizen of France by birth, became a resident of France at age 1, and plans to become a

resident of France after terminating his U.S. residency. Thus, E is eligible to submit a ruling request.

Effect of rulings and pending ruling requests. An expatriate who satisfies the tax liability or net worth test will be subject to new sections 877, 2107 or 2501, unless such individual obtains a favorable ruling, rather than merely submits a request, that the individual did not expatriate with a principal purpose to avoid U.S. taxes. If an individual's ruling request is pending before the Service at the time prescribed for filing the individual's income tax return for a particular year, the individual must report income on his or her U.S. income tax return for that year as if section 877 applied to him or her. If the individual obtains a favorable ruling at a later date, the individual may then amend that previous year's U.S. income tax return accordingly.

Challenging an adverse ruling. An individual who obtains an adverse ruling may challenge the ruling by initiating a refund suit to recover any taxes paid by reason of section 877. See H.R. Conf. Rep. No. 736, 104th Cong., 2d Sess. 325 (1996).

Time for submitting ruling requests. Ruling requests must be submitted no later than one year following the date of expatriation. If an individual does not submit a ruling request within this prescribed period and satisfies either the tax liability test or the net worth test, such individual will be treated as having a principal purpose to avoid U.S. taxes. However, an individual subject to new section 877 who expatriated after February 5, 1994, but on or before July 8, 1996, and who wishes to submit a ruling request as to whether such expatriation had for one of its principal purposes the avoidance of U.S. taxes must do so by July 8, 1997.

Ruling requests may be submitted prior to the expected date of expatriation, provided that the individual submitting the request has formed a definite intention to expatriate. The Service will not rule on requests involving alternative plans of proposed transactions or hypothetical situations. See section 7.02 of Rev. Proc. 97–1, 1997–1 I.R.B. 11, 24.

Procedures for submitting ruling requests. Individuals should refer to section 8 of Rev. Proc. 97–1, 1997–1 I.R.B. 11, 25, for general instructions on the proper procedures to follow when submitting ruling requests. Individuals should also consult section 15 of Rev. Proc. 97–1, 1997–1 I.R.B. 11, 46, for information on user fees.

Information that must be included in ruling requests. The burden of proof is on the individual requesting the ruling to establish to the satisfaction of the Secretary that the individual's expatriation did not (or will not) have for one of its principal purposes the avoidance of U.S. taxes under Subtitle A or Subtitle B of the Code. Therefore, individuals should submit any relevant information that will help the Secretary make a determination as to whether the individual's expatriation (or planned expatriation) had (or will have) for one of its principal purposes the avoidance of U.S. taxes. The ruling request must include the following information:

(1) the date (or expected date) of expatriation;

(2) a full explanation of the individual's reasons for expatriating;

(3) the individual's date of birth;

(4) all foreign countries where the individual is a resident for tax purposes and/or intends to obtain residence for tax purposes;

(5) all foreign countries of which the individual is a citizen and/or intends to acquire citizenship after expatriation;

(6) the countries where the individual's spouse (if any) and parents were born;

(7) a description of the individual's ties to the United States and the individual's ties to the foreign country where the individual resides (or intends to reside) for the period that begins five years prior to expatriation and ends on the date that the ruling request is submitted, including the location of the individual's permanent home, tax home (within the meaning of section 911(d)(3)), family and social relations, occupation(s), political, cultural, or other activities, business activities, personal belongings, the place from which the individual administers property, the jurisdiction in which the individual holds a driver's license, the location where the individual conducts routine personal banking activities, the location of the individual's cemetery plot (if any), and any other similar information;

(8) a balance sheet, at fair market value, that sets forth by category (e.g., cash, marketable securities, closely-held stock, business assets, qualified and nonqualified deferred compensation arrangements, individual retirement accounts, installment obligations, U.S. real property, foreign real property, etc.) the individual's assets and liabilities immediately prior to expatriation. The balance sheet must also set forth the following:

(i) the source of income and gain, without applying the source provisions of section 877, that such property would have generated during the 5-year period prior to expatriation and immediately after expatriation,

(ii) the source of income and gain, assuming that the source provisions of section 877 applied (as modified by section V of this notice), that such property would have generated during the 5-year period prior to expatriation and immediately after expatriation, and

(iii) the gain or loss that would be realized if the assets were sold for their fair market values on the date of expatriation.

The individual must separately list (not by category) each partnership in which the individual holds an interest, each trust that the individual is considered to own under sections 671 through 679, each trust that the individual is considered to own under Chapter 12 of Subtitle B of the Code, and each trust in which the individual holds a beneficial interest (as determined under the procedures described in section III of this notice). The individual must also describe the types of assets held by each partnership or trust, and indicate the methodology (as described in section III of this notice) used to determine the individual's beneficial interest in each trust. In addition, the individual should indicate whether there have been (or are expected to be) significant changes in the individual's assets and liabilities for the period that began five years prior to expatriation and ends ten years following the date of expatriation. If so, the individual should attach a statement explaining the changes in the individual's assets and liabilities during such period;

(9) a description of all exchanges described in section 877(d)(2)(B) and all removals of appreciated tangible personal property from the United States (as described in section V of this notice), that:

(i) occurred at any time beginning 5 years prior to expatriation (but not including exchanges that took place prior to February 6, 1995) and ending on the date that the ruling request is submitted, or

(ii) occurred, or are expected to occur, during the 10-year period following expatriation.

If the individual is subject to new section 877 because of section 511(g)(3)(A) of the Act (see section X

of this notice), the individual must also include a description of all exchanges described under section 877(d)(2)(B) that occurred on or after the date of the individual's expatriating act (see section X of this notice) and before February 6, 1995;

(10) a description of all occurrences under section 877(d)(2)(E)(ii) that are treated as exchanges under section 877(d)(2) (as described in section V of this notice) that:

(i) occurred at any time beginning 5 years prior to expatriation (but not including occurrences that took place prior to February 24, 1997) and ending on the date that the ruling request is submitted, or

(ii) occurred, or are expected to occur, during the 10-year period following expatriation;

(11) a statement describing the nature and status of any ongoing audits, disputes or other matters pending before the Internal Revenue Service;

(12) a statement as to whether the individual satisfied his or her U.S. tax liability during the period that he or she was a U.S. citizen or lawful permanent resident of the United States;

(13) copies of the individual's U.S. tax returns for each of the three years prior to expatriation;

(14) a copy of the information statement filed in accordance with section 6039F, as described in section IX of this notice (if such statement has not yet been filed, provide a draft copy of such statement);

(15) in the case of an individual with gross assets that have an aggregate fair market value in excess of $10,000,000, a calculation of the individual's projected U.S. and foreign income tax liability for the taxable year of expatriation (or expected expatriation) and the two taxable years following expatriation under each of the following circumstances:

(i) if it is determined that the individual expatriated with a principal purpose to avoid U.S. taxes under section 877,

(ii) if it is determined that the individual did not expatriate with a principal purpose to avoid U.S. taxes under section 877, and

(iii) if the individual had remained a U.S. citizen or U.S. lawful permanent resident.

The individual must also indicate whether the individual expects a substantial change in the individual's projected U.S. and foreign income tax liability as a result of a change in income for the remainder of the 10-year period following expatriation;

(16) in the case of an individual with gross assets that have an aggregate fair market value in excess of $10,000,000, an actuarial estimate of U.S. and foreign estate and other death taxes that would be owed on the individual's property, calculated based on the assumption that the individual owns the same property on the date of death that the individual owned (or expects to own) on the date of expatriation, under each of the following circumstances:

(i) if it is determined that the individual expatriated with a principal purpose to avoid U.S. taxes under section 2107,

(ii) if it is determined that the individual did not expatriate with a principal purpose to avoid U.S. taxes under section 2107, and

(iii) if the individual had remained a U.S. citizen or U.S. lawful permanent resident domiciled in the United States; and

(17) in the case of an individual with gross assets that have an aggregate fair market value in excess of $10,000,000, a statement as to whether the individual expects to make a gift during any year of the 10-year period following expatriation that would be subject to tax under section 2501 if the individual is determined to have expatriated with a principal purpose to avoid U.S. taxes. If so, the individual should describe the gift, provide an estimate of its fair market value, and indicate when and to whom the individual expects to make the gift.

The foregoing list of information must be provided with ruling requests submitted after March 10, 1997. Although individuals must provide good faith estimates of fair market values, formal appraisals are not required. In processing ruling requests, the Service may ask individuals with gross assets that have an aggregate fair market value of $10,000,000 or less to supply the information described in (15), (16) and (17) above. If an individual fails to provide the aforementioned information or any other information that may be reasonably required, the individual's ruling request may be closed pursuant to section 10.06(3) of Rev. Proc. 97–1, 1997–1 I.R.B. 11, 39. If an individual's ruling request is closed, that individual will not be considered to have ''submitted'' a ruling request within the meaning of section 877(c)(1)(B). Accordingly, if that individual satisfies either the tax liability test or the net worth test, the individual will be considered to have expatriated with a principal purpose to avoid U.S. taxes under section 877(a)(2).

Finally, an individual must attach his or her ruling to the individual's U.S. income tax return for the year in which the individual expatriates. See section 8.05 of Rev. Proc. 97–1, 1997–1 I.R.B. 11, 33. If the individual has already filed a U.S. income tax return for such year, the individual must attach the ruling to the individual's U.S. income tax return for the year in which he or she obtains the ruling.

SECTION V. EXCHANGES AND GAIN RECOGNITION AGREEMENTS

Background. Section 877(d)(1)(A) provides that gains on the sale or exchange of property (other than stock or debt obligations) located in the United States shall be treated as from sources within the United States. Section 877(d)(1)(B) provides that gains on the sale or exchange of stock issued by a domestic corporation or debt obligations of United States persons, or of the United States, a State, a political subdivision thereof, or the District of Columbia, shall be treated as from sources within the United States. Section 877(d)(1)(C) provides that income or gain derived from a foreign corporation will be from sources within the United States if an expatriate owned or is considered to own (under the principles of sections 958(a) and (b)), at any time during the 2-year period ending on the date of expatriation, more than 50 percent of (i) the total combined voting power of all classes of stock entitled to vote of such corporation, or (ii) the total value of the stock of such corporation. The amount of income or gain that is considered U.S. source is limited, however, to the amount that does not exceed the earnings and profits attributable to such stock earned before the date of the individual's expatriation and during periods that the ownership requirements are met.

Section 877(d)(2) generally provides that certain property transferred in nonrecognition exchanges by an individual subject to section 877 during the 10-year period referred to in section 877(a) will be treated as sold for its fair market value on the date of the exchange. Thus, any gain must be recognized by the individual in the taxable year of the exchange. Section 877(d)(2) applies to

exchanges that, without regard to section 877, are nontaxable under subtitle A of the Code and involve the exchange of property that would produce U.S. source income or gain for property that would produce foreign source income or gain.

Under section 877(d)(2)(C), however, an individual is not required to immediately recognize gain if the individual enters into an agreement with the Secretary specifying that any income or gain derived from the property acquired in the exchange (or any other property that has a basis determined in whole or in part by reference to such property) during the 10-year period referred to in section 877(a) shall be treated as U.S. source income. In addition, if the transferred property is disposed of by the acquiror, the gain recognition agreement will terminate and any gain not recognized by reason of the agreement must be recognized by the individual as of the date of such disposition.

Section 877(d)(2)(D) provides the Secretary with regulatory authority to substitute the 15-year period beginning five years prior to expatriation for the 10-year period referred to in section 877(a), and to apply section 877(d)(2) to all exchanges that occur during such 15-year period. Section 877(d)(2)(E) also authorizes the Secretary to issue regulations to treat as a taxable exchange the removal of appreciated tangible personal property from the United States, and any other occurrence that results in a change in the source of income or gain from property from U.S. source to foreign source without recognition of gain.

Fifteen-year period and expanded definition of "exchanges". Treasury and the Service expect to issue regulations under sections 877(d)(2)(D) and (E) that extend the 10-year period referred to section 877(a) and provide an expanded definition of exchanges. The regulations will apply to individuals who expatriate after February 5, 1995, and to individuals subject to section 511(g)(3)(A) of the Act (see section X of this notice). Until regulations are issued, taxpayers must comply with the rules set forth below.

Section 877(d)(2) must be applied by substituting the 15-year period beginning five years prior to expatriation for the 10-year period referred to in section 877(a). In addition, removal of appreciated tangible personal property from the United States with an aggregate fair market value in excess of $250,000 within this 15-year period must be treated as an exchange to which section 877(d)(2) applies. Accordingly, any gain derived from removal of property with an aggregate fair market value of $250,000 or less during this 15-year period will not be taxable under section 877. If an individual removes property with an aggregate fair market value in excess of $250,000 during this 15-year period, the individual must recognize a pro rata portion of the gain attributable to the value in excess of $250,000, unless he or she enters into a gain recognition agreement. A pro rata portion of the gain must be calculated by multiplying the total gain on the removed property by a fraction, the numerator of which is the excess of the aggregate fair market values of all removed property over $250,000 and the denominator of which is the aggregate fair market values of all removed property. Removal of appreciated tangible personal property during the 5-year period prior to expatriation (whether or not the fair market values exceed $250,000) will not be treated as an exchange if the removal occurred prior to February 6, 1995.

Any other occurrence (within the meaning of section 877(d)(2)(E)(ii)) within the 15-year period that results in a change of the source of income or gain from U.S. source to foreign source must also be treated as an exchange to which section 877(d)(2) applies. However, an occurrence during the 5-year period prior to expatriation will not be treated as an exchange if the occurrence took place prior to February 24, 1997.

Determination of source of certain gains. The principles of section 877(d)(1) generally apply for purposes of determining whether any exchange of property changes the source of income or gain from U.S. source to foreign source during the 15-year period beginning five years prior to expatriation. Thus, solely for purposes of determining the source of the expatriate's income or gain with respect to any exchange within this 15-year period, (i) the source of any gain on the sale or exchange of tangible personal property will be based on the physical location of the property, (ii) the source of gain from the sale or exchange of stock will be based on the corporation's place of incorporation (except as otherwise provided in section 877(d)(1)(C)), and (iii) the source of gain from the sale or exchange of debt obligations will be based on the residence of the issuer of such obligations. The source of gain on the sale or exchange of an interest in a partnership during the 15-year period will be determined as if the partner directly disposed of his or her share of the partnership's assets. In determining the partner's share of gain recognized from each partnership asset, the gain on the sale or exchange of the partnership interest shall be allocated among the assets of the partnership in proportion to the gain that the partner would have recognized had the partnership sold each asset for its fair market value. In all other cases, the source of an expatriate's income or gain with respect to any other transaction will be determined under the general source provisions of the Code (e.g., sections 861 through 865).

Recognition of gain. Except as otherwise indicated below, an individual must recognize any realized or unrealized gains, but not losses, as a result of any ''exchange'' described in section 877(d)(2)(B), (d)(2)(E)(i), or (d)(2)(E)-(ii), in the year of the exchange unless that individual enters into a gain recognition agreement. If an exchange occurs during the 5-year period prior to expatriation, the individual must recognize any gain from the exchange in the taxable year of the individual's expatriation unless the individual enters into a gain recognition agreement.

Examples. The following examples illustrate transactions that are treated as exchanges under section 877(d)(2) and when gain from such transactions must be recognized.

Example 5. F, a U.S. citizen by birth, enters into a notional principal contract in March 1997. Under the terms of that contract, F is obligated to make specified annual payments to an unrelated party in exchange for specified annual payments from the unrelated party for a period of five years. F is a calendar year taxpayer who uses the cash method of accounting. F moves her tax home to a foreign country in May 1997. F renounces her U.S. citizenship in 1998 with a principal purpose to avoid U.S. taxes.

The source of income from a notional principal contract is generally determined by reference to the residence of the taxpayer. For this purpose, the residence of an individual is the country in which the individual's tax home is located. See Treas. Reg. § 1.863–7(a)(1).

Before F changed her tax home in May 1997, F's income earned under the contract was treated as U.S. source income. After F changed her tax home, the source of this income became foreign source. Because F's change in tax home changed the source of her income from U.S. source to foreign source, it is an occurrence that is treated as an exchange to which section 877(d)(2) applies. Since this occurrence occurred in the 5-year period prior to her expatriation, F must recognize any gain from the contract in 1998 (the taxable year of her expatriation), unless she enters into a gain recognition agreement.

However, if F also owned stock in a foreign corporation, her change in tax home coupled with her expatriation would not be an occurrence that is

treated as an exchange to which section 877(d)(2) applies with respect to such stock. Pursuant to the special source rules described in this notice, the source of gain on the sale or exchange of stock is based on the corporation's place of incorporation. Thus, the gain on the sale or exchange of foreign stock would be foreign source for the entire 15-year period beginning five years prior to expatriation. Accordingly, there would not be an occurrence during this period that would change the source of such gain from U.S. source to foreign source.

Example 6. G is a U.S. citizen by birth. G owns a home in the United States that he uses as his principal residence. In April 1997, G sells his principal residence in the United States at a gain of $1,000,000. In June 1997, G purchases a new principal residence located abroad. G's purchase of the new residence satisfies the requirements of section 1034, and thus G does not recognize the $1,000,000 gain on the sale of his old residence. G expatriates in 1999 with a principal purpose to avoid U.S. taxes.

Under section 861(a)(5), gain from the disposition of a United States real property interest is treated as U.S. source income. A United States real property interest includes real property that is located in the United States. Section 897(c). Gain from the sale or exchange of real property located outside the United States is considered foreign source income. Section 862(a)(5).

Since G is not required to recognize the gain on the sale of his old residence by reason of section 1034, and the source of this gain would change from U.S. to foreign if G sold his new residence, it is an occurrence that is treated as an exchange to which section 877(d)(2) applies. Accordingly, G must recognize the gain from the sale of his old residence in 1999 (the taxable year of his expatriation), unless he enters into a gain recognition agreement.

Example 7. H is a former long-term resident of the United States. H owns a valuable painting that she purchased in 1965 for $500,000. H became a resident of the United States and brought the painting to the United States in 1975. The fair market value of the painting in 1975 was $2,000,000. H became a lawful permanent resident of the United States in 1980. On January 1, 1996, H expatriates with a principal purpose to avoid U.S. taxes. On January 1, 1997, H removes the painting from the United States. On that date, the fair market value of the painting is $5,000,000.

Under section 877(d)(1)(A), H's unrealized gain in the painting is U.S. source so long as the painting is located in the United States. Since the removal of H's appreciated painting from the United States changed the source of the unrealized gain thereon from U.S. source to foreign source, it is considered an exchange to which section 877(d)(2) applies. For purposes of section 877, H's basis in the painting is the painting's fair market value on the date that H first became a U.S. resident (i.e., $2,000,000). Section 877(e)(3)(B). Thus, H's unrealized gain on the painting on the date of removal is $3,000,000 ($5,000,000–$2,000,000).

Because the value of H's painting on the date of removal exceeds $250,000, H must recognize a pro rata portion of the gain attributable to the value in excess of $250,000, unless she enters into a gain recognition agreement. The pro rata portion of such gain is $2,850,000, determined by multiplying the total gain ($3,000,000) by a fraction, the numerator of which is the excess of the fair market value of the painting over $250,000 ($4,750,000) and the denominator of which is the fair market value of the painting ($5,000,000). Thus, H must recognize $2,850,000 in 1997 (the taxable year of the removal) unless she enters into a gain recognition agreement.

Example 8. J, a U.S. citizen by birth, expatriates on January 1, 1999, with a principal purpose to avoid U.S. taxes. On the date of J's expatriation, J owns appreciated stock in a domestic corporation. On January 1, 2000, J creates a foreign trust, FT, and contributes the stock to FT. Under the terms of the trust instrument, the income and corpus from FT may be distributed at the discretion of the trustee to J, J's spouse, or J's children.

If J had directly disposed of the domestic stock instead of contributing it to FT, the gain realized thereon would be treated as U.S. source income. Section 877(d)(1)(B). However, if FT disposed of the stock, the gain realized would be foreign source because FT is not a resident of the United States. See sections 865(a)(2) and (g)(1)(B). If FT then distributed the proceeds to J, his gain would also be foreign source.

Since J's contribution of the domestic stock to FT is nontaxable under subtitle A of the Code and changed the source of gain on the stock from U.S. to foreign, it is an occurrence that is treated as an exchange to which section 877(d)(2) applies. For this purpose, J's beneficial interest in FT is treated as property acquired in the exchange, and the stock contributed to FT is treated as property transferred in the exchange. Therefore, J must recognize the pre-contribution gain on the appreciated stock in 2000 (the taxable year of the exchange), unless he enters into a gain recognition agreement.

Guidance on gain recognition agreements. An individual who wishes to enter into a gain recognition agreement with the Secretary with respect to any exchange described in section 877(d)(2) must submit the agreement with the individual's U.S. income tax return (normally Form 1040NR) for the taxable year of the exchange. If an exchange occurred during the 5-year period prior to expatriation, the individual must submit a gain recognition agreement with his or her U.S. income tax return for the taxable year of the individual's expatriation. If an exchange occurred before the individual's 1996 taxable year, the individual must submit a gain recognition agreement with his or her 1996 Form 1040NR to avoid the recognition of gain.

The gain recognition agreement will be triggered if the individual disposes of the property to which the gain recognition agreement applies. In addition, any disposition of the transferred property by the acquiror of such property will also trigger gain, even if the disposition is otherwise part of a nonrecognition transaction. For purposes of the gain recognition agreement, property removed from the United States and property the source of income or gain from which changed from U.S. to foreign will be treated as property acquired in an exchange.

All gain recognition agreements must be signed under penalties of perjury and set forth the following information:

(1) a description of all property subject to the agreement, (i.e., a description of property both transferred and acquired in an exchange, a description of any appreciated tangible personal property that was removed from the United States, and/or a description of all property affected by an occurrence that changed the source of income or gain from the property from U.S. source to foreign source);

(2) a good faith estimate of the relevant fair market values of the property transferred and acquired in the exchange (formal appraisals are not required), their adjusted basis for U.S. tax purposes, and a calculation of the gain not recognized by reason of the gain recognition agreement (the ''deferred gain'') on a property-by-property basis;

(3) a statement that the individual agrees to recognize, under section 877, any income or gain during the 15-year period that begins five years prior to expatriation as U.S. source income if it is derived from property that was acquired in an exchange (as described in this notice);

(4) a statement that the individual agrees to recognize, under section 877, a proportionate amount of the deferred gain as U.S. source income as of the date of disposition if the acquiror of the transferred property disposes of all or a portion of the property in any manner during the 15-year period beginning five years prior to expatriation;

(5) a statement that the individual agrees to file a U.S. income tax return (normally Form 1040NR) for each year of the 10-year period following expatriation (whether or not such individual is otherwise required to file a return) that includes an annual certification each year describing any income or gain that is taxable pursuant to the gain recognition agreement. If the individual did not derive any income or gain that is taxable pursuant to the gain recognition agreement, the certification must provide a statement to that effect;

(6) if an exchange to which the gain recognition agreement applies occurred during the 5-year period prior to expatriation, a certification describing any income or gain during this 5-year period that is taxable pursuant to the gain recognition agreement. If the individual did not derive any income or gain that is taxable pursuant to the gain recogni-

tion agreement during this period, the certification must provide a statement to that effect;

(7) a representation that all records relating to the property to which the gain recognition agreement applies, including those of the acquiror (if any), will be made available for inspection by the Service during the period that ends 3 years from the date on which a U.S. income tax return is filed for the year(s) in which any income or gain that is taxable pursuant to the gain recognition agreement is recognized;

(8) a statement that the individual agrees to furnish a bond or other security that satisfies the requirements of Treas. Reg. § 301.7701–1 if the District Director determines that such security is necessary to ensure the payment of tax upon the deferred gain and any other income or gain that is taxable pursuant to the gain recognition agreement; and

(9) if applicable, the name, address, and U.S. taxpayer identification number (if any) of the acquiror of any property subject to the agreement.

If, during the period that the agreement is in force, the individual disposes of the property acquired in the exchange in a transaction in which gain or loss is not recognized under U.S. income tax principles, then the individual shall not be required to recognize gain, provided that the individual notifies the Secretary of the transfer with his or her next annual certification and modifies the gain recognition agreement accordingly.

Example. The following example illustrates how to enter into a gain recognition agreement.

Example 9. Assume the same facts as in example 8 above. To avoid the immediate recognition of gain on the contribution of stock to FT, J must attach a gain recognition agreement to his U.S. tax return for the year 2000 (the taxable year of the exchange). As part of such agreement, J must agree to recognize any income or gain that J derives from his beneficial interest in FT as U.S. source income during the remainder of the 10-year period following expatriation. J must also agree to recognize the pre-contribution gain on the transferred stock as U.S. source income if FT directly or indirectly disposes of the stock. In addition, J must agree to file an annual certification for each year of the remaining 10-year period following expatriation that indicates whether J derived any income or gain from his beneficial interest in FT and whether FT disposed of the stock. J must represent that all records relating to the transferred stock, including the trust's records, will be made available for inspection by the Service for the period ending 3 years from the date on which J files a U.S. income tax return for the year in which he recognizes the deferred gain as a result of a direct or indirect disposition of the stock by FT. J must also represent that all records relating to his beneficial interest in FT will be made available for inspection by the Service for the period ending 3 years from the date(s) on which J files a U.S. income tax return for the year(s) in which he recognizes any income or gain from his beneficial interest in FT.

SECTION VI. CONTRIBUTIONS TO CONTROLLED FOREIGN CORPORATIONS

Background. Section 877(d)(4) generally provides that when an expatriate contributes U.S. source property (''contributed property'') to a corporation that would be a controlled foreign corporation (as defined in section 957) and the individual would be a United States shareholder (as defined in section 951(b)) but for the individual's expatriation, then any income or gain on such property (or any other property that has a basis determined in whole or in part by reference to such property) received or accrued by the corporation during the 10-year period following expatriation shall be treated as received or accrued directly by the individual and not by the corporation. If the individual disposes of any stock in the corporation (or other stock that has a basis determined in whole or part by reference to such stock) during the 10-year period referred to in section 877(a) and while the contributed property is held by the corporation, the individual is taxable on the gain that would have been recognized by the corporation had it sold a pro rata share of the property (determined by comparing the value of the stock disposed of to the value of the stock held by the individual immediately prior to the disposition) immediately before the disposition. Section 877(d)(4)(D) provides that the Secretary may prescribe such regulations as may be necessary to prevent the avoidance of the purposes of section 877(d)(4), including where the property is sold to the corporation and where the contributed property is sold by the corporation. Section 877(d)(4)(E) provides that the Secretary shall require such information reporting as is necessary to carry out the purposes of section 877(d)(4).

Anti-abuse rules and reporting requirement. Treasury and the Service intend to issue regulations under sections 877(d)(4)(D) and (E) that extend the 10-year period referred to in section 877(d)(4), set forth reporting requirements, and provide anti-abuse rules intended to prevent individuals from utilizing controlled foreign corporations to hold or dispose of property that would otherwise produce income or gain from sources within the United States. The regulations will provide that if an individual acts with a principal purpose to avoid section 877(d)(4), then the Commissioner may redetermine the U.S. tax consequences of that action as appropriate to achieve the purposes of section 877(d)(4). The regulations will apply to individuals who expatriate after February 5, 1995, and to individuals subject to section 511(g)(3)(A) of the Act (see section X of this notice).

Until regulations are issued, individuals must comply with the rules set forth below. Individuals must apply section 877(d)(4) by substituting the 15-year period beginning five years prior to expatriation for the 10-year period referred to in section 877(d)(4). However, section 877(d)(4) will not apply to any contribution during the 5-year period prior to expatriation if the contribution occurred prior to February 24, 1997.

Moreover, an individual who makes a contribution described in section 877(d)(4)(A)(i) must attach the following information to the individual's U.S. tax return for the year in which such contribution occurs (whether or not the individual is otherwise required to file a U.S. tax return):

(1) the date of the contribution;

(2) a description of the property contributed, including a good faith estimate of its fair market value (formal appraisals are not required) and a statement of its adjusted basis for U.S. tax purposes on the date of the contribution;

(3) a description of the foreign corporation to which the property is contributed, including its name, address, place of incorporation, and its U.S. employer identification number, if any; and

(4) a description of the percentage interest, by vote and by value, owned or treated as owned by the individual under section 958 (determined as if such individual were a U.S. person).

If a contribution occurs prior to expatriation, this statement must be attached to the individual's U.S. income tax return for the taxable year of the individual's expatriation. If a contribution occurred prior to 1996, the individual must attach this statement to the individual's 1996 U.S. tax return (whether or not the individual is otherwise required to file a U.S. tax return).

SECTION VII. ANNUAL INFORMATION REPORTING

Background. Section 6001 generally provides that the Secretary may require any person, by notice upon such person

or by regulations, to make such returns, render such statements, or keep such records as the Secretary deems sufficient to show whether or not the person is liable for tax under the Code. Section 6011(a) generally provides that any person who is liable for tax imposed by the Code, or with respect to the collection thereof, shall make a return or statement according to forms and regulations prescribed by the Secretary. Section 6012(a)(1) generally provides that every individual whose gross income for the taxable year equals or exceeds the exemption amount must file a U.S. income tax return for such year. Section 6012(a)(1) further provides, in part, that nonresident individuals subject to tax imposed by section 871 may be exempted from making returns under section 6012 subject to conditions, limitations, and exceptions and under such regulations as may be prescribed by the Secretary. Treas. Reg. § 1.6012–1(b)(2)(i) generally provides, in part, that a nonresident alien individual who was not engaged in a trade or business in the United States during a taxable year is not required to file a return for such year if the nonresident's tax liability for the year is fully satisfied by the withholding of tax at the source under Chapter 3 of the Code.

Section 874(a) generally provides that a nonresident alien individual will receive the benefit of deductions and credits allowed to him by Subtitle A of the Code only if such individual files a true and accurate return, including all the information that the Secretary may deem necessary for the calculation of such deductions and credits.

Annual reporting of income. Because an individual who is liable for U.S. taxes is generally required to file a return and other such statements as the Secretary may prescribe, Treasury and the Service intend to issue regulations under section 877 that will require expatriates who are liable for tax to annually report certain information for the 10-year period following expatriation. Until the issuance of such regulations, taxpayers must report information in compliance with the rules set forth below and any other information that the Secretary may require at a later date. At such time that Form 1040NR is modified to reflect the rules described below, taxpayers must report information in accordance with the instructions to Form 1040NR instead of the procedures described below. The rules below apply to expatriates who are subject to section 877 as in effect before the Act, as well as those subject to section 877 as revised by the Act.

Beginning with the 1996 taxable year, an individual who expatriated with a principal purpose to avoid U.S. taxes under section 877 as in effect before the Act must annually file a U.S. income tax return (Form 1040NR), with the information described below, for each year of the remaining 10-year period following expatriation if such individual is liable for U.S. tax under any provision of the Code (e.g., section 871(a)) for such year. An individual who expatriated with a principal purpose to avoid U.S. taxes under section 877 as amended by the Act must also annually file a U.S. income tax return (Form 1040NR), with the information described below, for each year of the 10-year period following expatriation if such individual is liable for U.S. tax under any provision of the Code (e.g., section 871(a)) for such year.[3]

The return must bear the statement ''Expatriation Return'' across the top of page 1 of Form 1040NR. In addition, a statement must be attached to the return that sets forth by category (e.g., dividends, interest, etc.) all items of U.S. and foreign source gross income (whether or not taxable in the United States). The statement must identify the source of such income (determined under section 877 as modified by section V of this notice) and those items of income subject to tax under section 877. In addition, any expatriate who has not previously filed an information statement under section 6039F should also attach to his or her first nonresident return a statement containing the information described in section IX of this notice.

Treasury and the Service intend to amend Treas. Reg. § 1.6012–1(b)(2)(i) in accordance with the rules of this notice. Until the regulation is modified, an expatriate who is otherwise required to report information in accordance with this section of the notice must attach a statement to Form 1040NR, even if the individual has fully satisfied his or her tax liability through withholding of tax at source.

An expatriate who fails to furnish a complete statement in any year for which he or she is liable for any U.S. taxes will not be considered to have filed a true and accurate return. Therefore, such an individual will not be entitled to the benefit of any deductions or credits if the individual's tax liability for that year is later adjusted. See section 874(a).

An individual who is required to file the above statement for the taxable year that begins in 1995 will be considered to have timely filed his or her statement for that year if the individual files such statement by the due date (including extensions) for filing the individual's U.S. income tax return for the taxable year that begins in 1996.

SECTION VIII. INTERACTION WITH TAX TREATIES

Background. The legislative history of the Act indicates that Congress believed that section 877, as amended, is generally consistent with the underlying principles of U.S. income tax treaties to the extent that section 877 provides for a foreign tax credit for items taxed by another country. To the extent that there is a conflict with U.S. income tax treaties in force on August 21, 1996 (the date of enactment of section 877), Congress intended that ''the purpose of section 877, as amended...[is] not to be defeated by any treaty provision.'' H.R. Rep. No. 496, 104th Cong., 2d Sess. 155 (1996). See also, H.R. Conf. Rep. No. 736, 104th Cong., 2d Sess. 329 (1996). However, any conflicting treaty provisions that remain in force 10 years after August 21, 1996, will take precedence over section 877, as revised. Id.

Coordination with tax treaties. In accordance with Congressional intent, Treasury and the Service will interpret section 877 as consistent with U.S. income tax treaties. To the extent that there is a conflict, however, all provisions of section 877, as amended, prevail over treaty provisions in effect on August 21, 1996. This coordination rule is effective until August 21, 2006, and applies to those provisions of section 877 that were amended by the Act as well as those that were not amended by the Act. In addition, Treasury and the Service will interpret all treaties, whether or not in force on August 21, 1996, that preserve U.S. taxing jurisdiction with respect to former U.S. citizens or former U.S. long-term residents who expatriate with a principal purpose to avoid U.S. taxes as consistent with the provisions of section 877, as amended.

[3] Individuals should refer to Treas. Reg. § 1.6012–1(b)(2)(ii) for guidance on how to file a U.S. income tax return for the taxable year of the individual's expatriation.

SECTION IX. INITIAL INFORMATION REPORTING

Background. Section 6039F(a) requires each individual who loses U.S. citizenship to provide an information statement to the U.S. Department of State or a federal court, as applicable. The information reporting requirements of section 6039F apply to individuals who expatriate after February 5, 1995, and to individuals subject to section 511(g)(3)(A) of the Act (see section X of this notice).

Section 6039F(a)(1) requires that this information must be provided not later than the earliest date on which such individual (1) renounces the individual's U.S. nationality before a diplomatic or consular officer of the United States, (2) furnishes to the U.S. Department of State a statement of voluntary relinquishment of U.S. nationality confirming an act of expatriation, (3) is issued a certificate of loss of U.S. nationality by the U.S. Department of State, or (4) loses U.S. nationality because the individual's certificate of naturalization is cancelled by a U.S. court (collectively, the ''reporting date'').

Section 6039F(b) requires a former citizen to report his taxpayer identification number, mailing address of principal foreign residence, foreign country in which the individual is residing, foreign country of citizenship, information on the individual's assets and liabilities if such individual's net worth exceeds $500,000 (as adjusted by section 1(f)(3) for taxable years after 1996), and such other information as the Secretary may prescribe. Section 6039F(f) requires long-term residents who expatriate after February 5, 1995, to provide a similar statement with their U.S. tax returns for the taxable year of expatriation.

If a former citizen fails to provide the required information statement, section 6039F(d) generally provides that the individual will be subject to a penalty equal to the greater of (1) five percent of the tax required to be paid under section 877 for the taxable year ending during such year, or (2) $1,000. The penalty will be assessed for each year during which such failure continues for the 10-year period beginning on the date of loss of citizenship. The penalty will not be imposed if it is shown that such failure is due to reasonable cause and not willful neglect. Section 6039F(f) also applies this penalty to former long-term residents.

Information Statements. Until such time that a form is issued for providing the statement required by section 6039F, individuals must file an information statement that includes the information set forth below.

(1) A former U.S. citizen whose reporting date is on or before March 10, 1997, must provide the information statement to the Internal Revenue Service, 950 L'Enfant Plaza SW, Washington, D.C. 20224, ATTN: Compliance Support & Services, by June 8, 1997. Former U.S. citizens who furnished the information enumerated in section 6039F(b) to the appropriate entity prior to February 24, 1997, are not required to provide an additional statement.

(2) A former U.S. citizen whose reporting date is after March 10, 1997, and on or before June 8, 1997, must provide the information statement to (i) the American Citizens Services Unit, Consular Section, of the nearest American Embassy or consulate, (ii) Office of Policy Review and Interagency Liaison (CA/OCS/PRI), Room 4817, Department of State, Washington D.C., 20520–4818, or (iii) a federal court (if the expatriate's certificate of nationality was cancelled by such court), on or before June 8, 1997.

(3) A former U.S. citizen whose reporting date is after June 8, 1997 must provide the information statement to the (i) American Citizens Services Unit, Consular Section, of the nearest American Embassy or consul, or (ii) a federal court (if the expatriate's certificate of nationality was cancelled by such court) on or before such reporting date.

(4) A former long-term resident who expatriated after February 5, 1995, and before January 1, 1996, must attach the information statement to either a 1996 Form 1040NR (whether or not the individual is otherwise required to file a U.S. tax return) or an amended 1995 U.S. income tax return. To comply with new section 877, an individual whose 1995 tax liability changed as a result of new section 877 must amend the individual's 1995 return accordingly and include the information statement with that amended return. A former long-term resident who expatriated in the 1995 taxable year will be deemed to have timely furnished the information statement if a statement is filed by the due date (including extensions) for filing the individual's 1996 return. A former long-term resident who expatriated after 1995 must attach an information statement to the former resident's U.S. income tax return for the year of expatriation. Former long-term residents who have already furnished the information enumerated in section 6039F(b) to the Internal Revenue Service prior to February 24, 1997, are not required to provide an additional statement.

Former citizens and former long-term residents must include the following information in their information statements:

(1) name;

(2) date of birth;

(3) taxpayer identification number;

(4) mailing address prior to expatriation;

(5) address where the individual resided prior to expatriation, if different from (4) above;

(6) mailing address of principal foreign residence, if any;

(7) address where the individual expects to reside after expatriation, if different from (6) above;

(8) all foreign countries of which the individual is a citizen and the dates and methods by which such citizenship was acquired;

(9) the number of days (including vacation and nonwork days) that the individual was physically present in the United States during the year of expatriation (up to and including the date on which the information statement is filed) and each of the two preceding taxable years;

(10) in the case of an individual whose average annual net U.S. income tax (as defined in section 38(c)(1)) for the five taxable years prior to expatriation exceeded $100,000, the net U.S. income tax for each of these years (rounded to the nearest $50,000). If the individual's average annual net U.S. income tax liability for the preceding five taxable years did not exceed $100,000, the individual must provide a representation to that effect;

(11) in the case of an individual with gross assets that have an aggregate fair market value in excess of $500,000, a balance sheet, using good faith estimates of fair market values (formal appraisals are not required), that sets forth by category (e.g., cash, marketable securities, closely-held stock, business assets, qualified and nonqualified deferred compensation arrangements, individual retirement accounts, installment obligations, U.S. real property, foreign real property, etc.) the individual's assets and liabilities immediately prior to expatriation. The balance sheet must also set forth the following:

(i) the source of income and gain, without applying the provisions of section 877, that such property would have generated during the 5-year period prior to expatriation and immediately after expatriation,

(ii) the source of income and gain, assuming that the provisions of section 877 applied (as modified by section V of this notice), that such property would have generated during the 5-year period prior to expatriation and immediately after expatriation, and

(iii) the gain or loss that would be realized if the assets were sold for their fair market values on the date of expatriation.

The individual must separately list (not by category) each partnership in which the individual holds an interest, each trust that the individual is considered to own under sections 671 through 679, each trust that the individual is considered to own under Chapter 12 of Subtitle B of the Code, and each trust in which the individual holds a beneficial interest (as determined under the procedures described in section III of this notice). The individual must also describe the types of assets held by each partnership or trust, and indicate the methodology (as described in section III of this notice) used to determine the individual's beneficial interest in each trust. In addition, the individual should indicate whether there have been significant changes in the individual's assets and liabilities for the period that began five years prior to expatriation and ends on the date that the information statement is filed. If so, the individual should attach a statement explaining the changes in the individual's assets and liabilities during such period;

(12) in the case of a former long-term U.S. resident, a representation as to whether the former resident was treated as a resident of a foreign country under a U.S. income tax treaty for any year in the preceding 15 years. If so, the individual must list the foreign countries and years when this occurred. The individual must also list any year(s) that the former resident waived the benefits of that treaty; and

(13) a representation, signed under penalties of perjury by the individual, that the facts contained in the information statement are true, correct and complete to the best of the individual's knowledge and belief.

An individual who timely files a statement in accordance with the above guidelines will not be subject to the penalties described in section 6039F(d). All individuals whose reporting dates occur after such time that a form is issued for reporting information under section 6039F must complete and submit that form to comply with their reporting requirements under section 6039F.

SECTION X. TRANSITION PROVISION

Background. Sections 877 and 6039F generally apply to individuals who expatriate after February 5, 1995. However, section 511(g)(3)(A) of the Act provides a special transition provision in the case of a former citizen who performed an expatriating act specified in paragraph (1), (2), (3), or (4) of section 349(a) of the Immigration and Nationality Act (8 U.S.C. 1481(a)(1)–(4)) before February 6, 1995, but who did not on or before such date furnish to the U.S. Department of State a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of such act. Such an individual would not come within the general effective date of the amendments to sections 877 and 6039F because, under the provisions for determining the date of loss of citizenship (which were not modified by the Act), the date of loss of citizenship is retroactive to the date of the expatriating act (i.e., prior to February 6, 1995). See Treas. Reg. § 1.1–1(c).

The transition provision states that section 6039F and the amendments made to section 877 by the Act shall apply to such an individual, except that the 10-year period referred to in section 877(a) shall not expire before the end of the 10-year period beginning on the date the signed statement of voluntary relinquishment is furnished to the U.S. Department of State. Thus, such an individual is subject to new section 877 as of the date of loss of citizenship and the 10-year period referred to in section 877(a) shall not expire before the end of the 10-year period beginning on the date the signed statement of voluntary relinquishment is furnished to the U.S. Department of State.

Section 511(g)(3)(B) of the Act states that the transition provision of section 511(g)(3)(A) will not apply if the individual establishes to the satisfaction of the Secretary of the Treasury that the individual's loss of U.S. citizenship occurred before February 6, 1994. Accordingly, section 6039F will not apply to such an individual and he will be subject to section 877 as in effect before the amendments made by the Act.

Example. The following example illustrates the application of section 511(g)(3)(A) of the Act.

Example 10. K joined a foreign army on October 1, 1994, with the intent to relinquish his U.S. citizenship, but did not furnish a statement of voluntary relinquishment of citizenship to the U.S. Department of State until October 1, 1995. K is subject to new section 877 beginning on October 1, 1994, the date that K performed the expatriating act. However, the 10-year period referred to in section 877(a) will not expire before the end of the 10-year period beginning on the date that K furnished a statement of voluntary relinquishment of citizenship to the U.S. Department of State. K furnished this statement on October 1, 1995. Thus, K is subject to new section 877 for the period that began on October 1, 1994, and ends on September 30, 2005.

Special rule for individuals who claim to be within the exception under section 511(g)(3)(B) of the Act. An individual who (i) furnished a signed statement of voluntary relinquishment of U.S. nationality to the U.S. Department of State after February 5, 1995, and (ii) claims that new section 877 does not apply because of the exception to the transition provision in section 511(g)(3)(B) of the Act, must (whether or not the individual is otherwise required to file a U.S. tax return) attach a statement to Form 1040NR for the year in which the signed statement of voluntary relinquishment is furnished to the U.S. Department of State (or to the individual's 1996 Form 1040NR if the statement of voluntary relinquishment was furnished during 1995). The return must bear the statement ''Expatriation Return'' across the top of page 1 of such return. The statement attached to the return must include the nature and date of the expatriating act, the date the signed statement of voluntary relinquishment was furnished to the U.S. Department of State, and a copy of the individual's certificate of loss of nationality. An individual who does not file a statement in the manner prescribed above will not be considered to have established to the satisfaction of the Secretary of the Treasury that the individual lost U.S. citizenship before February 6, 1994.

SECTION XI. INTERACTION WITH SECTION 7701(b)(10)

Background. Section 7701(b)(10) applies to an alien individual who was treated as a resident of the United States during any period that includes at least three consecutive calendar years (the ''initial residency period'') and ceased to be treated as a U.S. resident, but subse-

quently becomes a U.S. resident before the close of the third calendar year beginning after the initial residency period. Under section 7701(b)(10), such an individual will be taxed in the manner provided by section 877(b) for the period after the close of the initial residency period and before the date on which the individual subsequently becomes a U.S. resident. This provision applies only if the tax imposed pursuant to section 877(b) exceeds the tax imposed under section 871.

Application of section 7701(b)(10). An individual described in section 7701(b)(10) will be subject to tax on U.S. source income in the manner provided by section 877(b) (as modified by section 877(d)) for the period after the close of the initial residency period and before the date on which the individual subsequently becomes a U.S. resident (the ''intervening period''). Because the tax imposed by reason of section 7701(b)(10) applies regardless of whether the individual had a principal purpose to avoid U.S. taxes, sections 877(a), (c), and (f), as amended, do not apply to an individual who is subject to tax in the manner provided by section 877(b) solely by reason of section 7701(b)(10).

Section 877(e) also does not generally apply to an individual who is subject to tax in the manner provided by section 877(b) solely by reason of section 7701(b)(10). However, to treat former residents who are subject to tax by reason of section 7701(b)(10) in a similar manner as former long-term residents who are subject to section 877, all property held by an individual on the date that such individual first became a resident of the United States shall be treated solely for purposes of section 7701(b)(10) as having a basis of not less than the fair market value of the property on such date, unless the individual elects not to have this treatment apply.

Reporting requirements for individuals subject to section 7701(b)(10). An individual who is liable for U.S. tax by reason of section 7701(b)(10) during any year of the intervening period must file U.S. income tax returns (Form 1040NR) reporting such tax liability for each of those years by the due date (including extensions) for filing the individual's U.S. income tax return for the year that the individual subsequently becomes a U.S. resident. If tax returns for the years of the intervening period have already been filed, the individual must amend those returns accordingly to comply with section 7701(b)(10).

An individual described in section 7701(b)(10) who is liable for U.S. taxes under any provision of the Code during the intervening period (e.g., section 871(a)) must attach a statement to his or her U.S. tax return that sets forth, by category (e.g., dividends, interest, etc.), all items of U.S. and foreign source gross income (whether or not taxable in the United States) derived during each year of the intervening period. Such statement must identify the source of such income (determined under section 877 as modified by section V of this notice), the items of income subject to tax in the manner provided by section 877(b), and any other information that the Secretary may prescribe at a later date.

The statement must be filed even if the individual has fully satisfied his or her U.S. tax liability for a taxable year through withholding at source. As discussed in section VII of this notice, Treasury and the Service expect to modify Treas. Reg. § 1.6012–1(b)(2)(i) in accordance with rules of this notice.

Any individual who fails to furnish a complete statement, as described above, for the years of the intervening period will not be considered to have filed a true and accurate return. Therefore, such an individual will not be entitled to the benefit of any deductions or credits if the individual's return is later adjusted. See section 874(a).

An individual who is required to file the above statement for the taxable year that begins in 1995 will be considered to have timely filed his or her statement for that year if the individual files such statement by the due date (including extensions) for filing the individual's U.S. income tax return for the taxable year during which the individual subsequently becomes a U.S. resident.

Exchanges under section 877(d)(2) and contributions under section 877(d)(4). An individual subject to tax by reason of section 7701(b)(10) must recognize any gain realized during the intervening period on exchanges of property described in section 877(d)(2), unless the individual enters into a gain recognition agreement in accordance with section V of this notice. The gain recognition agreement must be submitted with the individual's U.S. income tax return (Form 1040NR) for the year of the exchange. The gain recognition agreement and the return must be filed by the due date (including extensions) for filing the individual's U.S. income tax return for the year during which the individual subsequently becomes a U.S. resident. If a tax return for the year of the exchange has already been filed, the individual must amend that return and attach a gain recognition agreement to the amended return to comply with section 7701(b)(10).

The period of such a gain recognition agreement will be for the intervening period, and not the 15-year period beginning five years prior to expatriation. Moreover, annual certification is not required. Rather, the individual must submit with the gain recognition agreement a certification that the acquiror (if any) has not disposed of the transferred property, and that the individual did not dispose of the property acquired in the exchange (or any other property that has a basis determined in whole or in part by reference to such property). In addition, the certification must also state whether the individual derived any income or gain from the property acquired in the exchange during the intervening period.

If any property to which the gain recognition applies was disposed of during any year of the intervening period, the individual must recognize gain for the year of disposition. Any income or gain derived during the intervening period from a contribution described under section 877(d)(4) must also be recognized for the relevant year. However, section 7701(b)(10) will not cause an individual to recognize any income or gain with respect to any exchange under section 877(d)(2) or contribution of property under section 877(d)(4) that occurred prior to the beginning of the individual's initial residency period or after the date on which the individual subsequently becomes a U.S. resident.

Example. The following example illustrates how section 7701(b)(10) interacts with section 877 and when income that arises by reason of section 7701(b)(10) must be recognized.

Example 11. L was a resident alien of the United States in 1994, 1995 and 1996 because she satisfied the substantial presence test of section 7701(b)(3) for each of those years. In 1997 and 1998, L was not a resident of the United States. In 1999, L re-establishes residency in the United States. L is subject to tax in the manner provided by section 877(b) by reason of section 7701(b)(10). On February 1, 1997, L contributed property to a ''controlled foreign corporation'' in a transaction described in section 877(d)(4).

Any income or gain derived from the property that L contributed to the foreign corporation during the intervening period is subject to tax in the manner provided by section 877(d)(4). Thus, L

must report such income or gain by filing income tax returns for 1997 and 1998 by the due date (including extensions) for filing her 1999 U.S. income tax return. If income tax returns for 1997 and 1998 have already been filed, L must amend those returns to comply with section 7701(b)(10). Any income or gain derived after the intervening period is not taxable under section 877(d)(4).

Coordination with income tax treaties. The rules of section VIII (interaction with tax treaties) of this notice do not apply to an individual who is subject to tax in the manner provided by section 877(b) solely by reason of section 7701(b)(10). Accordingly, such an individual may claim benefits under a U.S. income tax treaty for transactions that occur during the intervening period if such individual is otherwise eligible for benefits as a foreign resident under the terms of such treaty.

Effective date. New section 877 will apply to an individual subject to tax thereunder by reason of section 7701(b)(10) if the individual's initial residency period ended after August 20, 1996.

REQUEST FOR COMMENTS

Treasury and the Service invite public comments on the guidance provided in this notice. Comments should be submitted by June 8, 1997, to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:CORP:T:R, (Notice 97–19)
Room 5228
Washington, D.C. 20044;

or, alternatively, via the internet at:

http://www.irs.ustreas.gov/prod/tax_regs/comments.html

The comments you submit will be available for public inspection and copying.

DRAFTING INFORMATION

The principal authors of this notice are Trina L. Dang and Michael Kirsch of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Dang or Mr. Kirsch at (202) 622–3860 (not a toll-free call).

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1531.

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

The collection of information related to the submission of ruling requests is required to help the Secretary make a determination as to whether an individual expatriated with a principal purpose to avoid U.S. taxes. The collections of information related to gain recognition agreements, initial information reporting and reporting of information with respect to contributions to certain foreign controlled foreign corporations are prescribed by statute. The collection of annual reporting information is necessary to monitor compliance with the provisions of section 877, as amended. The collections of information for individuals subject to section 7701(b)(10) are necessary to administer the provisions of section 7701(b)(10) that interact with section 877. This information will be used by the Service for tax administration purposes.

The respondents will be individuals who lose U.S. citizenship, cease to be taxed as lawful permanent residents of the United States, or cease to be taxed as residents of the United States. The estimated total annual burden for all respondents is 6,300 hours. The estimated annual burden per respondent varies from 0.5 hour to 2.5 hours, depending on individual circumstances, with an estimated average of 31 minutes. The estimated number of responses is 12,300. The estimated annual frequency of responses is annually or on occasion.

Books or records relating to collections 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 section 6103 of the Code.

Waiver of Certain Limitations on Obtaining Automatic Consent To Change an Accounting Period and Elect To Be an S Corporation Effective January 1, 1997

Notice 97–20

SUMMARY: The Internal Revenue Service waives certain limitations on a corporation's ability to automatically change its annual accounting period in order to elect to be an S corporation under § 1362(a) of the Internal Revenue Code effective for the taxable year beginning January 1, 1997.

BACKGROUND: Pursuant to § 1378, an S corporation generally must have a calendar year as its tax year. However, a corporation may not automatically change its annual accounting period to a calendar year if it attempts to elect to be an S corporation effective for the taxable year immediately following the short period required to effect the change. *See* § 1.442–1(c)(2)(v) of the Income Tax Regulations; Rev. Proc. 92–13, 1992–1 C.B. 665, section 4.01(5). In addition, a corporation is precluded under § 1.442–1(c)(2)(i) from automatically changing its annual accounting period if the corporation has changed it within the last ten calendar years, and under Rev. Proc. 92–13, section 4.01(2), if the corporation has changed it within the last six calendar years.

The Small Business Job Protection Act of 1996 (SBJPA), Pub. L. No. 104–188, 110 Stat. 1755, significantly amended Subchapter S of the Code, expanding eligibility to elect to be an S corporation. These amendments generally are effective for taxable years beginning after December 31, 1996, and are intended to allow more corporations to elect to be S corporations as of January 1, 1997.

WAIVER OF LIMITATIONS: Consistent with this intent, the Service waives the limitations of §§ 1.442–1(c)(2)(i) and (c)(2)(v), and of sections 4.01(2) and 4.01(5) of Rev. Proc. 92–13, on a corporation's ability to automatically change its annual accounting period to a calendar year effective for the short period ending December 31, 1996, provided that the corporation:

(1) is otherwise eligible to change its annual accounting period under either § 1.442–1(c) or Rev. Proc. 92–13;

(2) timely and otherwise validly elects to be an S corporation effective for the taxable year beginning on January 1, 1997; and

(3) follows the special filing procedures set forth below.

FILING PROCEDURES: A corporation that relies upon this notice to change its annual accounting period under either § 1.442–1(c) or Rev. Proc. 92–13 must:

(1) properly complete a Form 2553, Election by a Small Business Corporation;

(2) properly complete a Form 1128, Application to Adopt, Change or Retain a Tax Year, and attach it to the Form 2553;

(3) write ''FILED UNDER NOTICE 97–20'' at the top of both the Form 2553 and the Form 1128; and

(4) timely file the Form 2553 (with the attached Form 1128) with the appropriate Internal Revenue Service Center (Attention: ENTITY CONTROL) in accordance with the instructions for Form 2553. A corporation that qualifies to automatically change its annual accounting period under § 1.442–1(c) as a result of this notice should not file the statement required by § 1.442–1(c)(1).

DRAFTING INFORMATION: The principal author of this notice is Susie K. Bird of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information, contact Ms. Sandra Cheston at (202) 622–4840 (not a toll-free call).

PAPERWORK REDUCTION ACT: The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1532.

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 OMB control number.

The collections of information in this notice are in the FILING PROCEDURES section of this notice. This information is required by the Service to implement the provisions of the Small Business Job Protection Act of 1996 expanding eligibility to elect to be an S corporation. The collections of information are mandatory for a taxpayer that chooses to change its annual accounting period to a calendar year effective for the short period ending December 31, 1996, and elect to be an S corporation effective for the taxable year beginning January 1, 1997. The likely respondents are corporations.

The estimated total annual reporting burden is 500 hours.

The estimated annual burden per respondent will vary from 1 minute to 2 minutes, depending on individual circumstances, with an estimated average of 1.5 minutes. The estimated number of respondents is 20,000. The estimated frequency of responses is once.

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

---

26 CFR 601.204: Changes in accounting period and in methods of accounting.
(Also Part I, §§ 166, 446, 481, 585, 1362, 1374; 1.446–1, 1.1374–4)

Rev. Proc. 97–18

SECTION 1. PURPOSE

This revenue procedure provides guidance for any bank as defined in § 581 of the Internal Revenue Code (except any large bank as defined in § 585(c)(2)) that seeks to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method so that it may elect S corporation status for the tax year beginning in 1997.

SECTION 2. BACKGROUND

.01 Section 1315 of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188, 110 Stat. 1755, amended § 1361(b)(2) to allow banks (as defined in § 581) that do not use the reserve method of accounting for bad debts to qualify as small business corporations (and therefore qualify to elect S corporation status), effective for tax years beginning after December 31, 1996.

.02 Notice 97–5, 1997–2 I.R.B. 25, states that the Service will issue additional guidance granting permission for an automatic change in method of accounting for banks that change from the reserve method of accounting.

.03 Except as otherwise expressly provided, a bank must obtain the consent of the Commissioner of Internal Revenue to change a method of accounting for federal income tax purposes. To obtain this consent, a Form 3115 (Application for Change in Accounting Method) generally must be filed within 180 days after the beginning of the tax year in which the proposed change is to be made. Section 446(e) and § 1.446–1(e)(2)(i) and (3)(i) of the Income Tax Regulations.

.04 The Commissioner is authorized to prescribe administrative procedures setting forth the limitations, terms, and conditions the Commissioner deems necessary to obtain consent for effecting a change in method of accounting and to prevent amounts from being duplicated or omitted, including the tax year or years in which the § 481(a) adjustment is to be taken into account. Section 1.446–1(e)(3)(ii).

.05 In computing taxable income, § 481(a) requires a bank to take into account those adjustments necessary to prevent amounts from being duplicated or omitted when the bank's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding tax year.

SECTION 3. SCOPE

This revenue procedure applies to any bank as defined in § 581 (except any large bank as defined in § 585(c)(2)) that seeks to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method, effective for its first tax year beginning after December 31, 1996 (1997 tax year), in order to elect S corporation status for its 1997 tax year.

SECTION 4. AUTOMATIC PROCEDURE

.01 A bank, to which this revenue procedure applies, that elects under § 1362 to become an S corporation by filing a Form 2553 (Election by a Small Business Corporation) effective for its 1997 tax year will be deemed to have elected to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method effective for its 1997 tax year (year of change) and to have agreed to all the terms and conditions of this revenue procedure.

.02 The bank must file a Form 2553 within the first 2 months and 15 days of the first day of its 1997 tax year for the S corporation election to be effective for its 1997 tax year.

.03 In accordance with § 1.446–1(e)(3)(ii), the requirement to file an application on Form 3115 within the 180-day period provided in § 1.446–1(e)(3)(i) is waived for any application for change in method of accounting filed pursuant to this revenue procedure. In addition, under § 1.446–1(e)(2)(i), the consent of the Commissioner is hereby granted to any bank within the scope of this revenue procedure to change its method of accounting for bad debts, in accordance with this revenue procedure, from the § 585 reserve method to the § 166 specific charge-off method for the bank's 1997 tax year.

.04 A bank that uses this revenue procedure to change its method of ac-

counting for bad debts from the § 585 reserve method to the § 166 specific charge-off method may not later use Rev. Proc. 85–8, 1985–1 C.B. 495, to return to the § 585 reserve method.

.05 A bank changing its method of accounting under this revenue procedure also must file a Form 3115 in duplicate. The original Form 3115 must be attached to the bank's timely filed (including extensions) S corporation federal income tax return for its 1997 tax year. In addition, a copy of the Form 3115 must be filed with the national office addressed to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Financial Institutions and Products) CC:DOM:FI&P, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20044, no later than the date the original Form 3115 is filed with the 1997 S corporation federal income tax return. No user fee is required for a Form 3115 filed under this revenue procedure. A Form 3115 filed pursuant to this revenue procedure will not be acknowledged.

.06 In addition to the filing requirements in section 4.05 of this revenue procedure, a bank that is under examination at any time between February 19, 1997, and the due date for filing its original federal income tax return (including extensions) for its 1997 tax year must provide a copy of the Form 3115 to the examining agent no later than the earlier of (i) 180 days after February 19, 1997, or for a bank that is not under examination on February 19, 1997, 180 days after the bank first comes under examination, or (ii) the date the bank must file its original federal income tax return (including extensions) for its 1997 tax year.

SECTION 5. SECTION 481(a) ADJUSTMENT

.01 As a condition of the change in method of accounting under this revenue procedure, a bank must include the amount of its § 481(a) adjustment in its income, beginning with its 1997 tax year, ratably over the lesser of 6 years or the number of years that the bank has used the § 585 reserve method. See section 5.04 and 5.05 for exceptions to the § 481(a) adjustment period.

.02 Generally, the amount of a bank's § 481(a) adjustment for a change in method of accounting under this revenue procedure is the amount of the bank's reserve for bad debts as of the close of the tax year immediately before the year of change. However, the amount of the § 481(a) adjustment does not include the amount of a bank's pre-1988 reserves (as described in § 593(g)(2)(A)-(ii), without taking into account § 593(g)(2)(B)) if the bank changed in a prior year from the § 593 reserve method to the § 585 reserve method and § 593(g) applied to that change. The § 481(a) adjustment is recognized built-in gain under § 1374. See § 1.1374–4(d). In addition, banks should be aware of the effects of the interaction between provisions specially applicable to banks and provisions of subchapter S, for example, (i) §§ 593(e) and 1368 with respect to earnings and profits, and (ii) §§ 593(e) and (g)(3) and 1374.

.03 A change in method of accounting under this revenue procedure shall be treated as a voluntary change in method of accounting that is initiated by the bank; and therefore, the § 481(a) adjustment is not restricted to post-1953 items.

.04 A bank may elect to use a one-year § 481(a) adjustment period if its entire § 481(a) adjustment is less than $25,000. A bank that desires to elect this one-year adjustment period must so indicate by checking the ''Yes'' box in Question 26 on its Form 3115 and must include the entire § 481(a) adjustment in its income for the 1997 tax year.

.05 A bank taking a § 481(a) adjustment into account under this revenue procedure that ceases being a bank as defined in § 581 must include in its income for the tax year of the cessation any remaining balance of the § 481(a) adjustment.

SECTION 6. AUDIT PROTECTION FOR CHANGE IN METHOD OF ACCOUNTING

.01 A bank within the scope of this revenue procedure that timely complies with all of the terms and conditions of this revenue procedure will have audit protection (that is, the district director may not propose that the bank change the same method of accounting as the method that the bank is changing under this revenue procedure) for tax years before 1997 unless (1) the bank has received written notification from an examining agent (for example, by examination plan, information document request, notification of proposed adjustments or income tax examination changes) before February 19, 1997, specifically citing as an issue under consideration the bank's reserve method of accounting for bad debts, or (2) the bank's reserve method of accounting for bad debts was an issue under consideration by an appeals office or a federal court before February 19, 1997.

.02 The district director, however, will verify the amount of the § 481(a) adjustment and the § 481 adjustment period, and otherwise determine that the bank has fully complied with this revenue procedure.

SECTION 7. EXCLUSIVE PROCEDURE

.01 This revenue procedure is the exclusive procedure available to a bank within the scope of this revenue procedure to obtain the Commissioner's consent to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method. Any Form 3115 filed with the national office under Rev. Proc. 92–20, 1992–1 C.B. 685, by a bank that is within the scope of this revenue procedure, along with any user fee submitted, will be returned to the bank.

.02 The national office or district director may review a bank's Form 3115 filed under this revenue procedure. If it is determined that the bank does not qualify for the change in method of accounting under this revenue procedure, the national office or the district director will so advise the bank.

SECTION 8. FAILURE TO COMPLY

A bank to which this revenue procedure applies that changes its method of accounting for bad debts without complying with all of the applicable provisions of this revenue procedure will be deemed to have initiated the change without obtaining the consent of the Commissioner as required by § 446(e) and will not have audit protection for prior years as provided in section 6. Accordingly, the district director may propose to change the bank's reserve method in a prior year, and if the first year in which the bank improperly uses the requested method of accounting is no longer open for the assessment of a deficiency of tax, the Commissioner may use the Commissioner's statutory discretion to change the bank's method of accounting in a later year and impose an adjustment under § 481(a).

SECTION 9. DEFINITIONS

Except as otherwise provided in this revenue procedure, the following terms have the meaning given to them by Rev. Proc. 92–20:

Under examination (See section 3.02 of Rev. Proc. 92–20);

Year of change (See section 3.03 of Rev. Proc. 92–20); and

Filed (See section 3.04 of Rev. Proc. 92–20).

SECTION 10. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 85–8, 1985–1 C.B. 495, is modified.

SECTION 11. EFFECTIVE DATE

This revenue procedure is effective only for accounting method changes by a bank for which the 1997 tax year is the year of change.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Laura Howell of the Office of Assistant Chief Counsel (Passthroughs and Special Industries) and Nicholas Bogos of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, contact Ms. Howell at (202) 622–3060 or Mr. Bogos at (202) 622–3920 (not toll-free calls).

---

26 CFR 301.7502–1: Timely mailing treated as timely filing.

Rev. Proc. 97–19

CONTENTS

SECTION 1. PURPOSE

This revenue procedure provides the criteria that will be used during the interim period (defined in section 3.01 of this revenue procedure) to determine whether a private delivery service (''PDS'') qualifies as a designated private delivery service (''designated PDS'') under § 7502(f) of the Internal Revenue Code. This revenue procedure also provides the procedures under which a PDS can apply to become a designated PDS during the interim period.

SECTION 2. BACKGROUND

.01 Generally, a document is considered filed when it is received. *See*, *e.g.*, *Emmons v. Commissioner*, 92 T.C. 342, 345–47 (1989), *aff'd*, 898 F.2d 50 (5th Cir. 1990) (tax returns were filed on the date received because § 7502 did not apply). Section 7502 provides special rules that apply when a document is required to be filed (or a payment is required to be made) within a prescribed period or on or before a prescribed date under the authority of any provision of the internal revenue laws. These rules can apply to documents filed at offices of the Internal Revenue Service (''Service'') as well as the United States Tax Court.

.02 Section 7502(a) provides the general rule that if a document (or payment) is delivered by the United States mail after the due date in a postage prepaid, properly addressed envelope, then the date of the United States postmark is deemed to be the date of delivery (or the date of payment) if the date of the postmark is on or before the due date. (See § 7502(e) for special rules regarding the mailing of deposits.)

.03 Section 7502(c) and §§ 301.7502–1(c)(2) and (d)(1) of the Procedure and Administration Regulations provide the rules applicable to registered and certified mail. If a document or payment is sent by registered mail, the date of the registration is treated as the postmark date. If a document or payment is sent by certified mail, the date of the postmark on the sender's receipt is treated as the postmark date. Proof of proper registration of a document, or that a postmark certified mail sender's receipt was properly issued for a document, is prima facie evidence of delivery of that document. For payments sent by registered or certified mail, however, proof of proper registration of an item, or that a postmark certified mail sender's receipt was properly issued for an item, is not prima facie evidence of delivery.

.04 Section 7502(d) provides exceptions to the general rule of § 7502. The special filing and payment rules of § 7502 do not apply to the following:

(1) documents filed in, or payments made to, any court other than the United States Tax Court;

(2) currency or other medium of payment unless actually received and accounted for; and

(3) documents or payments that are required to be delivered by any method other than by mailing.

.05 Section 1210 of the Taxpayer Bill of Rights 2, Pub. L. No. 104–168, 110 Stat. 1452, 1474–1475 (1996), amended § 7502 by adding subsection (f). Prior to the amendment, the ''timely mailing as timely filing/paying'' rule of § 7502(a) could not apply to documents and payments delivered other than by United States mail. Section 7502(f) authorizes the Service to expand the ''timely mailing as timely filing/paying'' rule to documents and payments delivered by certain PDSs. A PDS must be designated by the Service before it will qualify for the ''timely mailing as timely filing/paying'' rule. Section 7502(f) also grants the Service authority to accept the equivalent of registered or certified mail services from designated PDSs.

.06 In Announcement 96–108, 1996–44 I.R.B. 15, the Service invited comments, and provided notice of a public hearing, with respect to developing interim criteria for designating PDSs for purposes of the ''timely mailing as timely filing/paying'' rule of § 7502. A

public hearing was held on December 6, 1996. All comments were considered during the drafting of this revenue procedure. The comments will also be considered during the drafting of permanent guidance.

SECTION 3. SCOPE

.01 This revenue procedure provides the rules for designating a PDS during the interim period. The interim period begins on February 25, 1997, and ends on the date on which the Service issues guidance superseding this revenue procedure.

.02 This revenue procedure provides rules applicable for designation solely for purposes of § 7502(f)(2). During the interim period, there will be no designation for purposes of § 7502(f)(3) (services that are equivalent to United States registered or certified mail).

.03 Designation will be determined with respect to each type of delivery service offered by a PDS (e.g., next business morning delivery, next business day delivery, etc.).

.04 PDSs will not be designated until the time specified in section 8.01 of this revenue procedure. Until such designation is announced, the ''timely mailing as timely filing/paying'' rule of § 7502 is available only with respect to items sent by United States mail.

SECTION 4. CRITERIA FOR DESIGNATION

The following criteria must be satisfied for each type of delivery service for which designation is sought.

.01 The delivery service offered must be available to the general public.

.02 The delivery service offered must be at least as timely and reliable on a regular basis as United States First-Class Mail.

.03 The delivery service offered must provide for the recording or marking of the date on which an item was given to the PDS for delivery (the ''received date'') under one of the following methods.

(1) The PDS must record electronically to its data base (kept in the regular course of its business) the received date and enter into, and comply with, a written agreement with the Service that addresses the period for which such data must be maintained and the terms and conditions under which the Service will be provided with such data.

(2) The PDS must indelibly mark the received date on the cover of the item so that it is readable by the human eye without mechanical assistance. A method does not qualify if only the sender or the sender's agent (instead of the PDS) marks the received date.

.04 The delivery service offered must provide for delivery to all street addresses within the United States to which documents and payments subject to § 7502 must be sent (e.g., all Service offices and the United States Tax Court).

.05 The delivery service offered must have established security procedures that prevent unauthorized access to the contents of an item by any person (e.g., employees, contractors/agents, and third parties).

.06 The name of the PDS and the type of delivery service being used must always be clearly identified on each item delivered by the PDS to an office described in § 7502.

.07 The PDS must comply with all requirements of the Private Express Statutes (18 U.S.C. §§ 1693–1699 and 39 U.S.C. §§ 601– 606). (See generally 39 C.F.R. Parts 310 and 320.)

SECTION 5. CONTENT OF APPLICATION

.01 To receive designation, a PDS must submit a written application. If a PDS uses a single application to request designation with respect to more than one type of delivery service it offers, the PDS must include all of the required information for each type of delivery service.

.02 The application must include the name and address of the principal place of business of the PDS and the name and telephone number of a contact person.

.03 The application must describe how the PDS satisfies each of the requirements of section 4 of this revenue procedure. In particular, an application should address the following topics.

(1) In addressing the requirement under section 4.02 of this revenue procedure, the PDS should discuss whether it guarantees delivery within the time specified for the type of delivery service and, if so, it should provide information on that program.

(2) In addressing the requirement under section 4.03 of this revenue procedure, the PDS must discuss its recording or marking procedures, including the security procedures that prevent falsification of the recording or marking of the received date. The PDS must also submit an example of a cover of an item. If the PDS is applying for qualification under section 4.03(1), it must describe its current data storage periods and all of the methods it currently provides for senders or recipients to obtain information concerning the received date (e.g., toll-free telephone number, Internet access, software/modem connection).

(3) In addressing the requirement under section 4.04 of this revenue procedure, the PDS must discuss how often and under what circumstances it uses contractors/agents in providing nationwide delivery.

(4) In addressing the requirement under section 4.07 of this revenue procedure, the PDS must include a statement that it certifies it is in compliance and will remain in compliance.

.04 A PDS should identify any information within its application that it considers to be confidential trade secrets.

.05 The application must include the following statement:

Under the penalties of perjury, I declare that I have examined this application and any accompanying information, and to the best of my knowledge and belief it is true, correct, and complete. This applicant will provide prompt written notification to the Service if any application information changes during the time it is under consideration for designation. This applicant will comply with all of the provisions of Rev. Proc. 97–19 during the time it is a designated private delivery service if it is designated during the interim period. I understand that noncompliance will result in the revocation of designation. I am authorized to make and sign this statement on behalf of this applicant.

.06 The application must be signed and dated by an authorized official of the private delivery service (not the applicant's representative) who has personal knowledge of the application information and whose duties are not limited to making the application. A stamped signature is not permitted.

.07 A PDS must submit an original and two copies of its application.

SECTION 6. APPLICATION ADDRESSES

A PDS may submit its written application by either mailing it to:

Internal Revenue Service
Attn: Chief, Taxpayer Service T Room 3408
1111 Constitution Avenue, N.W.
Washington, D.C. 20044,

or hand delivering it between the hours of 8:00 a.m. and 5:00 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: Chief, Taxpayer Service T Room 3408
1111 Constitution Avenue, N.W.
Washington, D.C.

SECTION 7. APPLICATION PERIODS

.01 During the interim period, there will be an initial application period and subsequent application periods.

(1) The initial application period ends on March 14, 1997.

(2) Subsequent application periods will end on each June 30th and December 31st thereafter.

.02 Once a PDS is designated, it does not need to reapply during the interim period unless it desires to receive designation with respect to a new type of delivery service it offers.

SECTION 8. NOTIFICATION OF DESIGNATION

.01 After reviewing those applications filed during the initial application period, the Service anticipates that by March 31, 1997, it will issue the first notice that lists the PDSs that are designated under these interim procedures. That notice will specify the period during which the designated PDSs will be designated. This period will not begin earlier than the date the notice is issued, and the period may begin either on the date the notice is issued or shortly thereafter. Except as provided in section 12 of this revenue procedure, this period will not end earlier than March 1, 1998, regardless of the time permanent guidance is issued.

.02 The Service will issue additional notices providing a revised list of the designated PDSs on or before September 1st and March 1st of each year of the interim period.

.03 In unusual circumstances, the Service may issue additional notices at other times. (See, for example, section 12.06 of this revenue procedure.)

SECTION 9. ADMINISTRATIVE REVIEW AND APPEAL PROCESS FOR DENIAL OF DESIGNATION

.01 A PDS that has been denied designation has the right to an administrative review and appeal. During the administrative review and appeal process, the denial of designation remains in effect.

.02 If the Service has denied designation with respect to any type of delivery service offered by a PDS, the Service will issue a letter of denial that explains to the applicant why the Service rejected the request for designation.

.03 An applicant that receives a letter of denial may obtain administrative review by mailing or delivering, within 30 calendar days of the date of the letter of denial, a written response to the Service at one of the application addresses listed in section 6 of this revenue procedure. The applicant's response must address the Service's explanation for the denial of designation.

.04 Upon receipt of an applicant's written response, the Service will reconsider its denial of designation. The Service may (1) designate the applicant by issuing a notice that provides a revised list of the designated PDSs, or (2) confirm its denial of designation by issuing a letter to the applicant.

.05 If an applicant receives a letter confirming the denial of designation, the applicant is entitled to an appeal, in writing, to the National Director of Appeals.

.06 The appeal must be mailed or delivered to the Service at one of the application addresses listed in section 6 of this revenue procedure within 30 calendar days of the date of the letter confirming the denial of designation. An applicant's written appeal must contain a detailed explanation, with supporting documentation, of why the denial should be reversed. In addition, the applicant must include a copy of the applicant's original application, a copy of the letter of denial, a copy of the applicant's request for administrative review, and a copy of the letter confirming the denial.

.07 Failure to respond within the 30-day periods described in sections 9.03 and 9.06 of this revenue procedure irrevocably terminates an applicant's right to an administrative review or appeal.

.08 A PDS that has been denied designation during any application period may reapply during the next application period.

SECTION 10. SPECIAL RULES

.01 A PDS is required to provide prompt written notification to the Service at one of the application addresses listed in section 6 of this revenue procedure if any application information changes during the time the PDS is under consideration for designation or during the time it is a designated PDS.

.02 If a designated PDS delivers an item that is sent by itself, a related person within the meaning of § 267, or a member of an affiliated group of which the designated PDS is also a member within the meaning of § 1504, such item will not qualify under the ''timely mailing as timely filing/paying'' rule unless the item is received by the addressee no later than two business days after the due date.

.03 For purposes of the postage prepaid requirement of § 7502(a)(2)(B), a sender is permitted to use a billing method other than advance payment if a designated PDS offers such billing method in accordance with established industry practices and the recipient is not charged without its permission. An item will not qualify under the ''timely mailing as timely filing/paying'' rule if the recipient is charged without its permission. Moreover, the Service will not accept delivery of an item if the Service is billed for the delivery charge without its permission. Similarly, the United States Tax Court may not accept delivery of an item if it is billed for the delivery charge without its permission.

SECTION 11. ADVERTISING STANDARDS FOR DESIGNATED DELIVERY SERVICES

.01 No designated PDS may, in any way, use or participate in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim.

.02 A designated PDS must adhere to all relevant federal, state, and local consumer protection laws that relate to advertising and soliciting.

.03 A designated PDS must not use the name of the Treasury Department, the Service (e.g., ''Internal Revenue Service'' or ''IRS''), or the United States Tax Court within its name.

.04 Advertising materials shall not carry the seal of any office within the Treasury Department or of the United States Tax Court.

.05 If a designated PDS uses any audio or video media (including radio, television, and the Internet) to advertise its status as a designated PDS, the broadcast must be pre-recorded. The designated PDS must keep a copy of such pre-recorded advertisement for a

period of at least 36 months from the date of the last transmission or use.

.06 If a designated PDS uses any written media (including newspapers, direct mail, billboards, and fax communications) to advertise its status as a designated PDS, the designated PDS must retain a copy (or example) of such advertisement, along with a list or other description of the persons to whom the communication was directed, for a period of at least 36 months from the date of the last communication.

SECTION 12. MONITORING OF DESIGNATED DELIVERY SERVICES AND REVOCATION PROCEDURES

.01 The Service may monitor designated PDSs to ensure compliance with the requirements of this revenue procedure. If the Service finds that a designated PDS failed to comply with the requirements of this revenue procedure, the Service will issue a warning letter that describes specific corrective action that must be taken in order to retain designation.

.02 If the designated PDS fails to take the appropriate corrective action within the time specified in the warning letter, a proposed revocation letter will be issued. If a designated PDS receives a proposed revocation letter, the designated PDS is entitled to an appeal, in writing, to the National Director of Appeals.

.03 The appeal must be mailed or delivered to the Service at one of the application addresses listed in section 6 of this revenue procedure within 30 calendar days of the date of the proposed revocation letter. A designated PDS's written appeal must contain a detailed explanation, with supporting documentation, of why the revocation should not be made. In addition, the designated PDS must include a copy of the warning letter and a copy of the proposed revocation letter. Failure to appeal within the 30-day period irrevocably terminates a designated PDS's right to an appeal.

.04 If a designated PDS fails to file a timely appeal or if an appeal is denied, the Service will revoke the designation. The revocation may be either with respect to a single type of delivery service offered by the designated PDS or with respect to all types of delivery services offered, depending on the nature of the violation. The revocation will be effective after issuance of a notice that provides a revised list of the designated PDSs.

.05 A PDS is not permitted to reapply for designation under the provisions of this revenue procedure if, after consideration of an appeal if timely requested, there has been a complete or partial revocation of its status as a designated PDS. The permanent guidance may also preclude such a PDS from reapplying for an additional specified period of time.

.06 In exceptional circumstances, the Service may revoke the status of a designated PDS before the appeals process is completed. Such revocation will be effective after issuance of a notice that provides a revised list of the designated PDSs. If, after consideration of an appeal, it is determined that a PDS is qualified for designation, the PDS will be redesignated. Such redesignation will be effective after issuance of a notice that provides a revised list of the designated PDSs.

SECTION 13. EFFECTIVE DATE

This revenue procedure is effective February 25, 1997.

SECTION 14. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545–1535.

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

The collections of information in this revenue procedure are in sections 4.03, 5, 9.03, 9.06, 10.01, 11.05, 11.06, and 12.03. This information is required for the Internal Revenue Service to determine whether a private delivery service should be a ''designated'' private delivery service. This information will be used to ensure that a private delivery service conforms to the requirements set forth in this revenue procedure. The collections of information are required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 3,069 hours.

The estimated average annual burden per respondent/recordkeeper is 614 hours. The estimated number of respondents and/or recordkeepers is five.

The estimated frequency of responses is on occasion.

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

SECTION 15. DRAFTING INFORMATION

The principal authors of this revenue procedure are Robert J. Basso and Renay France of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. France at (202) 622–6232 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Basis Reduction Due to Discharge of Indebtedness

REG–208172–91

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that provide ordering rules for the reduction of bases of property under sections 108 and 1017 of the Internal Revenue Code of 1986. The regulations will affect taxpayers that exclude discharge of indebtedness from gross income under section 108.

DATES: Written comments must be received by April 7, 1997. Outlines of oral comments to be presented at the public hearing scheduled for April 24, 1997, at 10 a.m. must be received by April 3, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–208172–91), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–208172–91), 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.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations generally, Sharon L. Hall or Christopher F. Kane of the Office of Assistant Chief Counsel (Income Tax & Accounting) at (202) 622–4930; concerning partnership adjustments under section 1017, Brian M. Blum of the Office of Assistant Chief Counsel (Passthroughs & Special Industries) at (202) 622–3050; concerning submissions and the hearing, Evangelista C. Lee of the Regulations Unit at (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

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

Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collections of information should be received by March 8, 1997. Comments are specifically requested concerning:

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

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

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

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

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

The collections of information in this proposed regulation are in §§ 1.108–4(b), 1.1017–1(e)(2), and 1.1017–1(f)(2)(ii) and (iii). This information is required for a taxpayer to elect to reduce the adjusted bases of depreciable property under section 108(b)(5), to elect to treat section 1221(1) real property as either depreciable property or depreciable real property, and to account for a partnership interest as either depreciable property or depreciable real property. This information will be used to determine whether taxpayers have properly reduced the bases of their properties. The collections of information are required to obtain a benefit. The likely respondents are individuals, farms, businesses or other for-profit institutions, and small businesses or organizations.

Estimated total annual reporting burden: *100,000* hours.

Estimated average annual burden per respondent: *1* hours.

Estimated number of respondents: *100,000*.

Estimated annual frequency of responses: *On occasion*.

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

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

Background

This notice contains proposed amendments to the income tax regulations (26 CFR Parts 1 and 301) under sections 108 and 1017 of the Internal Revenue Code of 1986 (Code). The amendments are proposed to conform the regulations to amendments to sections 108 and 1017 made by the Bankruptcy Tax Act of 1980, Pub. L. 96–589, § 2, 94 Stat. 3389 (1980), 1980–2 C.B. 607 (Bankruptcy Tax Act); the Technical Corrections Act of 1982, Pub. L. 97–448, § 102(h)(1), 96 Stat. 2365, 2372 (1983), 1983–1 C.B. 451; the Deficit Reduction Act of 1984, Pub. L. 98–369, §§ 474(r)(5) and 721(b)(2), 98 Stat. 494, 839, 966 (1984), 1984–3 C.B. (Vol. 1) 1; the Tax Reform Act of 1986, Pub. L. 99–514, §§ 104(b)(2), 231(d)(3)(D), 822, and 1171(b)(4), 100 Stat. 2085, 2105, 2179, 2373, 2513 (1986), 1986–3 C.B. (Vol. 1) 2; and the Omnibus Budget Reconciliation Act of 1993, Pub. L. 103–66, § 13150, 107 Stat. 312, 446 (1993), 1993–3 C.B. 1.

In general, section 108 excludes from gross income discharges of indebtedness if the discharge occurs in a title 11 case or when the taxpayer is insolvent, or if the indebtedness is ''qualified farm indebtedness'' or ''qualified real property business indebtedness.'' Taxpayers generally must reduce specified tax attributes, including adjusted bases of properties, to the extent income from

discharge of indebtedness is excluded from gross income under section 108. Section 1017 provides rules regarding any basis reductions required by, or elected under, section 108.

Explanation of Provisions

Overview

The legislative history of the Bankruptcy Tax Act states that the exclusion of discharge of indebtedness (COD income) from gross income under section 108 is intended to promote a debtor's fresh start. S. Rep. No. 1035, 96th Cong., 2d Sess. 10 (1980), 1980–2 C.B. 620, 624; H.R. Rep. No. 833, 96th Cong., 2d Sess. 11 (1980). The exclusion provided by the statute generally operates, however, to defer, rather than eliminate, income from discharge of indebtedness.

The deferral of income provided by statute is generally achieved by requiring a taxpayer to reduce specified tax attributes (including adjusted bases of property) under section 108(b) by an amount equal to the COD income excluded from gross income under section 108(a). Section 108(b)(2) requires a taxpayer to reduce tax attributes in the following order: (A) net operating loss; (B) general business credit; (C) minimum tax credit; (D) capital loss carryovers; (E) adjusted bases of property; (F) passive activity loss and credit carryovers; and (G) foreign tax credit carryovers. If the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income.

When basis reductions are necessary, section 1017(a) requires the taxpayer to reduce the adjusted bases of property held on the first day of the following tax year. Section 1017(b)(1) provides that the amount of the basis reduction required under section 1017(a), and the particular properties the bases of which are to be reduced, shall be determined under regulations.

General Rules for Basis Reduction

Consistent with the legislative history of the Bankruptcy Tax Act, the proposed regulations generally retain the ''tracing'' approach of the existing regulations issued under prior law. Thus, the proposed regulations require a taxpayer to reduce the adjusted basis of the property that secured the discharged indebtedness before reducing the adjusted bases of other property.

In addition, the proposed regulations modify the categories in the existing regulations to simplify the process of basis reduction. First, the distinction between purchase-money indebtedness and other secured indebtedness is eliminated. Second, the order of basis reduction for property that secured discharged indebtedness is changed. Thus, the first category of the general ordering rule is real property used in the taxpayer's trade or business or held for the production of income (other than section 1221(1) real property) that secured the discharged indebtedness, and the second category is personal property used in the taxpayer's trade or business or held for the production of income (other than inventory, accounts receivable, and notes receivable) that secured the discharged indebtedness. Therefore, if an indebtedness secured by a building, a parcel of land used in the taxpayer's trade or business, office equipment, and office furniture is discharged, the taxpayer proportionately reduces the adjusted bases of the building and the parcel of land, based upon their relative adjusted bases, to the full extent of the excluded COD income before reducing the adjusted bases of the office equipment and the office furniture. The IRS and Treasury Department believe that this modification of the current regulations will simplify the process of basis reduction for many taxpayers.

Special Rules for Depreciable Properties

Instead of reducing tax attributes in the order specified by section 108(b)(2), a taxpayer may elect under section 108(b)(5) first to reduce the adjusted bases of depreciable property (real and personal) to the extent of the excluded COD income. If the adjusted bases of depreciable property are insufficient to offset the entire amount of excluded COD income, the taxpayer must reduce any remaining tax attributes in the order specified in section 108(b)(2). Section 108(c) requires that excluded COD income from the cancellation of qualified real property business indebtedness must be applied against depreciable real property.

Section 1017(b)(3)(C) provides that a taxpayer must treat a partnership interest as depreciable property when reducing adjusted bases under section 108(b)(5), and as depreciable real property when reducing adjusted bases under section 108(c), to the extent the partnership correspondingly reduces the partner's proportionate interest in the adjusted bases of depreciable property (or depreciable real property) held by the partnership (inside basis).

The proposed regulations generally provide that a taxpayer may freely choose whether or not to request that a partnership reduce the partner's share of depreciable basis in partnership property and thereby permit the taxpayer to treat the partnership interest as depreciable property (or depreciable real property). In addition, the proposed regulations generally provide that the partnership is free to grant or deny its consent. In order to prevent avoidance of the general ordering rules of the proposed regulations through the use of partnerships, however, a partner is required to request consent if the partner owns (directly or indirectly) more than 50 percent of the capital and profits interests of the partnership, or if the partner receives a distributive share of COD income from the partnership. In addition, the partnership is required to grant consent if requests are made by partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership.

The proposed regulations provide that a partner requesting a reduction in inside basis must make the request before the due date (including extensions) for filing the partner's Federal income tax return for the taxable year in which the partner has COD income. A partnership that consents to a basis reduction must include a consent statement with its Form 1065, U.S. Partnership Return of Income, and must also provide a copy of that statement to the affected partner on or before the date the Form 1065 is filed. The IRS and Treasury Department recognize that under current law a partner may not always have sufficient information with which to decide to request a basis reduction until on, or shortly before, the due date (including extensions) for filing the partner's tax return. For example, for calendar year taxpayers, a partner's tax return and a partnership's Form 1065 are generally due on the same day. *See* sections 6031 and 6072. Comments are requested as to whether additional rules (such as requiring a partnership to inform partners of COD income prior to the date the Form 1065 is filed) are necessary to ensure that information is exchanged between the partnership and its partners in a timely fashion.

The proposed regulations remove § 301.9100–13T, which governs elec-

tions under section 108(b)(5), and add new proposed § 1.108–4. Under the temporary regulations, a taxpayer is required to make the election with the taxpayer's Federal income tax return for the taxable year in which the discharge occurs, but is permitted to file an election with an amended return, or claim for credit or refund, if the taxpayer establishes reasonable cause for failing to file the election with the original return. New proposed § 1.108–4 requires the taxpayer to make the election on the timely filed (including extensions) Federal income tax return for the taxable year the taxpayer has COD income that is excluded under section 108(a). Therefore, a taxpayer that fails to make the election on that return must request the Commissioner's consent to file a late election under § 301.9100–3T or any regulations that supersede § 301.9100–3T.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment 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.

Initial Regulatory Flexibility Act Analysis

This initial analysis is required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). In certain circumstances, the proposed regulations will require a partnership to include a statement with its Form 1065, U.S. Partnership Return of Income, and provide a copy of that statement with the taxpayer's Schedule K–1 (Form 1065), Partner's Share of Income, Credits, Deductions, etc., for the taxable year in which the COD income is excluded under section 108(a), stating the amount of the partner's share of the reduction in the partnership's adjusted bases of depreciable real or personal property (inside basis). This requirement will ensure that the partner knows it is entitled to reduce the adjusted basis of the partnership interest and that the affected partnership knows it must reduce the partner's interest in inside basis. The legal basis for this requirement is contained in sections 1017(b), 6001, and 7805(a).

Though the proposed regulations might affect any partnership owning depreciable property, the IRS and Treasury Department believe that partnerships owning depreciable real property are the most likely to be affected. Approximately 1,560,000 partnership returns were filed for 1993. Approximately 620,000 of these were for partnerships owning real property. It is unlikely, however, that many of these partnerships will be affected by the proposed regulations in any given year.

After a partner conveys information concerning the amount of COD income excluded from gross income under section 108(a) to the affected partnership, the partnership must reduce the partner's interest in inside basis. Accordingly, the partnership must prepare and maintain special entries on its books because this basis reduction will reduce the partner's share of the partnership's depreciation deductions, and ultimate gain or loss on the sale of the property, in subsequent years. In many cases, partnership returns are prepared using computer software that can prepare and maintain these special entries after the initial year.

The IRS and Treasury Department are not aware of any federal rules that may duplicate, overlap, or conflict with the proposed rule.

As an alternative to the disclosure described above, the IRS and Treasury Department considered, but rejected as too burdensome, a rule that would have required an affected partnership to disclose the reductions of adjusted basis on a property-by-property basis. There are no known alternative rules that are less burdensome to small entities but that accomplish the purpose of the statute. The IRS and Treasury Department request comments from small entities concerning possible alternatives.

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 available for public inspection and copying.

A public hearing has been scheduled for April 29, 1997, at 10 a.m. in IRS Auditorium, 7th Floor, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

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

Persons that wish to present oral comments at the hearing must submit written comments by April 7, 1997 and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 3, 1997.

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

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

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 is amended by adding entries in numerical order to read as follows:

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

Section 1.108–4 also issued under 26 U.S.C. 108.

Section 1.108–5 also issued under 26 U.S.C. 108.

Section 1.1017–1 also issued under 26 U.S.C. 1017.

§ 1.108(a)–1 [Removed]

Par. 2. Section 1.108(a)–1 is removed.

§ 1.108(a)–2 [Removed]

Par. 3. Section 1.108(a)–2 is removed.

§ 1.108(b)–1 [Removed]

Par. 4. Section 1.108(b)–1 is removed.

§ 1.1016–7 [Removed]

Par. 5. Section 1.1016–7 is removed.

§ 1.1016–8 [Removed]

Par. 6–7. Section 1.1016–8 is removed.

§ 1.1017–2 [Removed]

Par. 8. Section 1.1017–2 is removed.

Par. 9. Section 1.108–4 is added to read as follows:

§ 1.108–4 Election to reduce basis of depreciable property under section 108(b)(5).

(a) *Description*. An election under section 108(b)(5) is available whenever a taxpayer excludes discharge of indebtedness (COD income) from gross income under sections 108(a)(1)(A), (B), or (C) (concerning title 11 cases, insolvency, and qualified farm indebtedness, respectively). See sections 108(d)(2) and (3) for the definitions of *title 11 case* and *insolvent*. See section 108(g)(2) for the definition of *qualified farm indebtedness*.

(b) *Time and manner*. To make an election under section 108(b)(5), a taxpayer must enter the appropriate information on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, and attach the form to the timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this section may be revoked only with the consent of the Commissioner.

(c) *Effective date*. This section is effective for elections concerning discharges of indebtedness occurring on or after the date these regulations are published as final regulations in the **Federal Register.**

Par. 10. Section 1.108–5 is added to read as follows:

§ 1.108–5 Limitations on the exclusion of income from the discharge of qualified real property business indebtedness

(a) *Indebtedness in excess of value*. The amount excluded from gross income under section 108(a)(1)(D) (concerning discharges of qualified real property business indebtedness) shall not exceed the excess, if any, of the outstanding principal amount of that indebtedness immediately before the discharge over the net fair market value of the qualifying real property, as defined in § 1.1017–1(c)(1), immediately before the discharge. For purposes of this section, *net fair market value* means the fair market value of the qualifying real property (notwithstanding section 7701(g)) reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by that property immediately before and after the discharge.

(b) *Overall limitation*. The amount excluded from gross income under section 108(a)(1)(D) shall not exceed the aggregate adjusted bases of all depreciable real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of the discharge) reduced by the sum of any—

(1) Depreciation claimed for the taxable year the taxpayer excluded discharge of indebtedness from gross income under section 108(a)(1)(D); and

(2) Reductions to the adjusted bases of depreciable real property required under section 108(b) or section 108(g) for the same taxable year.

(c) *Effective date*. This section is effective for discharges of qualified real property business indebtedness occurring on or after the date these regulations are published as final regulations in the **Federal Register.**

Par. 11. Section 1.1017–1 is revised to read as follows:

§ 1.1017–1 Basis reductions following a discharge of indebtedness

(a) *General rule for section 108(b)(2)(E)*. This paragraph (a) applies to basis reductions under section 108(b)(2)(E) that are required by section 108(a)(1)(A) or (B) because the taxpayer excluded discharge of indebtedness (COD income) from gross income. A taxpayer must reduce in the following order, to the extent of the excluded COD income but not below zero, the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded COD income from gross income (in proportion to adjusted basis):

(1) Real property used in a trade or business or held for investment, other than real property described in section 1221(1), that secured the discharged indebtedness immediately before the discharge (see paragraph (f)(1) of this section for the treatment of partnership indebtedness as indebtedness secured by the taxpayer's interest in the partnership);

(2) Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the indebtedness immediately before the discharge (see paragraph (f)(1) of this section for the treatment of partnership indebtedness as indebtedness secured by the taxpayer's interest in the partnership);

(3) Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in section 1221(1);

(4) Inventory, accounts receivable, notes receivable, and real property described in section 1221(1); and

(5) Property not used in a trade or business nor held for investment.

(b) *Operating rules*—(1) *Prior tax-attribute reduction*. The amount of excluded COD income applied to reduce basis does not include any COD income applied to reduce tax attributes under sections 108(b)(2)(A) through (D) and, if applicable, section 108(b)(5). For example, if a taxpayer excludes $100 of COD income from gross income under section 108(a) and reduces tax attributes by $40 under sections 108(b)(2)(A) through (D), the taxpayer is required to reduce the adjusted bases of property by $60 ($100 – $40) under section 108(b)(2)(E).

(2) *Multiple discharged indebtednesses*. If a taxpayer has COD income attributable to more than one discharged indebtedness resulting in the reduction of tax attributes under sections 108(b)(2)(A) through (D) and, if applicable, section 108(b)(5), paragraph (b)(1) of this section must be applied by allocating the tax-attribute reductions among the indebtednesses in proportion to the amount of COD income attributable to each discharged indebtedness. For example, if a taxpayer excludes $20 of COD income attributable to secured indebtedness A and excludes $80 of COD income attributable to unsecured indebtedness B (a total exclusion of $100), and if the taxpayer reduces tax attributes by $40 under sections 108(b)(2)(A) through (D), the taxpayer must reduce the amount of COD income attributable to secured indebtedness A to $12 ($20 – ($20 ÷ $100 x $40)) and must reduce the amount of COD income attributable to unsecured indebtedness B to $48 ($80 – ($80 ÷ $100 x $40)).

(3) *Limitation on basis reductions under section 108(b)(2)(E) in bankruptcy or insolvency*. If COD income arises from a discharge of indebtedness in a title 11 case or while the taxpayer is insolvent, the amount of any basis reduction under section 108(b)(2)(E) shall not exceed the excess of—

(i) The aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge; over

(ii) The aggregate of the liabilities of the taxpayer immediately after the discharge.

(c) *Modification of ordering rules for basis reductions under sections 108(b)(5) and 108(c)*—(1) *In general*. The ordering rules prescribed in paragraph (a) of this section apply, with appropriate modifications, to basis reductions under sections 108(b)(5) and (c). Thus, a taxpayer may reduce only the adjusted bases of depreciable property under section 108(b)(5) and may reduce only the adjusted bases of depreciable real property under section 108(c). Furthermore, for basis reductions under section 108(c), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged qualified real property business indebtedness before reducing the adjusted bases of other depreciable real property. The term *qualifying real property* means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3). See paragraphs (e) and (f) of this section for elections relating to section 1221(1) property and partnership interests.

(2) *Partial basis reductions under section 108(b)(5)*. If the amount of basis reductions under section 108(b)(5) is less than the amount of the COD income excluded from gross income under section 108(a), the taxpayer must reduce the balance of its tax attributes, including any remaining adjusted bases of depreciable property, under section 108(b)(2). For example, if a taxpayer excludes $100 of COD income from gross income under section 108(a) and elects to reduce the adjusted bases of depreciable property by $10 under section 108(b)(5), the taxpayer must reduce its remaining tax attributes by $90 under section 108(b)(2).

(3) *Modification of fresh start rule for prior basis reductions under section 108(b)(5)*. After reducing the adjusted bases of depreciable property under section 108(b)(5), a taxpayer must compute the limitation on basis reductions under section 1017(b)(2) using the aggregate of the remaining adjusted bases of property. For example, if, immediately after the discharge of indebtedness in a title 11 case, a taxpayer's adjusted bases of property is $100 and its undischarged indebtedness is $70, and if the taxpayer elects to reduce the adjusted bases of depreciable property by $10 under section 108(b)(5), section 1017(b)(2) limits any further basis reductions under section 108(b)(2)(E) to $20 (($100 – $10) – $70).

(d) *Changes in security*. Any change in the property securing an indebtedness during the one-year period preceding the discharge of that indebtedness shall be disregarded if a principal purpose of that change is to affect the taxpayer's basis reductions under section 1017.

(e) *Election to treat section 1221(1) real property as depreciable*—(1) *In general*. For basis reductions under sections 108(b)(5) and (g), a taxpayer may elect under sections 1017(b)(3)(E) and (4)(C), respectively, to treat real property described in section 1221(1) as depreciable property. This election is not available, however, for basis reductions under section 108(c).

(2) *Time and manner*. To make an election under section 1017(b)(3)(E) or (4)(C), a taxpayer must enter the appropriate information on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, and attach the form to a timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a). An election under this paragraph (e) may be revoked only with the consent of the Commissioner.

(f) *Partnerships*—(1) *Partnership COD income*. For purposes of paragraph (a) of this section, a taxpayer must treat a distributive share of a partnership's COD income as attributable to a discharged indebtedness secured by the taxpayer's interest in that partnership.

(2) *Partnership interest treated as depreciable property*— (i) *In general*. For purposes of making basis reductions, if a taxpayer makes an election under section 108(b)(5) or (c) the taxpayer must treat a partnership interest as depreciable property (or depreciable real property) to the extent of the partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property), provided the partnership consents to a corresponding reduction in the partnership's basis (inside basis) in depreciable property (or depreciable real property) with respect to such partner.

(ii) *Request by partner and consent of partnership*—(A) *In general*. Except as otherwise provided in this paragraph (f)(2)(ii), a taxpayer may choose whether or not to request that a partnership reduce the inside basis of its depreciable property (or depreciable real property) with respect to the taxpayer, and the partnership may grant or withhold such consent, in its sole discretion. A request by the taxpayer must be made before the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(B) *Request for consent required*. A taxpayer must request a partnership's consent to reduce inside basis if the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership, or if reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of COD income of the partnership.

(C) *Granting of request required*. A partnership must consent to reduce its partners' shares of inside basis if consent is requested by partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. For example, if there is a cancellation of partnership indebtedness securing real property used in a partnership's trade or business, and if partners owning (in the aggregate) 60 percent of the capital and profits interests of the partnership elect to exclude the COD income under section 108(c), the partnership must make the appropriate reductions in those partners' shares of inside basis.

(iii) *Partnership consent statement*—(A) *Partnership requirement*. A consenting partnership must include with the Form 1065, U.S. Partnership Return of Income, for the taxable year of the partnership that ends with or within the taxable year the taxpayer excludes COD income from gross income under section 108(a), and must provide to the taxpayer on or before the date the Form 1065 is filed, a statement that—

(*1*) Contains the name, address, and taxpayer identification number of the partnership; and

(*2*) States the amount of the reduction of the partner's proportionate interest in the adjusted bases of the partnership's depreciable property or depreciable real property, whichever is applicable.

(B) *Taxpayer's requirement*. Statements described in paragraph (f)(2)(iii)(A) of this section must be attached to a taxpayer's timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has COD income that is excluded from gross income under section 108(a).

(iv) *Partner's share of partnership's adjusted basis*. [Reserved.]

(3) *Partnership basis reduction*. The rules of this section (including this paragraph (f)), apply in determining the properties to which the partnership's basis reductions must be made.

(g) *Special allocation rule for cases to which section 1398 applies*. If a bankruptcy estate and a taxpayer to whom section 1398 applies (concerning only individuals under Chapter 7 or 11 of title 11 of the United States Code) hold property subject to basis reduction under section 108(b)(2)(E) or (5) on the first day of the taxable year following the taxable year of discharge, the bankruptcy estate must reduce all of the adjusted bases of its property before the taxpayer is required to reduce any adjusted bases of property.

(h) *Effective date*. This section is effective for discharges of indebtedness occurring on or after the date these regulations are published as final regulations in the **Federal Register.**

PART 301—PROCEDURE AND ADMINISTRATION

Par. 12. The authority citation for part 301 continues to read as follows:

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

§ 301.9100–13T [Removed]

Par. 13. Section 301.9100–13T is removed.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 6, 1997, 8:45 a.m., and published in the issue of the Federal Register for January 7, 1997, 62 F.R. 955)

New Reporting for Medical Savings Accounts, Long-Term Care Accounts, and SIMPLE Retirement Accounts

Announcement 97–10

The Health Insurance Portability and Accountability Act of 1996 added section 220 to the Internal Revenue Code to permit eligible individuals to establish medical savings accounts (MSAs). The Act also added Code section 6050Q, which requires any person paying long-term care or accelerated death benefits to report the aggregate benefits paid and certain other information. In addition, the Small Business Job Protection Act of 1996 added section 408(p), which allows individuals to establish Savings Incentive Match Plans for Employees of Small Employers (SIMPLE) retirement accounts.

To carry out the MSA provisions, the IRS developed three new forms: **Form 1099–MSA,** Distributions From Medical Savings Accounts, for trustees to report distributions from an MSA; Form 5498–MSA, Medical Savings Account Information, for trustees to report contributions to an MSA; and **Form 8851**, Summary of Medical Savings Accounts, for trustees to report the number of MSAs established.

For insurance companies and other payers to report the aggregate benefits paid and other information required under section 6050Q, the IRS developed **Form 1099–LTC**, Long-Term Care and Accelerated Death Benefits.

The filing requirements for trustees and other payers are as follows:

If the Form Is	Then File With or Furnish to	By This Date
1099–MSA (Copy A)	IRS	March 2, 1998
1099–MSA (Copy B)	Recipient	February 2, 1998
Form 5498–MSA (Copy A)	IRS	June 1, 1998
Form 5498–MSA (Copy B)	Participant	June 1, 1998
Form 8851	IRS	June 2, 1997 (For MSAs established from Jan. 1—Apr. 30, 1997)
Form 8851	IRS	August 1, 1997 (For MSAs established from May 1—June 30, 1997)
Form 1099–LTC (Copy A)	IRS	March 2, 1998
Form 1099–LTC (Copy B)	Policyholder	February 2, 1998
Form 1099–LTC (Copy C)	Insured	February 2, 1998

Copy A of Forms 1099–MSA, 5498–MSA, and 1099–LTC are provided for your information. Form 8851 is also included. Printed forms are expected to be available in late February.

No new forms are required for trustees to report distributions from and contributions to a SIMPLE. Trustees must report distributions from a SIMPLE on Form 1099–R and report contributions to a SIMPLE on Form 5498. The filing dates for Form 1099–R and Form 5498 will remain the same as in prior years. The 1997 versions of these forms have been revised for reporting SIMPLEs. Printed copies of Forms 1099–R and 5498 can be obtained by calling 1–800–829–3676.

All the forms discussed above can be downloaded from the IRS's Internet Web Site at http://www.irs.ustreas.gov.

0594 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code			OMB No. 1545-1517 **1997** Form **1099-MSA**	**Distributions From Medical Savings Accounts**
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Gross distribution $	2 Earnings on excess contributions $	**Copy A** **For Internal Revenue Service Center** **File with Form 1096.**
RECIPIENT'S name		3 Distribution code		For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)				
City, state, and ZIP code				
Account number (optional)				

Form **1099-MSA** Cat. No. 23114L Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

0527 ☐ VOID ☐ CORRECTED

TRUSTEE'S name, street address, city, state, and ZIP code		1 Employee MSA contributions made in 1997 and 1998 for 1997 $	OMB No. 1545-1518 **1997** Form **5498-MSA**	**Medical Savings Account Information**
		2 Total MSA contributions made in 1997 $		
TRUSTEE'S Federal identification number	PARTICIPANT'S social security number	3 Total MSA contributions made in 1998 for 1997 $		**Copy A** **For Internal Revenue Service Center** **File with Form 1096.**
PARTICIPANT'S name		4 MSA rollover contributions (not included in boxes 1, 2, or 3) $	5 Fair market value of account $	For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)				
City, state, and ZIP code				
Account number (optional)				

Form **5498-MSA** Cat. No. 23097L Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page.

Form **8851**

Department of the Treasury
Internal Revenue Service

Summary of Medical Savings Accounts

▶ **For Paperwork Reduction Act Notice, see back of form.**

OMB No. 1545-1508

1997

Trustee's name | Employer identification no.

Number, street, and room/suite no.

City, state, and ZIP code | Telephone number ( )

a This report is for the period: ☐ **January 1 through April 30, 1997** ☐ **May 1 through June 30, 1997**

b Total number of medical savings accounts (see instructions) . . . ▶

c Total number of previously uninsured account holders (see instructions). . . ▶

d Total number of excludable account holders (see instructions) . . . . ▶

	Name of Account Holder (Last name, first name, and middle initial)	Social Security Number	Check if Previously Uninsured	Check if Excludable
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
16				
17				
18				
19				
20				

Cat. No. 22932F

Form **8851** (1997)

0593 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Gross long-term care benefits paid $	OMB No. 1545-1519	Long-Term Care and Accelerated Death Benefits
		2 Accelerated death benefits paid $	1997 Form 1099-LTC	
PAYER'S Federal identification number	POLICYHOLDER'S identification number	3 Check one: ☐ Per diem ☐ Reimbursed amount	INSURED'S social security no.	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G.
POLICYHOLDER'S name		INSURED'S name		
Street address (including apt. no.)		Street address (including apt. no.)		
City, state, and ZIP code		City, state, and ZIP code		
Account number (optional)		4 (optional) ☐ Chronically ill ☐ Terminally ill	Date certified	

Form 1099-LTC Cat. No. 23021Z Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

Foundations Status of Certain Organizations

Announcement 97–18

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

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

Agape Community Outreach Inc., Beaver Springs, PA
Aim for Success, Inc., Mamaroneck, NY
Alaska National Guard Historical Holding-Museum Fund Inc., Ft. Richardson, AK
Allentown Liberty Bell Rotary Club Foundation, Quakertown, PA
American Dental Group Incorporated, Washington, DC
American Institute of Med. & Public Health of Central & Eastern Europe, Inc., New York, NY
Anacostia Growth Fund Inc., Washington, DC
Asanteman-Kuo of Washington DC Metropolitan Area, Silver Spring, MD
Assembly of Sons Ministry, Laurel, MD
Banquete Del Million Y Del Amor, Arlington, VA
Barnabas Family Ministries Society, Canada
Birdsboro Library Inc., Birdsboro, PA
Catch Foundation A Washington Non-profit Corporation, Seattle, WA
Catholic Leadership Institute, Bala Cynwyd, PA
Center for Middle East Research Inc., Washington, DC
Community Services Housing Inc., Charlottesville, VA
Consumers Loan Advocates Inc., Lake Bluff, MN
Cop Care, Inc., Seaford, NY
Council for Safe Families, Inc., New York, NY
DDD, Inc., Brooklyn, NY
Election Aid Incorporated, Camden, NJ
Essex Horse Trials Inc., Gladstone, NJ
First Stage Theatre, Lititz, PA
Grantsburg Hockey Association, Grantsburg, WI
Greater Baltimore Community Housing Resource Board Inc., Baltimore, MD
Hobbit Hollow Inc., Centreville, VA
Humane Society of Calvert County, Prince Frederick, MD
IFF Wildlife Habitat Club, Union Beach, NJ
Institute for Catholic Liberal Education Inc., Falls Church, VA
Institute of International Trade and Development, Washington, DC
Kentucky School Reform Corporation, Philadelphia, PA
Kids of the Kingdom, Inc., Scranton, PA
Kinder Castle Learning Center Inc., Dodgeville, WI
Land Council Inc., Washington, DC
Learning Curve Foundation, Sergeantsville, NJ
Margaret Brent Special Center PSSO Association Inc., New Carrollton, MD
Memorial to the Ancestors Project Map Inc., Newark, NJ
Mercer County Tenant Action Inc., Mercer, PA
Mid State Health Advisory Corp., Lawrenceville, NJ
Miracle Man Ranch, Virginia Beach, VA
Mission of Hope and Center for Learning Inc., Philadelphia, PA
Missions in Action Inc., Lynchburg, VA
Monmouth County Association of School Administrators, Oceanport, NJ
National Association of Purchasing Management, Salisbury, MD
Native American Economic Development Advocacy, Baltimore, MD
New Jersey Association for Middle Level, Lebanon Hill, NJ
New Visions Inc., Laurel, MD
Northeast Chamber Orchestra, Philadelphia, PA
North Philadelphia Community Help, Philadelphia, PA

North Philadelphia East Local Development Corporation, Philadelphia, PA
Offender Aid and Restoration of Prince William Manassas, Manassas, VA
Older But Wiser, Inc., Portland, OR
Options in Supported Living Inc., Rockville, MD
Paige Anne Foundation, Glenn Dale, MD
Palmer Revival Ministries Inc., Lewistown, PA
Panther Junior Olympic Volleyball Club, Baltimore, MD
Pennsylvania Human Performance Foundation, Bethlehem, PA
Performing Arts League of Philadelphia, Philadelphia, PA
Perry School Community Services Center Inc., Washington, DC
Piscataway Township Education Foundation, Piscataway, NJ
Power of No Association, Merrifield, VA
Prince Georges County Housing Development Corp., Upper Marlboro, MD
Princeton Downtown Teen Center NJ Non-Profit Corp., Princeton, NJ
Professional Bicultural Development Associates Inc., South Orange, NJ
Profound Paralysis Foundation, Lovettsville, VA
Project Teach, Penndel, PA
Queen Annes Advocates for Youth Inc., Crumpton, MD
Radford Band Boosters Inc., Radford, VA
Rainbows Way Inn, Inc., Mesa, AZ
Reads, Inc., Philadelphia, PA
Recycling Association of Central Virginia, Richmond, VA
Renegade Productions Inc., Newtown, PA
R Group Inc., Wilmington, DE
Rocking, Inc., Media, PA
Self Improvement Life Style Center, Philadelphia, PA
September Place, Chesapeake, VA
Seventh Councilmatic District Constituent Fund, Upper Marlboro, MD
Ships at Sea Inc., Virginia Beach, VA
SNAP Special Needs Alliance of Parents Inc., Pennsburgh, PA
South Lakes High School Band Boosters Association, Reston, VA
Sports Medicine Foundation Inc., York, PA
STARS Inc., Hagerstown, MD
Steel Recycling Foundation, Pittsburgh, PA
St. James Preparatory School Inc., Newark, NJ
Stonebridge Educational Foundation, Chesapeake, VA
Storks Nest Fund, Washington, DC
Support Forum Inc., Middletown, NJ
Threshold Housing Development Inc., Uniontown, PA
Tidewater Ministers Community Development Inc., Norfolk, VA
Union County Regional Education Foundation Inc., Clark, NJ
United Way of Carbon County, Weatherly, PA
Upper Darby Rotary Foundation, Drexel Hill, PA
Virginia Beach Chapter National Audubon Society Inc., Virginia Beach, VA
Washington Community Gymnastics Center, Washington, DC
Wildcats Wrestling Association Inc., Carlstadt, NJ
Womens Way USA, Philadelphia, PA
Woodbridge Academy of Music Inc., Metuchen, NJ
World Affairs Council of Greater Valley Forge Inc., Southwestern, PA
WRC North Fork Heights, Brookville, PA
York Rotary Charitable Endowment Fund, York, PA
You Owe Yourself the Chance, Forestville, MD
Youth and Family Services of Southern Maryland Inc., Charlotte Hall, MD

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

Fact-of-Filing

Announcement Number 97–19

The Internal Revenue Service (IRS) will continue, through December 31, 1997, its program to respond to requests for fact-of-filing information from firms in the tax professional community with respect to their employees and associates. The tax professional community consists of all firms who prepare tax returns, offer tax advice, or provide tax service. This includes practitioners governed by Treasury Department Circular 230.

It is limited to individual income tax returns (Form 1040 series) for tax years 1994 through 1996. A YES or NO answer will be provided for each request. The Service will answer requests for tax years 1994 and 1995 within 45 days of receipt of the request. Processing of requests for tax year 1996 will not be accomplished before November 14, 1997.

The fact-of-filing confirmation may be requested by the individual taxpayer or by the employer. No consent form is needed for confirmations mailed to the taxpayer's address listed on the IRS master file. However, if the request directs the information to a third party (someone other than the IRS or the individual taxpayer), the IRS must receive a consent form for each taxpayer on which fact-of-filing information is requested.

All requests for fact-of-filing information or revocation of consent for participants in this program will be processed at the Kansas City Service Center. The requests should be mailed to:

DISCLOSURE OFFICE
STOP 7000, ANNEX 5
POST OFFICE BOX 24551
KANSAS CITY, MISSOURI 64131

Unless the request is made by the individual taxpayer, with instructions to mail the confirmation to the address listed on the IRS master file, the requests for fact-of-filing information on individual taxpayers must include completed consent forms. The Service recommends the use of the FORM 8821, TAX INFORMATION AUTHORIZATION and that the statement ''Fact of Filing for Individual Income Tax Returns (Form 1040 Series)'' be included in the column for Type of Tax. However, if this form is not used, the substitute form must contain the following at a minimum:

Taxpayer(s) Name and Social Security Number
Taxpayer Address(es) (Street, City, State, and ZIP)
Appointee: (TO WHOM DISCLOSURE IS TO BE MADE)
Name(s)
Address(es)
Return Information to be disclosed: (FACT-OF-FILING FOR INDIVIDUAL INCOME TAX RETURN(S) (FORM 1040 SERIES)

Tax Years 1994, 1995, and 1996
Signature of Taxpayer(s)
Date of Taxpayer(s)' Signature

The consent forms must be received by the IRS Dislosure Office in the Kansas City Service Center within 60 days of the date of the signature(s) on the consent form. The consent forms for this program may only authorize release of fact-of-filing data for tax years 1994, 1995, and 1996.

The Service will process revocations of consent filed by the individual taxpayer. Revocation of consent must be filed at the Kansas City Service Center. The revocation will be effective upon receipt by that office.

The IRS will confirm fact-of-filing or no record of filing with the individual taxpayer or the appointee listed on the taxpayer(s)' consent form. Unless the individual taxpayer asks for written confirmation, individual written confirmations will be by a list to the employer (appointee listed on the consent form) for taxpayers with a record of filing. The individual taxpayer will always receive written notification when the Service is informing the appointee that the IRS has no record of filing for the year(s) requested.

The name(s) of non-filers identified through a request for fact-of-filing information will be forwarded to the IRS Compliance function servicing the individual geographical area. This function will determine compliance actions to be taken by the Service.

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

A—Individual.

Acq.—Acquiescence.

B—Individual.

BE—Beneficiary.

BK—Bank.

B.T.A.—Board of Tax Appeals.

C.—Individual.

C.B.—Cumulative Bulletin.

CFR—Code of Federal Regulations.

CI—City.

COOP—Cooperative.

Ct.D.—Court Decision.

CY—County.

D—Decedent.

DC—Dummy Corporation.

DE—Donee.

Del. Order—Delegation Order.

DISC—Domestic International Sales Corporation.

DR—Donor.

E—Estate.

EE—Employee.

E.O.—Executive Order.

ER—Employer.

ERISA—Employee Retirement Income Security Act.

EX—Executor.

F—Fiduciary.

FC—Foreign Country.

FICA—Federal Insurance Contribution Act.

FISC—Foreign International Sales Company.

FPH—Foreign Personal Holding Company.

F.R.—Federal Register.

FUTA—Federal Unemployment Tax Act.

FX—Foreign Corporation.

G.C.M.—Chief Counsel's Memorandum.

GE—Grantee.

GP—General Partner.

GR—Grantor.

IC—Insurance Company.

I.R.B.—Internal Revenue Bulletin.

LE—Lessee.

LP—Limited Partner.

LR—Lessor.

M—Minor.

Nonacq.—Nonacquiescence.

O—Organization.

P—Parent Corporation.

PHC—Personal Holding Company.

PO—Possession of the U.S.

PR—Partner.

PRS—Partnership.

PTE—Prohibited Transaction Exemption.

Pub. L.—Public Law.

REIT—Real Estate Investment Trust.

Rev. Proc.—Revenue Procedure.

Rev. Rul.—Revenue Ruling.

S—Subsidiary.

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

Stat.—Statutes at Large.

T—Target Corporation.

T.C.—Tax Court.

T.D.—Treasury Decision.

TFE—Transferee.

TFR—Transferor.

T.I.R.—Technical Information Release.

TP—Taxpayer.

TR—Trust.

TT—Trustee.

U.S.C.—United States Code.

X—Corporation.

Y—Corporation.

Z—Corporation.

Numerical Finding List[1]

Bulletin 1997–1 through 1997–9

Announcements:

97–1, 1997–2 I.R.B. *63*
97–2, 1997–2 I.R.B. *63*
97–3, 1997–2 I.R.B. *63*
97–4, 1997–3 I.R.B. *14*
97–5, 1997–3 I.R.B. *15*
97–6, 1997–4 I.R.B. *11*
97–7, 1997–4 I.R.B. *12*
97–8, 1997–4 I.R.B. *12*
97–9, 1997–5 I.R.B. *27*
97–11, 1997–6 I.R.B. *19*
97–12, 1997–7 I.R.B. *55*
97–13, 1997–8 I.R.B. *38*
97–14, 1997–8 I.R.B. *38*
97–15, 1997–9 I.R.B. *23*
97–16, 1997–9 I.R.B. *23*
97–17, 1997–9 I.R.B. *23*

Notices:

97–1, 1997–2 I.R.B. *22*
97–2, 1997–2 I.R.B. *22*
97–3, 1997–1 I.R.B. *8*
97–4, 1997–2 I.R.B. *24*
97–5, 1997–2 I.R.B. *25*
97–6, 1997–2 I.R.B. *26*
97–7, 1997–1 I.R.B. *8*
97–8, 1997–4 I.R.B. *7*
97–9, 1997–2 I.R.B. *35*
97–10, 1997–2 I.R.B. *41*
97–11, 1997–2 I.R.B. *50*
97–12, 1997–3 I.R.B. *11*
97–13, 1997–6 I.R.B. *13*
97–14, 1997–8 I.R.B. *23*
97–15, 1997–8 I.R.B. *23*
97–16, 1997–9 I.R.B. *15*

Proposed Regulations:

REG–209040–88, 1997–7 I.R.B. *34*
REG–209494–90, 1997–8 I.R.B. *24*
REG–209839–96, 1997–8 I.R.B. *26*
REG–209672–93, 1997–6 I.R.B. *15*
REG–209762–95, 1997–3 I.R.B. *12*
REG–209817–96, 1997–7 I.R.B. *41*
REG–209828–96, 1997–6 I.R.B. *15*
REG–209834–96, 1997–4 I.R.B. *9*
REG–242996–96, 1997–9 I.R.B. *18*
REG–246018–96, 1997–8 I.R.B. *30*
REG–247678–96, 1997–6 I.R.B. *17*
REG–247862–96, 1997–8 I.R.B. *32*
REG–248770–96, 1997–8 I.R.B. *33*
REG–249819–96, 1997–7 I.R.B. *50*
REG–252231–96, 1997–7 I.R.B. *52*
REG–252233–96, 1997–9 I.R.B. *19*

Revenue Procedures:

97–1, 1997–1 I.R.B. *11*
97–2, 1997–1 I.R.B. *64*
97–3, 1997–1 I.R.B. *84*
97–4, 1997–1 I.R.B. *96*
97–5, 1997–1 I.R.B. *132*
97–6, 1997–1 I.R.B. *153*
97–7, 1997–1 I.R.B. *185*
97–8, 1997–1 I.R.B. *187*
97–9, 1997–2 I.R.B. *56*
97–10, 1997–2 I.R.B. *59*

Revenue Procedures—Continued

97–11, 1997–6 I.R.B. *13*
97–12, 1997–4 I.R.B. *7*
97–13, 1997–5 I.R.B. *18*
97–14, 1997–5 I.R.B. *20*
97–15, 1997–5 I.R.B. *21*
97–16, 1997–5 I.R.B. *25*
97–16, 1997–9 I.R.B. *15*

Revenue Rulings:

97–1, 1997–2 I.R.B. *10*
97–2, 1997–2 I.R.B. *7*
97–3, 1997–2 I.R.B. *5*
97–4, 1997–3 I.R.B. *6*
97–5, 1997–4 I.R.B. *5*
97–6, 1997–4 I.R.B. *4*
97–7, 1997–5 I.R.B. *14*
97–8, 1997–7 I.R.B. *4*
97–9, 1997–9 I.R.B. *4*

Social Security Domestic Coverage Threshold

1997–9, I.R.B. *17*

Treasury Decisions:

8688, 1997–3 I.R.B. *7*
8689, 1997–3 I.R.B. *9*
8690, 1997–5 I.R.B. *5*
8691, 1997–5 I.R.B. *16*
8692, 1997–3 I.R.B. *4*
8693, 1997–6 I.R.B. *9*
8694, 1997–6 I.R.B. *11*
8695, 1997–4 I.R.B. *5*
8696, 1997–6 I.R.B. *4*
8697, 1997–2 I.R.B. *11*
8698, 1997–7 I.R.B. *29*
8699, 1997–6 I.R.B. *4*
8700, 1997–7 I.R.B. *5*
8701, 1997–7 I.R.B. *23*
8702, 1997–8 I.R.B. *4*
8703, 1997–8 I.R.B. *18*
8704, 1997–8 I.R.B. *12*
8705, 1997–8 I.R.B. *16*
8706, 1997–9 I.R.B. *11*
8707, 1997–7 I.R.B. *17*
8709, 1997–9 I.R.B. *5*

[1]A cumulative list of all Revenue Rulings, Revenue Procedures, Treasury Decisions, etc., published in Internal Revenue Bulletins 1996–27 through 1996–53 will be found in Internal Revenue Bulletin 1997–1, dated January 6, 1997.

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

Bulletin 1997–1 through 1997–9

*Denotes entry since last publication

Revenue Procedures:

66–3
Modified by
97–11, 1997–6 I.R.B. *13*

87–21
Modified by
97–11, 1997–6 I.R.B. *13*

92–20
Modified by
97–1, 1997–1 I.R.B. *11*

92–20
Modified by
97–10, 1997–2 I.R.B. *59*

92–90
Superseded by
97–1, 1997–1 I.R.B. *11*

94–52
Revoked by
97–11, 1997–6 I.R.B. *13*

96–1
Superseded by
97–1, 1997–1 I.R.B. *11*

96–2
Superseded by
97–2, 1997–1 I.R.B. *64*

96–3
Superseded by
97–3, 1997–1 I.R.B. *84*

96–4
Superseded by
97–4, 1997–1 I.R.B. *96*

96–5
Superseded by
97–5, 1997–1 I.R.B. *132*

96–6
Superseded by
97–6, 1997–1 I.R.B. *153*

96–7
Superseded by
97–7, 1997–1 I.R.B. *185*

96–8
Superseded by
97–8, 1997–1 I.R.B. *187*

Revenue Rulings:

70–480
Revoked by
97–6, 1997–4 I.R.B. *4*

72–527
Obsoleted by
8704, 1997–8 I.R.B. *12*

74–59
Revoked by
8708, 1997–10 I.R.B. *14*

Revenue Rulings—Continued

92–19
Supplemented in part by
97–2, 1997–2 I.R.B. *7*

96–12
Superseded by
97–3, 1997–1 I.R.B. *84*

96–13
Modified by
97–1, 1997–1 I.R.B. *11*

96–22
Superseded by
97–3, 1997–1 I.R.B. *84*

96–34
Superseded by
97–3, 1997–1 I.R.B. *84*

96–39
Superseded by
97–3, 1997–1 I.R.B. *84*

96–43
Superseded by
97–3, 1997–1 I.R.B. *84*

96–56
Superseded by
97–3, 1997–1 I.R.B. *84*

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