

## 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. 2000-1, page 250.

**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 January 2000.

#### T.D. 8849, page 245.

Final regulations under section 663(c) of the Code relate to the separate share rules applicable to estates.

#### T.D. 8850, page 265.

Final regulations under section 6038 of the Code relate to the reporting requirements of U.S. persons owning interests in controlled foreign partnerships or corporations. Also, certain amendments to the final regulations under section 6038B govern reporting of transfers to foreign partnerships and corporations.

#### T.D. 8851, page 275.

Final regulations under section 6046A of the Code relate to the reporting requirements of U.S. persons that acquire or dispose of an interest in a foreign partnership, or whose proportional interest in a foreign partnership changes.

#### T.D. 8852, page 253.

Final regulations under sections 1366, 1367, and 1368 of the Code relate to the passthrough of items of an S corporation to its shareholders, the adjustments to the basis of stock of the shareholders, and the treatment of distributions by an S corporation.

#### REG-106012-98, page 290.

Proposed regulations under section 118 of the Code relate to the exclusion from gross income for a contribution in aid of construction (CIAC) from any person (whether or not a shareholder) to a required public utility that provides water or sewerage disposal services. The

regulations define what constitutes a CIAC and provides rules for adjusting the basis of water or sewerage disposal facilities acquired as, or acquired or constructed with any money received as, a CIAC. The regulations also provide the time and manner for taxpayers to notify the Secretary of amounts treated as a contribution to capital under this provision. A public hearing is scheduled for April 27, 2000.

#### Rev. Proc. 2000-10, page 287.

##### **Qualified Zone Academy Bond limitations for 2000.**

This procedure sets forth the maximum face amount of Qualified Zone Academy Bonds that may be issued for each state in 2000. For this purpose, "state" includes the District of Columbia and U.S. possessions.

#### Notice 2000-1, page 288.

**Effective date of proposed regulations under section 1.368-2(d)(4).** Proposed regulations relating to the solely for voting stock requirement in reorganizations under section 368(a)(1)(C) of the Code, when finalized, will be modified to generally apply to transactions occurring after December 31, 1999. But in certain cases, taxpayers will be able to request a private letter ruling permitting them to apply the proposed regulations to transactions occurring before the proposed effective date.

### EMPLOYEE PLANS

#### Announcement 2000-1, page 294.

This document provides interim information about the reporting requirements applicable to certain plans of state and local government employers for amounts provided under section 457. Comments are also requested regarding types of plans that should be treated as bona fide severance plans for purposes of section 457.

(Continued on the page following the Introduction)

Finding Lists begin on page ii.



# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities

and by applying the tax law with integrity and fairness to all.

## Introduction

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

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

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

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and proce-

dures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

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

### **Part II.—Treaties and Tax Legislation.**

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

### **Part III.—Administrative, Procedural, and Miscellaneous.**

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

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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

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## ESTATE TAX

### **Announcement 2000-3, page 296.**

This document contains corrections to T.D. 8846, 1999-51 I.R.B. 679, relating to the effect of certain administration expenses on the valuation of property for marital and charitable deduction purposes.

## ADMINISTRATIVE

### **Rev. Proc. 2000-9, page 280.**

**Per diem allowances.** This procedure provides optional rules for substantiating the amount of certain reimbursed

travel expenses of an employee and for determining the amount of deductible meals while traveling away from home. Rev. Proc. 98-64 superseded.

### **Announcement 2000-2, page 295.**

Information letters written by the national office of Chief Counsel and by the Office of the Commissioner, Tax Exempt and Government Entities Division, to the public in response to inquiries postmarked or, if not mailed, received after January 1, 2000, will be available for public inspection quarterly beginning March 31, 2000, and on a continuing quarterly basis.

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here

# 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 January 2000. See Rev. Rul. 2000-1, page 250.

## Section 62.—Adjusted Gross Income Defined

*26 CFR 1.62-2: Reimbursements and other expense allowance arrangements.*

Rules are set forth under which a reimbursement or other expense allowance arrangement for the cost of lodging, meal, and incidental expenses or meal and incidental expenses incurred by an employee while traveling away from home will satisfy the requirements of § 62(c) of the Code as to substantiation of the amount of the expenses. See Rev. Proc. 2000-9, page 280.

*26 CFR 1.62-2T: Reimbursements and other expense allowance arrangements (temporary).*

Rules are set forth under which a reimbursement or other expense allowance arrangement for the cost of lodging, meal, and incidental expenses or meal and incidental expenses incurred by an employee while traveling away from home will satisfy the requirements of § 62(c) of the Code as to substantiation of the amount of expenses. See Rev. Proc. 2000-9, page 280.

## Section 162.—Trade or Business Expense

*26 CFR 1.162-17: Reporting and substantiation of certain business expenses of employees.*

Rules are set forth for substantiating the amount of a deduction or an expense for lodging, meal, and incidental expenses or meal and incidental expenses incurred while traveling away from home that most nearly represents current costs. See Rev. Proc. 2000-9, page 280.

## Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

*26 CFR 1.267(a)-1: Deductions disallowed.*

When a payor provides a per diem allowance to an employee who is a related party, the rules set forth for the deemed substantiation to the payor of the amount of the employee's ordinary and necessary business expenses for lodging, meal, and inci-

dental expenses or meal and incidental expenses incurred while traveling away from home do not apply. See Rev. Proc. 2000-9, page 280.

## Section 274.—Disallowance of Certain Entertainment, Etc., Expenses

*26 CFR 1.274-5T: Substantiation requirements (temporary).*

Rules are set forth for an optional method for substantiating the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses or meal and incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Rules are also set forth for an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. See Rev. Proc. 2000-9, page 280.

*26 CFR 1.274(d)-1T: Substantiation requirements (temporary).*

Rules are set forth for an optional method for substantiating the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses or meal, and incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. See Rev. Proc. 2000-9, page 280.

## Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2000. See Rev. Rul. 2000-1, page 250.

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

The adjusted applicable federal long-term rate is set forth for the month of January 2000. See Rev. Rul. 2000-1, page 250.

## Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-

term, and long-term rates are set forth for the month of January 2000. See Rev. Rul. 2000-1, page 250.

## 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 January 2000. See Rev. Rul. 2000-1, page 250.

## 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 January 2000. See Rev. Rul. 2000-1, page 250.

## Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2000. See Rev. Rul. 2000-1, page 250.

## 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 January 2000. See Rev. Rul. 2000-1, page 250.

## Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2000. See Rev. Rul. 2000-1, page 250.

## Section 663.—Special Rules Applicable to Sections 661 and 662

*26 CFR 1.663(a)-1: Special rules applicable to sections 661 and 662; exclusion; gifts, bequests, etc.*

**DEPARTMENT OF TREASURY**  
**Internal Revenue Service**  
**26 CFR Part 1**

**Section 663(c); Separate Share Rules Applicable to Estates**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning separate share rules applicable to estates under section 663(c) of the Internal Revenue Code. These regulations provide that substantively separate and independent shares of different beneficiaries are to be treated as separate estates for purposes of computing distributable net income and applying the distribution provisions of sections 661 and 662. These regulations also provide that a surviving spouse's statutory elective share of a decedent's estate and a pecuniary formula bequest are separate shares. Further, a revocable trust that elects to be treated as part of a decedent's estate is a separate share.

DATES: *Effective Date:* December 28, 1999.

*Applicability Dates:* For dates of applicability of these regulations, see §1.663(c)-6.

FOR FURTHER INFORMATION CONTACT: Laura Howell, (202) 622-3060 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Background**

On January 6, 1999, a notice of proposed rulemaking was published in the **Federal Register** (64 FR 790 (REG-114841-98, 1999-11 I.R.B., 41)) relating to the application of the separate share rules to estates under section 663(c). Written comments were received on the proposed regulations, and a public hearing was held on April 22, 1999. After consideration of all the comments, the proposed regulations under section 663(c) are adopted as revised by this Treasury decision.

**Explanation of Provisions**

*General Separate Share Rules*

The proposed regulations define a separate share as a separate economic interest in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries (for example, rights to income or gains from specified items of property) are not affected by economic interests accruing to another beneficiary or class of beneficiaries. The proposed regulations conclude that there are separate shares in an estate when a beneficiary or class of beneficiaries has an interest in a decedent's estate (whether corpus or income, or both) that no other beneficiary or class of beneficiaries has.

Two commentators suggested a narrower definition of a separate share. One commentator suggested that separate shares exist only when the estate is administered as two or more well-defined shares that could be separate estates. Another commentator suggested that separate share treatment should apply only where the existence of separate shares is clear and the funding thereof does not require burdensome adjustments due to disproportionate distributions.

Generally, the final regulations clarify the definition and narrow the application of the separate share rules that are in the proposed regulations. The final regulations generally define a separate share as a separate economic interest in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by economic interests accruing to another beneficiary or class of beneficiaries. The final regulations add "nor are affected by" to clarify the definition of a separate share. Under this revised definition, a separate share generally exists only if it includes both corpus and the income attributable thereto and is independent from any other share. Thus, income earned on assets in one share (first share) and appreciation and depreciation in the value of those assets have no effect on any other share. Similarly, the income and changes in value of any other share have no effect on the first share.

*Effect on Section 663(a)(1)*

The proposed regulations provide that the separate share rules do not change the

rules involving bequests of specific sums of money or specific property described in section 663(a)(1).

Commentators asked for clarification concerning whether the separate share rules apply to bequests described in section 663(a)(1). One commentator recommended that separate share treatment should apply to these bequests. Another commentator suggested that while revising §1.663(c) to apply to estates, the IRS and the Treasury Department should reconsider and amend §1.663(a)-1(b)(1) to permit principal distributions that are made to fund both pecuniary formula bequests and surviving spouses' elective shares to be recognized as coming within the definition of excluded gifts or bequests described in section 663(a)(1).

The final regulations provide that bequests described in section 663(a)(1) are not separate shares. The separate share rules are applicable only to determine the distributable net income of each share when applying the distribution provisions of sections 661 and 662 to the trust or estate and its beneficiaries. Bequests described in section 663(a)(1) are not subject to the distribution provisions and therefore are not separate shares.

*Surviving Spouse's Elective Share*

The proposed regulations provide that a surviving spouse's statutory elective share constitutes a separate share of an estate. As a result, the surviving spouse may be taxed on the estate's gross income only to the extent of the surviving spouse's share of that income under state law.

One commentator recommended that separate share treatment for a surviving spouse's elective share should be reconsidered. Elective shares should be a matter of further study because they are forced by state law, differ from state to state, and usually are part of an acrimonious conflict. Another commentator requested clarification of whether a surviving spouse's statutory elective share is included in the subchapter J estate. Further, this commentator recommended that an elective share that is not entitled to income or appreciation should be excluded from the subchapter J estate, but an elective share that is entitled to income and appreciation should be included in the subchapter J estate.

Conversely, other commentators agreed that separate share treatment should apply

to a surviving spouse's statutory elective share regardless of whether the surviving spouse is entitled to income and shares in appreciation or depreciation. One commentator suggested that the separate share examples in the proposed regulations be revised to track more closely the Uniform Probate Code model because it will likely be adopted by most states.

These final regulations do not change the result of the proposed regulations. However, under these final regulations, a surviving spouse's elective share that under local law is entitled to income and to share in appreciation or depreciation constitutes a separate share under the general definition. Further, under a special rule in the final regulations, a surviving spouse's elective share that is not entitled to income or does not share in appreciation or depreciation is also a separate share.

#### *Revocable Trust as a Part Of Estate*

The proposed regulations provide that a qualified revocable trust that elects under section 645 to be treated as part of the decedent's estate for income tax purposes constitutes a separate share. In response to comments, these final regulations include a reference that the electing revocable trust itself may have two or more separate shares. These final regulations further provide that qualified revocable trusts within the definition of section 645(b)(1) are subject to the separate share rules applicable to estates rather than trusts whether or not an election is made to be part of the estate.

#### *Pecuniary Formula Bequests*

The preamble to the proposed regulations requests comments concerning the treatment of pecuniary formula bequests as separate shares. Several commentators, noting that pecuniary formula bequests are similar to a surviving spouse's statutory elective share, suggested that such bequests be treated as separate shares. Commentators disagreed, however, on whether pecuniary formula bequests not entitled to income should be separate shares.

Under these final regulations, any pecuniary formula bequest that is entitled to income and to share in appreciation or depreciation under the governing instrument or local law constitutes a separate share under the general definition. Further, under a special rule, a pecuniary formula

bequest that is not entitled to income or to share in appreciation or depreciation is also a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments. This provision regarding three or fewer installments parallels the specific bequest requirements in section 663(a)(1).

#### *Administrative Rules*

Commentators requested guidance concerning several administrative matters. Commentators asked for guidance concerning when separate shares come into existence. The final regulations provide that separate shares come into existence at the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate share exists.

Two commentators expressed concern about the need to readjust the separate shares as a result of an IRS examination. One commentator suggested that separate share treatment should apply to pecuniary formula bequests only if no amended returns and no adjustments to any tax periods would be required when the tax returns were filed in good faith. Another commentator recommended that separate share treatment should not apply to residuary bequests unless or until the regulations provide simple and practical methods of compliance for possible adjustments made during IRS examinations.

These final regulations do not adopt either suggestion. The regulations provide that the fiduciary must use a reasonable and equitable method to determine the value of each separate share and the allocation of taxable income to each share. This approach gives the fiduciary flexibility, within limits, in applying the separate share rules. However, redeterminations in value of those separate shares must be taken into account.

Commentators asked for a clarification of whether gross income of an estate must be allocated to a separate share based upon the amount of income each share is entitled to under the terms of the governing instrument or applicable local law. These final regulations clarify that, in computing the distributable net income for each separate share, the portion of gross income that is income within the meaning of section 643(b) must be allocated to each share based upon the

amount of income each share is entitled to under the terms of the governing instrument or applicable local law. A similar allocation rule is provided for the amount of gross income that is not attributable to cash received by a trust or estate, such as a distributive share of a partnership's tax items, or the pro rata share of an S corporation's tax items.

Commentators asked whether the general rule for allocating gross income is applicable for income in respect of a decedent under section 691(a). These final regulations clarify that such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether a share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount allocated to each share is based upon the relative value of each of those shares that could potentially be funded with such amounts.

One commentator requested clarification concerning the allocation of expenses to a separate share. These final regulations do not change the long standing rule under §1.663(c)-2 of the Income Tax Regulations that any expense which is applicable solely to one separate share of a trust is not available as a deduction to any other share of the same trust. The IRS and the Treasury Department are not aware of any issues that have arisen in applying this rule.

#### *Interest on Pecuniary Bequests or Delayed Estate Distributions*

Commentators questioned why the proposed regulations take the position that interest, imposed by state law, on a pecuniary bequest or a delayed estate distribution is a payment of interest by the estate and not a distribution for purposes of sections 661 and 662. These same commentators indicated that alternatively such interest payments should be deductible administrative expenses if the interest was required to be paid by state law as part of the distribution and settlement of the estate. The final regulations retain the position taken in the proposed regulations because the IRS and the Treasury Department view this result as compelled by section 163(h) which disallows a deduction for personal interest as described in section 163(h)(2).

#### *Requests Concerning Applicable Dates*

One commentator suggested that either the applicable date of these final regulations should be retroactive to the date that section 1307 of the Tax Reform Act of 1997 became applicable, or the regulations should provide that during the interim period before final regulations are published, the IRS will accept any reasonable interpretation of the separate share rules, including those rules provided in the proposed regulations.

Another commentator requested that the final regulations, to the extent applicable to trusts, apply prospectively and apply either only to trusts that become irrevocable after the date the regulations are finalized or only to taxable years of trusts beginning after the date the regulations are finalized.

The final regulations have taken these comments into account as noted below.

### Effective Dates

These final regulations are applicable for estates and qualified revocable trusts within the meaning of section 645(b)(1) with respect to decedents who die after December 28, 1999. However, for estates and qualified revocable trusts with respect to decedents who died after the date that section 1307 of the Tax Reform Act of 1997 became effective but before December 28, 1999, the IRS will accept any reasonable interpretation of the separate share provisions, including those provisions provided in 1999-11 I.R.B. 41 (see §601.601(d)(2)(ii)(b)). For trusts other than qualified revocable trusts, §1.663(c)-2 is applicable for taxable years of such trusts beginning after December 28, 1999.

### Effect on Other Documents

The following publications are obsolete as of December 28, 1999:

Rev. Rul. 64-101 (1964-1 C.B. 77).

Rev. Rul. 71-167 (1971-1 C.B. 163).

### Special Analyses

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these final regulations

do not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Drafting Information

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

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

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

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

Sections 1.663(c)-1, 1.663(c)-2, 1.663(c)-3, 1.663(c)-4, 1.663(c)-5, and 1.663(c)-6 also issued under 26 U.S.C. 663(c).

\* \* \*

Par. 2. In §1.663(a)-1, paragraph (b)(3) is amended by revising *Example 1*, *Example 2*, and *Example 3* to read as follows:

*§1.663(a)-1 Special rules applicable to sections 661 and 662; exclusion; gifts, bequests, etc.*

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

*Example 1.* Under the terms of a will, a legacy of \$5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of \$25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of \$5,000 in a lump sum to A, transferred the X company stock to W, and made no other distributions to beneficiaries. The distributions to A and W qualify for the exclusion under

section 663(a)(1).

*Example 2.* Under the terms of a will, the testator's estate was to be distributed to A. No provision was made in the will for the distribution of the estate's income during the period of administration. The estate had income of \$50,000 for the taxable year. The estate distributed to A stock with a basis of \$40,000 and with a fair market value of \$40,000 on the date of distribution. No other distributions were made during the year. The distribution does not qualify for the exclusion under section 663(a)(1), because it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property (\$40,000) represents a distribution within the meaning of sections 661(a) and 662(a) (see §1.661(a)-2(c)).

*Example 3.* Under the terms of a trust instrument, trust income is to be accumulated for a period of 10 years. During the eleventh year, the trustee is to distribute \$10,000 to B, payable from income or corpus, and \$10,000 to C, payable out of accumulated income. The trustee is to distribute the balance of the accumulated income to A. Thereafter, A is to receive all the current income until the trust terminates. Only the distribution to B would qualify for the exclusion under section 663(a)(1).

\* \* \* \* \*

Par. 3. Section 1.663(c)-1 is amended as follows:

1. The section heading is revised.

2. Paragraph (a) is amended by revising the words "trust" and "trusts" to read "trust (or estate)" and "trusts (or estates)", respectively, in the first through fourth sentences.

3. Paragraph (b)(2) is removed and paragraphs (b)(3) and (b)(4) are redesignated as paragraphs (b)(2) and (b)(3), respectively.

4. Paragraphs (b) through (d) are amended by revising the words "trust" and "trusts" to read "trust (or estate)" and "trusts (or estates)", respectively.

The revision reads as follows:

*§1.663(c)-1 Separate shares treated as separate trusts or as separate estates; in general.*

\* \* \* \* \*

Par. 4. Section 1.663(c)-2, is revised to read as follows:

*§1.663(c)-2 Rules of administration.*

(a) *When separate shares come into existence.* A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists.

(b) *Computation of distributable net income for each separate share*—(1) *General rule.* The amount of distributable net income for any share under section 663(c) is computed as if each share constituted a separate trust or estate. Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

(2) *Section 643(b) income.* This paragraph (b)(2) governs the allocation of the portion of gross income includible in distributable net income that is income within the meaning of section 643(b). Such gross income is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law.

(3) *Income in respect of a decedent.* This paragraph (b)(3) governs the allocation of the portion of gross income includible in distributable net income that is income in respect of a decedent within the meaning of section 691(a) and is not income within the meaning of section 643(b). Such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.

(4) *Gross income not attributable to cash.* This paragraph (b)(4) governs the allocation of the portion of gross income includible in distributable net income that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items). Such gross income is allocated among the separate shares in the same proportion as section 643(b) income from the same source would be allocated under the terms of the governing instrument or applicable local law.

(5) *Deductions and losses.* Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share

of the same trust or estate.

(c) *Computations and valuations.* For purposes of calculating distributable net income for each separate share, the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations required by paragraph (b) of this section.

Par. 5. Section 1.663(c)-3 is amended by revising the section heading and the first sentence of paragraph (a), and removing paragraph (f) to read as follows:

*§1.663(c)-3 Applicability of separate share rule to certain trusts.*

(a) The applicability of the separate share rule provided by section 663(c) to trusts other than qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created.

\* \* \* \* \*

**§1.663(c)-4 [Redesignated as §1.663(c)-5]**

Par. 6. Section 1.663(c)-4 is redesignated as §1.663(c)-5.

Par. 7. A new §1.663(c)-4 is added to read as follows:

*§1.663(c)-4 Applicability of separate share rule to estates and qualified revocable trusts.*

(a) *General rule.* The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries. Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift

or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

(b) *Special rule for certain types of beneficial interests.* Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

(c) *Shares with multiple beneficiaries and beneficiaries of multiple shares.* A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share.

Par. 8. Newly designated §1.663(c)-5 is amended by:

1. Revising the section heading and introductory text.

2. Redesignating the *Example* as *Example 1* and, in newly designated *Example 1*, redesignating paragraphs (a) through (e) as paragraphs (i) through (v), respectively.

3. Adding *Example 2, Example 3, Example 4, Example 5, Example 6, Example 7, Example 8, Example 9, Example 10, and Example 11.*

The revisions and additions read as follows:

*§1.663(c)-5 Examples.*

Section 663(c) may be illustrated by the following examples:

*Example 1. \* \* \**

*Example 2 (i) Facts.* Testator, who dies in 2000, is survived by a spouse and two children. Testator's will contains a fractional formula bequest dividing the residuary estate between the surviving spouse and a trust for the benefit of the children. Under the fractional formula, the marital



bequest constitutes 60% of the estate and the children's trust constitutes 40% of the estate. During the year, the executor makes a partial proportionate distribution of \$1,000,000, (\$600,000 to the surviving spouse and \$400,000 to the children's trust) and makes no other distributions. The estate receives dividend income of \$20,000, and pays expenses of \$8,000 that are deductible on the estate's federal income tax return.

(ii) *Conclusion.* The fractional formula bequests to the surviving spouse and to the children's trust are separate shares. Because Testator's will provides for fractional formula residuary bequests, the income and any appreciation in the value of the estate assets are proportionately allocated between the marital share and the trust's share. Therefore, in determining the distributable net income of each share, the income and expenses must be allocated 60% to the marital share and 40% to the trust's share. The distributable net income is \$7,200 (60% of income less 60% of expenses) for the marital share and \$4,800 (40% of income less 40% of expenses) for the trust's share. Because the amount distributed in partial satisfaction of each bequest exceeds the distributable net income of each share, the estate's distribution deduction under section 661 is limited to the sum of the distributable net income for both shares. The estate is allowed a distribution deduction of \$12,000 (\$7,200 for the marital share and \$4,800 for the trust's share). As a result, the estate has zero taxable income (\$20,000 income less \$8,000 expenses and \$12,000 distribution deduction). Under section 662, the surviving spouse and the trust must include in gross income \$7,200 and \$4,800, respectively.

*Example 3.* The facts are the same as in *Example 2*, except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

*Example 4 (i) Facts.* Testator, who dies in 2000, is survived by a spouse and one child. Testator's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the benefit of the child in the

amount needed to reduce the estate taxes to zero and a bequest of the residuary to the surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. During the 2000 taxable year, the estate receives dividend income of \$200,000 and pays expenses of \$15,000 that are deductible on the estate's federal income tax return. The executor partially funds the child's trust by distributing to it securities that have an adjusted basis to the estate of \$350,000 and a fair market value of \$380,000 on the date of distribution. As a result of this distribution, the estate realizes long-term capital gain of \$30,000.

(ii) *Conclusion.* The estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because, under the terms of the will, no estate income is allocated to the bequest to the child's trust, the distributable net income for that trust's share is zero. Therefore, with respect to the \$380,000 distribution to the child's trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662. Because no distributions were made to the spouse, there is no need to compute the distributable net income allocable to the marital share. The taxable income of the estate for the 2000 taxable year is \$214,400 (\$200,000 (dividend income) plus \$30,000 (capital gain) minus \$15,000 (expenses) and minus \$600 (personal exemption)).

*Example 5.* The facts are the same as in *Example 4*, except that during 2000 the estate reports on its federal income tax return a pro rata share of an S corporation's tax items and a distributive share of a partnership's tax items allocated on Form K-1s to the estate by the S corporation and by the partnership, respectively. Because, under the terms of the will, no estate income from the S corporation or the partnership would be allocated to the pecuniary bequest to child's trust, none of the tax items attributable to the S corporation stock or the partnership interest is allocated to the trust's separate share. Therefore, with respect to the \$380,000 distribution to the trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662.

*Example 6.* The facts are the same as in *Example 4*, except that during 2000 the estate receives a distribution of \$900,000 from the decedent's individual retirement account that is included in the estate's gross income as income in respect of a decedent under section 691(a). The entire \$900,000 is allocated to corpus under applicable local law. Both the separate share for the child's

trust and the separate share for the surviving spouse may potentially be funded with the proceeds from the individual retirement account. Therefore, a portion of the \$900,000 gross income must be allocated to the trust's separate share. The amount allocated to the trust's share must be based upon the relative values of the two separate shares using a reasonable and equitable method. The estate is entitled to a deduction under section 661 for the portion of the \$900,000 properly allocated to the trust's separate share, and the trust must include this amount in income under section 662.

*Example 7 (i) Facts.* Testator, who dies in 2000, is survived by a spouse and three adult children. Testator's will divides the residue of the estate equally among the three children. The surviving spouse files an election under the applicable state's elective share statute. Under this statute, a surviving spouse is entitled to one-third of the decedent's estate after the payment of debts and expenses. The statute also provides that the surviving spouse is not entitled to any of the estate's income and does not participate in appreciation or depreciation of the estate's assets. However, under the statute, the surviving spouse is entitled to interest on the elective share from the date of the court order directing the payment until the executor actually makes payment. During the estate's 2001 taxable year, the estate distributes to the surviving spouse \$5,000,000 in partial satisfaction of the elective share and pays \$200,000 of interest on the delayed payment of the elective share. During that year, the estate receives dividend income of \$3,000,000 and pays expenses of \$60,000 that are deductible on the estate's federal income tax return.

(ii) *Conclusion.* The estate has four separate shares consisting of the surviving spouse's elective share and each of the three children's residuary bequests. Because the surviving spouse is not entitled to any estate income under state law, none of the estate's gross income is allocated to the spouse's separate share for purposes of determining that share's distributable net income. Therefore, with respect to the \$5,000,000 distribution, the estate is allowed no deduction under section 661, and no amount is included in the spouse's gross income under section 662. The \$200,000 of interest paid to the spouse must be included in the spouse's gross income under section 661. Because no distributions were made to any other beneficiaries during the year, there is no need to compute the distributable net income of the other three separate shares. Thus, the taxable income of the estate for the 2000 taxable year is \$2,939,400 (\$3,000,000 (dividend income) minus \$60,000 (expenses) and \$600 (personal exemption)). The estate's \$200,000 interest payment is a nondeductible personal interest expense described in sec-

tion 163(h).

*Example 8.* The will of Testator, who dies in 2000, directs the executor to distribute the X stock and all dividends therefrom to child A and the residue of the estate to child B. The estate has two separate shares consisting of the income on the X stock bequeathed to A and the residue of the estate bequeathed to B. The bequest of the X stock meets the definition of section 663(a)(1) and therefore is not a separate share. If any distributions, other than shares of the X stock, are made during the year to either A or B, then for purposes of determining the distributable net income for the separate shares, gross income attributable to dividends on the X stock must be allocated to A's separate share and any other income must be allocated to B's separate share.

*Example 9.* The will of Testator, who dies in 2000, directs the executor to divide the residue of the estate equally between Testator's two children, A and B. The will directs the executor to fund A's share first with the proceeds of Testator's individual retirement account. The date of death value of the estate after the payment of debts, expenses, and estate taxes is \$9,000,000. During 2000, the \$900,000 balance in Testator's individual retirement account is distributed to the estate. The entire \$900,000 is allocated to corpus under applicable local law. This amount is income in respect of a decedent within the meaning of section 691(a). The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the \$900,000 of income in respect of a decedent must be allocated to A's share.

*Example 10.* The facts are the same as in *Example 9*, except that the will directs the executor to fund A's share first with X stock valued at \$3,000,000, rather than with the proceeds of the individual retirement account. The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the \$900,000 of gross income attributable to the proceeds from the individual retirement account must be allocated between the two shares to the extent that they could potentially be funded with those proceeds. The maximum amount of A's share that could potentially be funded with the income in respect of decedent is \$1,500,000 (\$4,500,000 value of share less \$3,000,000 to be funded with stock) and the maximum amount of B's share that could potentially be funded with income in respect of decedent is \$4,500,000. Based upon the relative values of these amounts, the gross income attributable to the proceeds of the individual retirement account is allocated \$225,000 (or one-fourth) to A's share

and \$675,000 (or three-fourths) to B's share.

*Example 11.* The will of Testator, who dies in 2000, provides that after the payment of specific bequests of money, the residue of the estate is to be divided equally among the Testator's three children, A, B, and C. The will also provides that during the period of administration one-half of the income from the residue is to be paid to a designated charitable organization. After the specific bequests of money are paid, the estate initially has three equal separate shares. One share is for the benefit of the charitable organization and A, another share is for the benefit of the charitable organization and B, and the last share is for the benefit of the charitable organization and C. During the period of administration, payments of income to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662.

Par. 9. Section 1.663(c)-6 is added to read as follows:

*§1.663(c)-6 Effective dates.*

Sections 1.663(c)-1 through 1.663(c)-5 are applicable for estates and qualified revocable trusts within the meaning of section 645(b)(1) with respect to decedents who die after December 28, 1999. However, for estates and qualified revocable trusts with respect to decedents who died after the date that section 1307 of the Tax Reform Act of 1997 became effective but before December 28, 1999, the IRS will accept any reasonable interpretation of the separate share provisions, including those provisions provided in 1999-11 I.R.B. 41 (see §601.601(d)(2)(ii)(b) of this chapter). For trusts other than qualified revocable trusts, §1.663(c)-2 is applicable for taxable years of such trusts beginning after December 28, 1999.

Robert E. Wenzel,  
*Deputy Commissioner of  
Internal Revenue.*

Approved December 13, 1999.

Jonathan Talisman,  
*Acting Assistant Secretary  
for the Treasury.*

(Filed by the Office of the Federal Register on December 27, 1999, 8:45 a.m., and published in the issue of the Federal Register for December 28, 1999, 64 F.R. 72540)

## 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 January 2000. See Rev. Rul. 2000-1, page 250.

## 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 January 2000. See Rev. Rul. 2000-1, page 250.

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

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

**Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate.** For purposes of sections 1274, 1288, 382, and other section of the Code, tables set forth the rates for January 2000.

## Rev. Rul. 2000-1

This revenue ruling provides various prescribed rates for federal income tax purposes for January 2000 (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. 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. Finally, Table 6 contains the deemed rate of return for transfers made during calendar year 2000 to pooled income funds described in § 642(c)(5) that have been in existence for less than 3 taxable years immediately preceding the taxable year in which the transfer is made.

REV. RUL. 2000-1 TABLE 1

Applicable Federal Rates (AFR) for January 2000

*Period for Compounding*

|                   | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------|---------------|-------------------|------------------|----------------|
| <i>Short-Term</i> |               |                   |                  |                |
| AFR               | 5.88%         | 5.80%             | 5.76%            | 5.73%          |
| 110% AFR          | 6.48%         | 6.38%             | 6.33%            | 6.30%          |
| 120% AFR          | 7.08%         | 6.96%             | 6.90%            | 6.86%          |
| 130% AFR          | 7.68%         | 7.54%             | 7.47%            | 7.42%          |
| <i>Mid-Term</i>   |               |                   |                  |                |
| AFR               | 6.21%         | 6.12%             | 6.07%            | 6.04%          |
| 110% AFR          | 6.84%         | 6.73%             | 6.67%            | 6.64%          |
| 120% AFR          | 7.47%         | 7.34%             | 7.27%            | 7.23%          |
| 130% AFR          | 8.12%         | 7.96%             | 7.88%            | 7.83%          |
| 150% AFR          | 9.39%         | 9.18%             | 9.08%            | 9.01%          |
| 175% AFR          | 11.00%        | 10.71%            | 10.57%           | 10.48%         |
| <i>Long-Term</i>  |               |                   |                  |                |
| AFR               | 6.45%         | 6.35%             | 6.30%            | 6.27%          |
| 110% AFR          | 7.11%         | 6.99%             | 6.93%            | 6.89%          |
| 120% AFR          | 7.77%         | 7.62%             | 7.55%            | 7.50%          |
| 130% AFR          | 8.43%         | 8.26%             | 8.18%            | 8.12%          |

REV. RUL. 2000-1 TABLE 2

Adjusted AFR for January 2000

*Period for Compounding*

|                            | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|----------------------------|---------------|-------------------|------------------|----------------|
| Short-term<br>adjusted AFR | 4.01%         | 3.97%             | 3.95%            | 3.94%          |
| Mid-term<br>adjusted AFR   | 4.66%         | 4.61%             | 4.58%            | 4.57%          |
| Long-term<br>adjusted AFR  | 5.59%         | 5.51%             | 5.47%            | 5.45%          |

REV. RUL. 2000-1 TABLE 3

Rates Under Section 382 for January 2000

|  |       |
|--|-------|
| Adjusted federal long-term rate for the current month  | 5.59% |
| 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.) | 5.72% |

REV. RUL. 2000-1 TABLE 4

Appropriate Percentages Under Section 42(b)(2)  
for January 2000

|  |       |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.48% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.64% |

REV. RUL. 2000-1 TABLE 5

Rate Under Section 7520 for January 2000

|   |      |
|---|------|
| 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 | 7.4% |
|---|------|

Rev. Rul. 2000-1 TABLE 6

Deemed Rate of Transfers to New Pooled Income Funds During 2000

|  |       |
|--|-------|
| Deemed rate of return for transfers during 2000 to pooled income funds that have been in existence for less than 3 taxable years | 6.80% |
|--|-------|

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2000. See Rev. Rul. 2000-1, page 250.

## Section 1366.—Pass-Thru of Items to Shareholders

26 CFR 1.1366-1: Shareholder's share of items of an S corporation.

### T.D. 8852

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

## Passthrough of Items of an S Corporation to its Shareholders

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

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

**DATES:** *Effective Date:* These regulations are effective August 18, 1998.

*Applicability Dates:* For dates of applicability, see §1.1366-5, §1.1367-3, and §1.1368-4, plus Transition Rule and Effective Date under

### SUPPLEMENTARY INFORMATION.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations under section 1366, Martin Schäffer, Deane M. Burke, or David Shulman (202) 622-3070; concerning the regulations under sections 1367 and 1368, Brenda Stewart, (202) 622-3120.

### 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 of 1995 (44 U.S.C. 3507) under control number 1545-1613. Responses to this collection of information are mandatory.

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 this requirement is reflected in the burden of Form 1040, "U.S. Individual Income Tax Return", and Form 1120S, "U.S. Income Tax Return for an S corporation".

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

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

#### Background

This document amends 26 CFR part 1 to provide additional rules under sections 1366, 1367, and 1368 relating to the passthrough of items of an S corporation to its shareholders, the adjustments to the basis of stock of the shareholders, and the treatment of distributions by an S corporation.

On August 18, 1998, the IRS published in the **Federal Register** (63 FR 44181), a notice of proposed rulemaking (REG-209446-82) regarding sections 1366, 1367, and 1368. Comments responding to the proposed regulations were received. The public hearing was canceled because there were no requests to speak. After considering the comments received, the proposed regulations are adopted as amended by this Treasury decision.

### Explanation of Revisions and Summary of Comments

#### 1. Aggregation of deductions from an S corporation with deductions from other sources.

The proposed regulations provide that a shareholder of an S corporation must aggregate its separate deductions and exclusions with the shareholder's pro rata share of the S corporation's separately stated deductions or exclusions in determining the allowable amount of any deduction or exclusion that is subject to a limitation in the Code.

The proposed regulations provide an example of this rule for property expensed under section 179. A commentator suggested that the example implies that a shareholder must expense its pro rata share of section 179 expense from the S corporation before it can expense any separately acquired property.

The example is intended to illustrate that a shareholder may expense only up to the amount allowable under section 179 in any given year regardless of whether the property is owned individually or through an S corporation. The example is not intended to imply that a shareholder must elect to expense property held in an S corporation before it can expense any separately acquired property. However, once an S corporation elects to expense property under section 179, a shareholder will generally elect to expense personal property only to the extent the shareholder's pro rata share of the corporation's section 179 expense does not exceed the shareholder's individual limitation under section 179(b). Accordingly, no modifications have been made to the example in the final regulations.

The commentator also requested that the final regulations provide additional examples that illustrate the aggregation of the shareholder's pro rata share of deductions and exclusions from an S corporation with deductions and exclusions from other sources and the operation of any limitations on those aggregated deductions and exclusions. Specifically, the commentator requested that the final regulations include an example in which the shareholder's aggregate section 179 expenses from several passthrough sources exceeds the maximum section 179 expense allowable. The allocation of the section 179 expense among the various

sources is more appropriately addressed in the regulations under section 179 and is beyond the scope of these regulations. Accordingly, the final regulations do not adopt this comment.

## 2. *Recharacterization of gains and losses at the shareholder level.*

Generally, the items of an S corporation that are passed through, and reported by, a shareholder are characterized at the corporate level in the same manner that partnership items are characterized at the partnership level.

However, the proposed regulations also contain exceptions to this general rule for contributions of either noncapital gain property or capital loss property if an S corporation is formed or availed of by any shareholder or shareholders for a principal purpose of selling or exchanging the property that in the hands of the shareholder or shareholders would have produced a different character of gain or loss. The character of the gain or loss will be the same as it would have been if the property were in the hands of the shareholder or shareholders at the time of the sale or exchange.

Commentators suggested that, in the absence of a statutory provision like section 724 in the partnership context, the IRS lacked the authority to recharacterize gain or loss at the shareholder level. Thus, the commentators asserted that the final regulations should not adopt the recharacterization rules.

Alternatively, the commentators suggested limiting the recharacterization rule to sales or exchanges occurring within a specified time period.

Unlike the partnership rules, the recharacterization rules in the proposed regulations are limited to transactions in which an S corporation is used for a principal purpose of changing the character of the gain or loss of contributed property. These rules are reasonable approaches to remedying any improper attempts to utilize section 1366(b) to avoid tax. The length of time between the contribution of the property to the S corporation and the S corporation's sale or exchange of the property will be a factor considered in evaluating whether the S corporation was availed of for a principal purpose of changing the character of the gain or loss. However, the final regulations do not adopt any particular time period. Thus,

the final regulations retain the recharacterization rules as proposed.

## 3. *Gross income reporting requirement.*

Section 1366(c), like section 702(c) in the partnership context, provides for the passthrough of gross income to a shareholder for federal income tax purposes. Thus, where it is necessary to determine the amount or character of the gross income of a shareholder, the proposed regulations provide that a shareholder's gross income includes the shareholder's pro rata share of the gross income of the S corporation. This amount is the amount of gross income of the corporation used to derive the shareholder's pro rata share of S corporation taxable income or loss.

A commentator suggested that the rule in the proposed regulations attempts to narrow the disclosure exception under section 6501(e) by applying a pro rata concept with respect to a shareholder's gross income. The commentator recommended that the final regulations not adopt the gross income reporting rules or, alternatively, provide a de minimis exception to the rule for certain shareholders who own minority interests in an S corporation.

The rule in the proposed regulations parallels the rules for determining the amount of gross income reported by a partner in a partnership. See section 702(c); §1.702-1(c)(2). Accordingly, the final regulations do not adopt this suggestion.

## 4. *Carryover of disallowed losses under section 1366(d).*

Section 1366(d) provides that a shareholder's disallowed losses and deductions for any taxable year shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder. The proposed regulations provide that a shareholder's losses and deductions disallowed under section 1366(d) are personal to the shareholder and cannot in any manner be transferred to another person. A commentator requested that the final regulations provide an exception to this rule for transferees that have an identity of investment interest or common basis with the transferor, such as when stock is transferred incident to divorce under section 1041.

Under section 1366(d), the carryover of disallowed losses and deductions is with respect to the shareholder whose invest-

ment limited the items of loss or deduction. Thus, the carryover is not available to a transferee who acquires the stock whether by sale, death, gift, or otherwise. Accordingly, the final regulations retain the rule that disallowed losses and deductions are nontransferable.

The proposed regulations also provide that if a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed. A commentator suggested that the final regulations permit a former shareholder of an S corporation who subsequently reacquires stock in the S corporation to utilize the losses and deductions previously disallowed to the shareholder.

Losses and deductions that are disallowed in any taxable year carry over under section 1366(d) to the succeeding taxable year of the corporation with respect to a particular shareholder. If a shareholder completely terminates its interest in the corporation, the shareholder will not be a shareholder in the succeeding taxable year of the corporation and the disallowed losses would not carry over. There is no statutory authority for the carryover of disallowed items if a shareholder is not a shareholder in the year succeeding the disallowance. The disallowed items of loss and deduction are amounts that exceed the shareholder's economic investment in the corporation. Once the shareholder terminates its interest in the corporation, it is not necessary to preserve the shareholder's position in the corporation. Thus, the final regulations do not adopt this commentator's suggestion.

## 5. *Basis in S corporation stock received as a gift.*

Section 1366(d)(1) limits the amount of corporate losses and deductions that can pass through to, and be deducted by, a shareholder to the shareholder's adjusted basis in the corporation's stock and debt of the corporation to the shareholder.

The proposed regulations provide that, for purposes of section 1366(d)(1), a shareholder's basis in stock acquired by gift is the basis of the stock used for purposes of determining loss under section 1015. Thus, if the fair market value of the stock exceeds the donor's adjusted basis on the date of the gift, for purposes of section 1366(d)(1), the adjusted basis of the stock in the hands of the donee is its ad-

justed basis in the hands of the donor. However, if the donor's adjusted basis in the stock exceeds the stock's fair market value on the date of the gift, for purposes of section 1366(d)(1), the adjusted basis of the stock in the hands of the donee is the stock's fair market value on the date of the gift.

One commentator argued that the basis for determining loss under section 1015 is applicable only on the disposition of the gifted asset. The basis for determining loss in section 1015 generally does not affect the basis for depreciation or the deductibility of net expenses arising out of the use or operation of the gifted asset.

The proposed regulations, however, apply the loss basis rule in section 1015 not for purposes of determining the depreciable basis of a gifted asset, but rather for purposes of determining the amount of passthrough losses and deductions (including depreciation deductions and operating losses) that are allowable to a shareholder under section 1366. The donee of loss stock cannot dispose of the stock and recognize the loss inherent in the stock on the date of gift. If the donee could use the donor's basis to take depreciation deductions and operating losses of the S corporation, the donee in effect would realize the benefit of the loss inherent in the stock.

Another commentator agreed that the basis for determining loss in section 1015 ought to be the basis of gifted stock for purposes of section 1366. Thus, the final regulations continue to provide that for purposes of section 1366, the basis of stock acquired by gift is the basis for determining loss under section 1015.

#### *6. Allocation of disallowed losses in certain corporate separations.*

The proposed regulations provide rules for the carryover of disallowed losses and deductions in the case of certain corporate reorganizations. In the case of an S corporation that transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which sec-

tion 355 (or so much of section 356 as relates to section 355) applies, any disallowed loss or deduction with respect to a shareholder of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. The proposed regulations provide that the amount of disallowed loss or deduction allocated to the distributing (or controlled) corporation with respect to the shareholder is an amount that bears the same ratio to each item of disallowed loss or deduction as the value of the shareholder's stock in the distributing (or controlled) corporation bears to the total value of the shareholder's stock in the distributing and controlled corporations, in each case as determined immediately after the distribution.

A commentator suggested that the term value as used in the proposed regulations is ambiguous and that the final regulations should specifically state "fair market value." The commentator also recommended that because the computation of fair market value introduces a host of valuation issues into the transaction, the final regulations should permit an allocation of disallowed losses and deductions based on the relative adjusted bases of the assets of the distributing and controlled corporations. Finally, the commentator requested that the final regulations allow S corporations to allocate disallowed losses and deductions to the controlled or distributing corporation based upon the source of those losses and deductions. The final regulations permit shareholders to allocate disallowed losses and deductions according to any reasonable method, including a method based on the relative fair market value of the shareholder's stock in the distributing and controlled corporations immediately after the distribution, a method based on the relative adjusted bases of the assets in the distributing and controlled corporations immediately after the distribution, or, in the case of losses and deductions clearly attributable to either the distributing or controlled corporation, a method that allocates such losses and deductions accordingly.

#### *7. Allocation of tax on passive investment income under section 1366(f)(3).*

Section 1366(f)(3) provides that if any tax is imposed under section 1375 for a taxable year, each item of passive investment income is reduced by an amount which bears the same ratio to the amount of the tax as the amount of the item bears to the total passive investment income for the taxable year.

A commentator requested guidance in the final regulations on whether the allocation of any tax imposed under section 1375 is made based on the total gross or total net passive investment income. Under section 1375, the amount of excess passive investment income is allocated to the items of passive investment income based on the net passive investment income of the corporation. The allocation of the tax imposed on the excess passive investment income should be similarly allocated. Accordingly, the final regulations clarify that the allocation of any tax under section 1375 is based on the total net passive investment income for the taxable year.

#### *8. Accrual of charitable contribution deductions under section 170(a)(2).*

The proposed regulations under section 1366 provide that each shareholder must take into account the shareholder's pro rata share of any charitable contributions paid by the corporation during the corporation's taxable year. A commentator requested that the final regulations clarify that separately stated items include charitable contributions paid or deemed to be paid. The commentator suggested that an accrual basis S corporation may elect under section 170(a)(2) to treat charitable contributions as paid in the year prior to the year in which the charitable contribution is actually paid.

Under section 1363(b), S corporations generally compute their taxable income in the same manner as in the case of an individual. However, S corporations are not permitted to take charitable contribution deductions by virtue of the cross reference in section 1363(b)(2) to section 703(a)(2). Instead, the deductions for charitable contributions pass through to the shareholders of the S corporation. Individuals cannot make the election under section 170(a)(2). Treasury and the Service believe that an S corporation also cannot make the election under section 170(a)(2). Accordingly, the final regulations do not adopt this suggestion.

## 9. Treatment of section 108 income

The regulations enumerate items of income (including tax-exempt income), loss, deduction, or credit of an S corporation that must be taken into account separately by each shareholder pursuant to section 1366(a)(1)(A). "Tax-exempt income" does not include income from discharge of indebtedness excluded from income under section 108 because such income is not permanently excludible from income in all circumstances in which section 108 applies. One commentator objected to this treatment of section 108 income, arguing that such income is tax-exempt and that application of section 108 at the S corporation level pursuant to section 108(d)(7)(A) does not preclude the pass-through of section 108 income. Another commentator, however, agreed with the approach taken by the regulations.

Treasury and the Service continue to believe that the absence of a stock basis increase for income of an S corporation excluded under section 108(a) is consistent with the legislative history of section 108 and the specific rules that apply to the discharge of indebtedness income of S corporations. Accordingly, the treatment of section 108 income is unchanged in the final regulations.

## 10. Adjustment to Basis of Stock

Section 1367(a) and §1.1367-1 of the proposed regulations prescribe the order of adjustments required by subchapter S to the basis of a shareholder's stock in an S corporation and the manner in which those adjustments are made.

A commentator suggested that the final regulations should provide that life insurance premiums on policies owned by the S corporation do not affect either a shareholder's basis in stock/debt or the corporation's accumulated adjustments account (AAA). The commentator further suggested that §1.1367-1(c)(2) (relating to noncapital, nondeductible expenses) be amended to make special provision for accounts receivable when debt is restored.

Because these comments relate to provisions in §1.1367-1 that were not affected by the amendments contained in the proposed regulations, the comments are not reflected in the final regulations.

## 11. Adjustments Required Before Deter-

## mining Tax Effect of Distribution.

Section 1.1368-2 of the proposed regulations provides rules for determining the source of a distribution made by an S corporation with respect to its stock and the tax effect of the distribution to the shareholders for taxable years of the corporation beginning on or after August 18, 1998.

One commentator interpreted §1.1368-2(a)(5) of the proposed regulations, which prescribes the order in which adjustments are made to the AAA for purposes of determining the source of a distribution, as providing that the AAA is adjusted in the same order as the adjustments to the basis of a share of stock under §1.1367-1 of the proposed regulations. The commentator stated that although the Small Business Job Protection Act of 1996 (1996 Act) changed the order of the adjustments to the basis of a share of stock, the 1996 Act did not change the order of the adjustments to the AAA except in situations involving a net negative adjustment (where the reductions in the account for the taxable year exceed the increases for the taxable year). When a net negative adjustment occurs, the AAA is adjusted to take into account distributions before the AAA is adjusted to take into account any net negative adjustment.

Consistent with the comment received, the final regulations make clear that except in situations involving a net negative adjustment, the order of adjustments to the AAA is not changed. Examples are added to the final regulations to illustrate the effect of the 1996 Act on the AAA ordering rules.

## 12. Transition Rule and Effective Date sections 1367 and 1368.

Sections 1.1367-3 and 1.1368-4 of the proposed regulations provide that the amendments to the final regulations under section 1367 and 1368 apply only to taxable years of the corporation beginning on or after August 18, 1998.

Commentators suggested that because the amendments to sections 1367 and 1368 under the 1996 Act are effective for taxable years beginning after December 31, 1996, the final regulations should be effective, at least on an elective basis, for the period beginning from the effective date of the 1996 Act and

ending on the effective date of the final regulations.

Sections 1.1367-3 and 1.1368-4 of the final regulations reflect this comment and provide that for taxable years beginning on or after January 1, 1997, and before August 18, 1998, the adjustments to the basis of a shareholder's stock and the treatment of distributions by an S corporation, respectively, must be determined in a reasonable manner, taking into account the statute and the legislative history. Return positions consistent with the final regulations will be considered reasonable.

## Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations do not impose a collection of information that is not already required by the underlying statute or the current regulations and reflected in the appropriate forms. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Drafting Information

The principal authors of these final regulations are Terri A. Belanger, Deane M. Burke, and Brenda Stewart of the Office of Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in their development.

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## 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 continues to read in part as follows:

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

Par. 2. Sections 1.1366-0 and 1.1366-1 are added, §1.1366-2 is revised, and §§1.1366-3 through 1.1366-5 are added to read as follows:

#### *§1.1366-0 Table of contents.*

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

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

(a) Determination of shareholder's tax liability.

(1) In general.

(2) Separately stated items of income, loss, deduction, or credit.

(3) Nonseparately computed income or loss.

(4) Separate activities requirement.

(5) Aggregation of deductions or exclusions for purposes of limitations.

(b) Character of items constituting pro rata share.

(1) In general.

(2) Exception for contribution of noncapital gain property.

(3) Exception for contribution of capital loss property.

(c) Gross income of a shareholder.

(1) In general.

(2) Gross income for substantial omission of items.

(d) Shareholders holding stock subject to community property laws.

(e) Net operating loss deduction of shareholder of S corporation.

(f) Cross-reference.

#### *§1.1366-2 Limitations on deduction of passthrough items of an S corporation to its shareholders.*

(a) In general.

(1) Limitation on losses and deductions.

(2) Carryover of disallowance.

(3) Basis limitation amount.

(i) Stock portion.

(ii) Indebtedness portion.

(4) Limitation on losses and deductions

allocated to each item.

(5) Nontransferability of losses and deductions.

(6) Basis of stock acquired by gift.

(b) Special rules for carryover of disallowed losses and deductions to post-termination transition period described in section 1377(b).

(1) In general.

(2) Limitation on losses and deductions.

(3) Limitation on losses and deductions allocated to each item.

(4) Adjustment to the basis of stock.

(c) Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions.

(1) Liquidations and reorganizations.

(2) Corporate separations to which section 368(a)(1)(D) applies.

#### *§1.1366-3 Treatment of family groups.*

(a) In general.

(b) Examples.

#### *§1.1366-4 Special rules limiting the passthrough of certain items of an S corporation to its shareholders.*

(a) Passthrough inapplicable to section 34 credit.

(b) Reduction in passthrough for tax imposed on built-in gains.

(c) Reduction in passthrough for tax imposed on excess net passive income.

#### *§1.1366-5 Effective date. §1.1366-1 Shareholder's share of items of an S corporation.*

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

end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return. For the limitation on allowance of a shareholder's pro rata share of S corporation losses or deductions, see section 1366(d) and §1.1366-2.

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

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

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

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

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

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

(vi) Each of the corporation's separate items of gains and losses from wagering transactions (section 165(d)); soil and

water conservation expenditures (section 175); deduction under an election to expense certain depreciable business expenses (section 179); medical, dental, etc., expenses (section 213); the additional itemized deductions for individuals provided in part VII of subchapter B (section 212 and following) of the Internal Revenue Code; and any other itemized deductions for which the limitations on itemized deductions under sections 67 or 68 applies;

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

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

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

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

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

(4) *Separate activities requirement.* An S corporation must report, and each shareholder must take into account in the shareholder's return, the shareholder's

pro rata share of an S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2) and (3) of this section for each of the corporation's activities as defined in section 469 and the regulations thereunder.

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

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

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

(b) *Character of items constituting pro rata share—(1) In general.* Except as provided in paragraph (b)(2) or (3) of this section, the character of any item of income, loss, deduction, or credit described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section is determined for the S corporation and retains that character in the hands of the shareholder. For example, if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder's pro rata share of that gain will also be characterized as a capital gain regardless of whether the shareholder is otherwise a dealer in that type of property. Similarly, if an S corporation engages in an activity that is not for profit (as defined in section 183), a shareholder's pro rata share of the S corporation's deductions will be characterized as not for profit. Also, if an S corporation makes a charitable contribution to an or-

ganization qualifying under section 170(b)(1)(A), a shareholder's pro rata share of the S corporation's charitable contribution will be characterized as made to an organization qualifying under section 170(b)(1)(A).

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

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

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

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

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

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

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

(e) *Net operating loss deduction of shareholder of S corporation.* For purposes of determining a net operating loss deduction under section 172, a shareholder of an S corporation must take into account the shareholder's pro rata share of items of income, loss, deduction, or credit of the corporation. See section 1366(b) and paragraph (b) of this section for rules on determining the character of the items. In determining under section 172(d)(4) the nonbusiness deductions allowable to a shareholder of an S corporation (arising from both corporation

sources and any other sources), the shareholder separately takes into account the shareholder's pro rata share of the deductions of the corporation that are not attributable to a trade or business and combines this amount with the shareholder's non-business deductions from any other sources. The shareholder also separately takes into account the shareholder's pro rata share of the gross income of the corporation not derived from a trade or business and combines this amount with the shareholder's nonbusiness income from all other sources. See section 172 and the regulations thereunder.

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

§1.1366-2 *Limitations on deduction of passthrough items of an S corporation to its shareholders.*

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

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

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

(2) *Carryover of disallowance.* A shareholder's aggregate amount of losses and deductions for a taxable year in excess of the sum of the adjusted basis of the shareholder's stock in an S corporation and of any indebtedness of the S corporation to the shareholder is not allowed for the taxable year. However, any disallowed loss or deduction retains its character and is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(3)(i) and (ii) of this section.

(3) *Basis limitation amount*—(i) *Stock portion.* A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (2) of

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

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

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

tion as the loss or deduction bears to the total of the losses and deductions. For this purpose, the total of losses and deductions for the taxable year is the sum of the shareholder's pro rata share of losses and deductions for the taxable year, and the losses and deductions disallowed and carried forward from prior years pursuant to section 1366(d)(2).

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

(6) *Basis of stock acquired by gift.* For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (2) of this section, the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

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

(2) *Limitation on losses and deductions.* The aggregate amount of losses and deductions taken into account by a shareholder under paragraph (b)(1) of this section cannot exceed the adjusted basis of the shareholder's stock in the corporation determined at the close of the last day of the post-termination transition period. For this purpose, the adjusted basis of a shareholder's stock in the corporation is determined at the close of the last day of the post-termination transition period without regard to any reduction required

under paragraph (b)(4) of this section. If a shareholder disposes of a share of stock prior to the close of the last day of the post-termination transition period, the adjusted basis of that share is its basis as of the close of the day of disposition. Any losses and deductions in excess of a shareholder's adjusted stock basis are permanently disallowed. For purposes of section 1366(d)(3)(B) and this paragraph (b)(2), the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

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

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

(c) *Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions—(1) Liquidations and reorganizations.* If a corporation acquires the assets of an S corporation in a transaction to which section 381(a) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributor or transferor S corporation is available to that shareholder as a shareholder of the acquiring corporation. Thus, where the acquiring corporation is an S corporation, a loss or deduction of a shareholder of the distributor or transferor S corporation disallowed prior to or during the taxable year of the transaction is treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder of the acquiring S corporation after the transac-

tion. Where the acquiring corporation is a C corporation, a post-termination transition period arises the day after the last day that an S corporation was in existence and the rules provided in paragraph (b) of this section apply with respect to any shareholder of the acquired S corporation that is also a shareholder of the acquiring C corporation after the transaction. See the special rules under section 1377 for the availability of the post-termination transition period if the acquiring corporation is a C corporation.

(2) *Corporate separations to which section 368(a)(1)(D) applies.* If an S corporation transfers a portion of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributing S corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. Such allocation shall be made according to any reasonable method, including a method based on the relative fair market value of the shareholder's stock in the distributing and controlled corporations immediately after the distribution, a method based on the relative adjusted basis of the assets in the distributing and controlled corporations immediately after the distribution, or, in the case of losses and deductions clearly attributable to either the distributing or controlled corporation, any method that allocates such losses and deductions accordingly.

§1.1366-3 *Treatment of family groups.*

(a) *In general.* Under section 1366(e), if an individual, who is a member of the family of one or more shareholders of an S corporation, renders services for, or furnishes capital to, the corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to those items taken into account by the individual and the shareholders as may be necessary to reflect the value of the services rendered or capital furnished. For these purposes, in determining the

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

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

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

*Example 2.* The stock of an S corporation is owned by A and B. For the taxable year, the corporation has paid compensation to a partnership that rendered services to the corporation during the taxable year. The spouse of A is a partner in that partnership. Consequently, if based on all the relevant facts and circumstances the partnership did not receive reasonable compensation for the services ren-

dered to the corporation, the Internal Revenue Service, in its discretion, may make adjustments to those items taken into account by the partnership and the corporation as may be necessary to reflect the value of the services rendered.

*§1.1366-4 Special rules limiting the passthrough of certain items of an S corporation to its shareholders.*

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

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

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

*§1.1366-5 Effective date.*

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

Par. 3. Section 1.1367-0 is amended in the table as follows:

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

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

The additions and revisions read as follows:

*§1.1367-0 Table of contents.*

\*\*\*\*\*

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

\*\*\*\*\*

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

(f) Ordering rules for taxable years begin-

ning on or after

August 18, 1998.

(g) Elective ordering rule.

(h) Examples.

(i) [Reserved]

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

\*\*\*\*\*

Par. 4. Section 1.1367-1 is amended as follows:

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

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

3. New paragraph (f) is added.

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

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

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

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

c. New *Example 2* is added.

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

e. *Example 5* is added.

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

The additions and revisions read as follows:

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

\*\*\*\*\*

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

\*\*\*\*\*

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

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

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

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

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

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

(h) \* \* \*

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

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

(ii) Pursuant to the ordering rules of paragraph (f) of this section, A first increases the basis of each share of stock by \$3 (\$300/100 shares) and then decreases the basis of each share by \$1 (\$100/100 shares) for the distribution. A next decreases the basis of each share by \$2 (\$200/100 shares) for the noncapital, nondeductible expenses and then decreases the basis of each share by \$3 (\$300/100 shares) for the items of loss. Thus, on January 1,

2003, A has a basis of \$3 per share in the original block of 50 shares (\$6 + \$3 - \$1 - \$2 - \$3) and a basis of \$5 per share in the second block of 100 shares (\$8 + \$3 - \$1 - \$2 - \$3).

\* \* \* \* \*

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

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

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

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

(i) [Reserved]

(j) *Adjustments for items of income in respect of a decedent.* The basis determined under section 1014 of any stock in an S corporation is reduced by the portion of the value of the stock that is attributable to items constituting income in re-

spect of a decedent. For the determination of items realized by an S corporation constituting income in respect of a decedent, see sections 1367(b)(4)(A) and 691 and applicable regulations thereunder. For the determination of the allowance of a deduction for the amount of estate tax attributable to income in respect of a decedent, see section 691(c) and applicable regulations thereunder.

Par. 5. §1.1367-3 is revised to read as follows:

*§1.1367-3 Effective date and transition rule.*

Except for §1.1367-1(f), (h) *Example 2* and *Example 5*, and (j), §§1.1367-1 and 1.1367-2 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1367-1(f), (h) *Example 2* and *Example 5*, and (j) apply only to taxable years of the corporation beginning on or after August 18, 1998. For taxable years beginning before January 1, 1994, and taxable years beginning on or after January 1, 1997, and before August 18, 1998, the basis of a shareholder's stock must be determined in a reasonable manner, taking into account the statute and legislative history. Except for §1.1367-1(f), (h) *Example 2* and *Example 5*, and (j), return positions consistent with §§1.1367-1 and 1.1367-2 are reasonable for taxable years beginning before January 1, 1994. Return positions consistent with §1.1367-1(f), (h) *Example 2* and *Example 5*, and (j) are reasonable for taxable years beginning on or after January 1, 1997, and before August 18, 1998.

Par. 6. Section 1.1368-0 is amended in the table as follows:

1. The entry for §1.1368-1(e) is revised and entries for §1.1368-1(e)(1) and (2) are added.

2. The entry for §1.1368-2(a)(4) is revised.

3. An entry for §1.1368-2(a)(5) is added.

4. The entry for §1.1368-2(d) is revised.

The additions and revisions read as follows:

*§1.1368-0 Table of contents.*

\* \* \* \* \*

*§1.1368-1 Distributions by S corporations.*

\* \* \* \* \*

(e) Certain adjustments taken into account.

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

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

\*\*\*\*\*

*§1.1368-2 Accumulated adjustments account (AAA).*

(a) \*\*\*

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

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

\*\*\*\*\*

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

\*\*\*\*\*

Par. 7. Section 1.1368-1 is amended by revising paragraphs (d)(1) and (e) to read as follows:

*§1.1368-1 Distributions by S corporations.*

\*\*\*\*\*

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

\*\*\*\*\*

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

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

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

(2) *Taxable years beginning on or after*

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

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

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

\*\*\*\*\*

Par. 8. Section 1.1368-2 is amended as follows:

1. Paragraphs (a)(1) and (a)(3)(ii), and the paragraph heading and introductory text of paragraph (a)(4) are revised.

2. Paragraph (a)(5) is added.

3. The paragraph heading for paragraph (d) is revised.

The additions and revisions read as follows:

*§1.1368-2 Accumulated adjustments account (AAA).*

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

\*\*\*\*\*

(3) \*\*\*

(ii) *Extent of allowable reduction.* The AAA may be decreased under paragraph (a)(3)(i) of this section below zero. The AAA is decreased by noncapital, nondeductible expenses under paragraph (a)(3)(i)(C) of this section even though a portion of the noncapital, nondeductible

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

\*\*\*\*\*

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

\*\*\*\*\*

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

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

(ii) The AAA is decreased under paragraph (a)(3)(i) of this section (without taking into account any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)) before it is decreased under paragraph (a)(3)(iii) of this section;

(iii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368(b) or (c)(1) applies;

(iv) The AAA is decreased by any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)); and

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

\*\*\*\*\*

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

\*\*\*\*\*

Par. 9. Section 1368-3 is amended as follows:

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

2. *Example 3* through *Example 6* are redesignated as *Example 6* through *Example 9*, respectively.

3. *Example 2* is redesignated as *Example 3*.

4. The heading for newly redesignated *Example 3* is revised.

5. New *Example 2*, *Example 4*, and *Example 5* are added.

The revisions and additions read as follows:

**§1.1368-3 Examples.**

\* \* \* \* \*

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

*Example 2. Distributions by S corporations without earnings and profits for taxable years beginning on or after August 18, 1998.* (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 2001, the first day of its 2001 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of \$1 per share as of that date. On March 1, 2001, S makes a distribution of \$38 to A. The balance in Corporation S's AAA is \$100. For S's 2001 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is \$50. A's pro rata share of the amount of the items described in sections 1367(a)(2)(B) through (D) (relating to decreases in basis of stock for items other than distributions) is \$26, \$20 of which is attributable to items described in section 1367(a)(2)(B) and (C) and \$6 of which is attributable to items described in section 1367(a)(2)(D) (relating to decreases in basis attributable to noncapital, nondeductible expenses).

(ii) Under section 1368(d)(1) and §1.1368-1(e)(1) and (2), the adjustments to the basis of A's stock in S described in sections 1367(a)(1) are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is \$6.00 (\$1 + [\$50/10]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under §1.1367-1(c)(3), the amount of the distribution that is attributable to each share of A's stock is \$3.80 (\$38 distribution/10 shares). Thus, A's basis per share in the stock is \$2.20 (\$6.00 - \$3.80), after taking into account the distribution. Under section 1367(a)(2)(D), the basis of each share of A's stock in S after taking into account the distribution, \$2.20, is decreased by \$.60 (\$6 noncapital, nondeductible expenses/10). Thus, A's basis per share after taking into account

the nondeductible, noncapital expenses is \$1.60. Under section 1367(a)(2)(B) and (C), A's basis per share is further decreased by \$2 (\$20 items described in section 1367(a)(2)(B) and (C)/10 shares). However, basis may not be reduced below zero. Therefore, the basis of each share of A's stock is reduced to zero. As of January 1, 2002, A has a basis of \$0 in his shares of S stock. Pursuant to section 1366(d)(2), the \$.40 of loss in excess of A's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to A.

*Example 3. Distributions by S corporations with C corporation earnings and profits for taxable years beginning before January 1, 1997. \* \* \**

*Example 4. Distributions by S corporations with earnings and profits and no net negative adjustment for taxable years beginning on or after August 18, 1998.* (i) Corporation S, an S corporation, has accumulated earnings and profits of \$1,000 and a balance in the AAA of \$2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of \$20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of \$1,500 to B. B's pro rata share of the income earned by S during 2001 is \$2,000 and B's pro rata share of S's losses is \$1,500. For the taxable year ending December 31, 2001, S does not have a net negative adjustment as defined in section 1368(e)(1)(C). S does not make the election under section 1368(e)(3) and §1.1368-1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The AAA is increased from \$2,000 to \$4,000 for the \$2,000 of income earned during the 2001 taxable year. The AAA is decreased from \$4,000 to \$2,500 for the \$1,500 of losses. The AAA is decreased from \$2,500 to \$1,000 for the portion of the distribution (\$1,500) to B that does not exceed the AAA.

(iii) As of December 31, 2001, B's basis in his stock is \$10 (\$20 + \$20 (\$2,000 income/100 shares) - \$15 (\$1,500 distribution/100 shares) - \$15 (\$1,500 loss/100 shares).

*Example 5. Distributions by S corporations with earnings and profits and net negative adjustment for taxable years beginning on or after August 18, 1998.*

(i) Corporation S, an S corporation, has accumulated earnings and profits of \$1,000 and a balance in the AAA of \$2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of \$20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of \$2,000 to B. B's pro rata share of the income earned by S during 2001 is \$2,000 and B's pro rata share of S's losses is \$3,500. For the taxable year ending December 31, 2001, S has a net negative adjustment as defined in section 1368(e)(1)(C). S does not make the election under section 1368(e)(3) and §1.1368-1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The AAA is increased from \$2,000 to \$4,000 for the \$2,000 of income earned during the 2001 taxable year. Because under section 1368(e)(1)(C)(ii) and §1.1368-2(a)(ii), the net negative adjustment is not taken into account, the AAA is decreased from \$4,000 to \$2,000 for the portion of the losses (\$2,000) that does not exceed the income earned during the 2001 taxable year. The AAA is reduced from \$2,000 to zero for the portion of the distribution to B (\$2,000) that does not exceed the AAA. The AAA is decreased from zero to a negative \$1,500 for the portion of the \$3,500 of loss that exceeds the \$2,000 of income earned during the 2001 taxable year.

(iii) Under §1.1367-1(c)(1), the basis of a shareholder's share in an S corporation stock may not be reduced below zero. Accordingly, as of December 31, 2001, B's basis per share in his stock is zero (\$20 + \$20 income - \$20 distribution - \$35 loss). Pursuant to section 1366(d)(2), the \$15 of loss in excess of B's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to B.

\* \* \* \* \*

Par. 10. §1.1368-4 is revised to read as follows:

**§1.1368-4 Effective date and transition rule.**

Except for §§1.1368-1(e)(2), 1.1368-2(a)(5), and 1.1368-3 *Example 2*, *Example 4*, and *Example 5*, §§1.1368-1, 1.1368-2, and 1.1368-3 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1368-1(e)(2), §1.1368-2(a)(5), and §1.1368-3 *Example 2*, *Example 4*, and *Example 5* apply only to taxable years of the corporation beginning on or after August 18, 1998. For taxable years beginning before January 1, 1994, and taxable years beginning on or after January 1, 1997, and before August 18, 1998, the treatment of distributions by an S corporation to its shareholders must be determined in a reasonable manner, taking into account the statute and legislative history. Except with regard to the deemed dividend rule under §1.1368-1(f)(3), §1.1368-1(e)(2), §1.1368-2(a)(5), and §1.1368-3 *Example 2*, *Example 4*, and *Example 5*, return positions consistent with §§1.1368-1, 1.1368-2, and 1.1368-3 are reasonable for taxable years beginning before January 1, 1994. Return positions consistent with §§1.1368-1(e)(2), 1.1368-2(a)(5), and 1.1368-3 *Example 2*, *Example 4*, and *Example 5* are reasonable for taxable years beginning on or after January 1, 1997, and



before August 18, 1998.

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 11. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. In §602.101, paragraph (b) is

amended by adding the entry for 1.1366-1 to the table as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \* \*

Robert E. Wenzel,  
*Deputy Commissioner of Internal Revenue.*

Approved December 13, 1999.

Jonathan Talisman,  
*Acting Assistant Secretary of the Treasury.*

(Filed by the office of the Federal Register on December 21, 1999, 8:45 a.m., and published in the issue of the Federal Register for December 22, 1999, 64 F.R. 71641)

| CFR part or section where identified and described | Current OMB control No. |
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**Section 1397E.—Credit to Holders of Qualified Zone Academy Bonds**

What is the 2000 qualified zone academy bond national limitation for each State, the District of Columbia, and the possessions of the United States? See Rev. Proc. 2000-10, page 287.

**Section 6038.—Information Reporting With Respect to Certain Foreign Corporations and Partnerships**

26 CFR 1.6038-2: Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations beginning after December 31, 1962.

**T.D. 8850**

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

**Information Reporting With Respect to Certain Foreign Partnerships and Certain Foreign Corporations**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

2000-2 I.R.B.

**SUMMARY:** This document contains final regulations under section 6038 of the Internal Revenue Code relating to information reporting requirements for United States persons owning interests in controlled foreign partnerships (CFPs). This document also contains amendments to the final regulations under section 6038 relating to the reporting requirements of U.S. shareholders of certain foreign corporations and amendments to the final regulations under section 6038B relating to the reporting requirements with respect to transfers of property to foreign partnerships and to foreign corporations.

**DATES: Effective Dates:** These regulations are effective December 29, 1999, except that §1.6038B-2(a)(5) is effective January 1, 2000.

**Applicability Dates:** For dates of applicability, see §§1.6038-2(l), 1.6038-3(l), and 1.6038B-2(c)(4) and (j)(3).

**FOR FURTHER INFORMATION CONTACT:** Eliana Dolgoff, (202) 622-3860 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Paperwork Reduction Act**

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance

with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control numbers 1545-1615, 1545-1617, and 1545-1317. Responses to these collections of information are mandatory.

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

The burden of complying with the collection of information required to be reported on Form 8865 is reflected in the burden for Form 8865.

The burden of complying with the collection of information required to be reported on Form 5471 is reflected in the burden for Form 5471.

The burden of complying with the collection of information required to be reported on Form 926 is reflected in the burden for Form 926.

The estimated annual burden per respondent of complying with the collection of information in §1.6038-3(c)(1)(ii)(B) and (2)(ii)(B) varies from .5 hours to 1.5 hours, depending on individual circumstances, with an estimated average of 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of**

**Management and Budget**, Attn: Desk Officer of the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

## Background

On September 9, 1998, the IRS published in the **Federal Register** (63 FR 48144 (REG-118966-97, 1998-39 I.R.B. 29)) proposed regulations relating to the reporting requirements under section 6038 of United States persons that are direct or indirect partners of CFPs. A public hearing on the proposed regulations was held on November 10, 1998, even though no requests to speak at the hearing were received. Though no comments were made at the hearing, written comments were received. After consideration of all of the written comments, the proposed regulations under section 6038 are adopted as revised by this Treasury decision. The revisions are discussed in the Summary of Public Comments and Explanation of Revisions section of this preamble. This document also contains amendments to certain other final regulations. These amendments are also discussed below.

## Summary of Public Comments and Explanation of Revisions

### A. General Comments Regarding the Proposed Section 6038 CFP Regulations

Some commentators suggested that the final regulations should exempt state and local government employee retirement plans from the section 6038 reporting requirements. The final regulations provide that trusts relating to state and local government employee retirement plans are not required to report under section 6038, unless required to do so in the instructions to Form 8865, "Return of U.S. Persons with Respect to Certain Foreign Partnerships."

One commentator asserted that the reasonable cause exception to the section 6038 penalties appears to apply only to failures to file Form 8865 and therefore would not protect a taxpayer who files an incomplete Form 8865 because the taxpayer was unable to obtain all the re-

quired information from the foreign partnership. The reasonable cause exception has been modified to make clear that it applies to both a failure to file Form 8865 and to a failure to submit all information required to be submitted.

Commentators requested that the final regulations provide that the section 6038 penalties do not apply when there is minor noncompliance with the reporting requirements under section 6038. The commentators expressed concern that taxpayers will be subject to penalties for small discrepancies in the information reported and suggested that the penalties apply only if there is a substantial failure to report the required information, or if materially false or inaccurate information is submitted. Because the IRS and Treasury believe adding such a standard might encourage taxpayers to submit incomplete Forms 8865, the standard was not added to the final regulations. A taxpayer may, nonetheless, avoid application of the section 6038 penalties because of minor noncompliance with the section 6038 reporting requirements by demonstrating reasonable cause. See §1.6038-3(k)(4).

Commentators also requested that the IRS add additional, specific reasonable cause exceptions to the section 6038 penalties. For example, one commentator requested a specific exception be provided for controlling ten-percent partners (see definition in §1.6038-3(a)(2)) that are unable to obtain all information required to be reported by controlling ten-percent partners. The final regulations do not contain additional, specific reasonable cause exceptions. Whether there is reasonable cause depends on all the facts and circumstances of the particular case. Any person who is unable to obtain information may apply for a reasonable cause determination specific to that person's situation.

Finally, a commentator asked that in the case of an affiliated group of corporations filing a consolidated income tax return, the final regulations not require the members to file separate Forms 8865 if one member of the group files Form 8865. The final regulations adopt this recommendation. The common parent corporation of an affiliated group of corporations filing a consolidated income tax return may file one Form 8865 on behalf of all other members of the group required to file Form 8865 pursuant to sec-

tion 6038 with respect to a particular foreign partnership.

### B. Section 6038/Section 6031 Overlap.

Some commentators requested that the final regulations address the potential overlap between section 6031 and section 6038. In general, section 6031(e) provides that a foreign partnership must file Form 1065, "U.S. Partnership Return of Income," if it has gross income derived from sources within the United States or gross income that is effectively connected with the conduct of a trade or business within the United States. Section 6038 provides generally that a U.S. partner of a foreign partnership must file Form 8865 with respect to that partnership if the partner individually, or collectively with other ten-percent or greater U.S. partners, owns more than a fifty-percent interest in the partnership. Therefore, in some cases, both Forms 1065 and 8865 would be required to be filed with regard to the same partnership for the same tax year of the partnership. Although the two forms are not identical, and one is filed by the partnership while the other is filed by the relevant partners, the information required by the two forms is substantially the same.

Additionally, some confusion may result from the fact that the two forms contain similarly titled schedules. In particular, each form has a Schedule K-1 on which information about a partner's distributive share of partnership income, deductions, etc., is to be reported. The IRS is working to eliminate discrepancies between the two schedules. However, even if the discrepancies are eliminated, it is still possible the two schedules will not contain identical information because one schedule will be prepared by a partner and one will be prepared by the partnership.

In response to the comments that the overlap between section 6031 and section 6038 reporting will be burdensome to taxpayers when both sets of requirements apply, and to help avoid any confusion on the part of taxpayers with respect to which Schedule K-1 they should use to compute their tax liabilities, the final section 6038 regulations reduce the burden imposed by section 6038 in the case of an overlap. They provide that if a foreign partnership completes and files Form 1065, a U.S. person required to report under section 6038 must use a copy of the filed Form 1065, including the Schedules K-1, in conjunction with fulfilling the

person's section 6038 reporting obligation. Specifically, the instructions to Form 8865 will state which schedules on Form 1065 are considered equivalent to schedules on Form 8865. A U.S. partner must attach to the partner's Form 8865 a copy of the Form 1065 schedules that are considered equivalent to the schedules the partner is required to complete on Form 8865 as a controlling fifty-percent partner (see definition in §1.6038-3(a)(1)) or as a controlling ten-percent partner. A partner should not complete a schedule on Form 8865 when the partner attaches a copy of the equivalent Form 1065 schedule to its Form 8865. Should a schedule on Form 8865 ask for information that is not required to be reported on the equivalent Form 1065 schedule, the partner is not required to report that information on its Form 8865 if a copy of the completed equivalent Form 1065 schedule is attached to its Form 8865. A partner attaching copies of schedules from Form 1065 to its Form 8865 must still complete the parts of Form 8865 that the person is required to complete as a controlling fifty-percent partner, or as a controlling ten-percent partner, and for which there is no equivalent Form 1065 schedule (for example, a partner must still complete the first page of Form 8865 and certain schedules on page two of the form).

An example of how a person will use a completed Form 1065 to fulfill its section 6038 filing obligation is as follows. Section 1.6038-3(g)(2)(iii) requires a controlling fifty-percent partner to report aggregate information about the partners' distributive shares of income, gain, losses, deductions and credits. Such information is reported on Schedule K of Form 8865. The same information is also required to be submitted on Schedule K of Form 1065. The instructions to Form 8865 will provide that Schedules K on Forms 1065 and 8865 are equivalent. Accordingly, if the partnership completes and files a Form 1065, a controlling fifty-percent partner filing Form 8865 must attach a copy of the Schedule K from the Form 1065 to the partner's Form 8865 and should not complete Schedule K on Form 8865. The partner must also attach all other Form 1065 schedules that are considered equivalent to Form 8865 schedules that the partner must complete as a controlling fifty-percent partner. Additionally, the partner must still complete page one of Form 8865 and Sched-

ules A "Constructive Ownership of Partnership Interest," A-1 "Certain Partners of Foreign Partnership," A-2 "Affiliation Schedule," and N "Transactions Between Controlled Foreign Partnership and Partners or Other Related Entities" of Form 8865.

Similarly, a controlling ten-percent partner must submit on Schedule K-1 of Form 8865 a statement of the income, gain, losses, deductions and credits allocated to the partner's direct interest in the partnership. See §1.6038-3(g)(1)(i). The same information is also required to be reported on Schedule K-1 of Form 1065. Therefore, if the partnership completes and files Form 1065, the partner must attach to its Form 8865 a copy of its Schedule K-1 from the Form 1065 completed by the partnership and should not complete Schedule K-1 on Form 8865. The partner is still required to complete the portions of pages one and two of Form 8865 applicable to controlling ten-percent partners, as well as Schedule N.

Another comment asserted that the proposed regulations imposed an excessive reporting burden on taxpayers and that they had the effect of nullifying the section 6031(e) limitation on reporting required of foreign partnerships. The comment suggested that the IRS require only those items specifically enumerated in section 6038(a)(1) to be reported under section 6038.

Section 6038 grants the IRS authority to require taxpayers to submit more than the items enumerated in section 6038(a)(1). Section 6038 provides that the Secretary may require the furnishing of any other information that is similar or related in nature to that specified in the first sentence of section 6038(a)(1), or which the Secretary determines to be appropriate to carry out the provision of Title 26. The IRS has determined that all of the information that the final section 6038 regulations require taxpayers to submit is necessary for the IRS to carry out the provisions of Title 26.

Additionally, as explained above, section 6031(e) and section 6038 differ with respect to whom they require to report and when the reporting obligation applies. Section 6031(e) applies only to the requirement that a Form 1065 be filed, to the application of the TEFRA partnership-level audit procedures, and to the requirement that a partnership report information about

its operations, even when there is limited U.S. ownership in the partnership. In contrast, section 6038 requires certain U.S. partners to report information when the foreign partnership in which they own an interest has substantial U.S. ownership. Section 6031(e) was added to the Internal Revenue Code at the same time that section 6038 was amended to apply to CFPs. See Taxpayer Relief Act of 1997, Public Law 105-34, sections 1141-1142 (111 Stat. 983)(1997). Therefore, rather than intending section 6031(e) to limit the amount of information required to be reported pursuant to section 6038, Congress intended the two provisions to work together to ensure that the IRS receives sufficient information about foreign partnerships.

### C. Tiered Partnerships

Commentators requested that section 6038 reporting apply only to first-tier CFPs, i.e., section 6038 reporting should only be required of U.S. persons with respect to foreign partnerships in which they own a direct interest. However, section 6038(e)(3)(B) provides that rules similar to the rules of section 267(c) shall apply when determining whether a person owns a fifty-percent interest in a foreign partnership. Additionally, the statute does not require that a U.S. person own its interest in the CFP directly. Therefore, the final regulations require section 6038 reporting of United States persons whose ownership interests are entirely the result of constructive ownership from other persons.

Nevertheless, certain exceptions and modifications to this rule may apply. Persons that do not own direct interests may qualify for a reduced reporting obligation pursuant to the exception for constructive owners in §1.6038-3(c)(2). Additionally, certain information required by the final section 6038 regulations must be submitted only if the partner owns a direct interest in the foreign partnership. For example, §1.6038-3(g)(1)(i) provides that the person reporting under section 6038 must provide a statement of the income, gain, losses, deductions and credits allocated to that person's direct interest in the partnership. Accordingly, if a person is reporting under section 6038 but owns no direct interest in the partnership, that person will not have to submit information under §1.6038-3(g)(1)(i). Finally, the final regulations require attribution from nonresident alien family members only if the per-

son to whom the interest is being attributed already owns a direct or indirect (under the rules of section 267(c)(1) or (5)) interest in the partnership. See §1.6038-3(b)(4).

*D. Failure to Recognize That an Arrangement is a Partnership or That a Partnership is a Foreign Partnership*

Commentators expressed concern that taxpayers might fail to report under section 6038 because they failed to recognize that their arrangement constituted a partnership. Additionally, if no entity is formed under foreign law, but a partnership is determined to exist, it may be difficult to determine whether the partnership is foreign or domestic. Some commentators recommended that the IRS exclude partnerships not formed under a foreign law statute from the reporting requirements, subject to an anti-abuse rule. The final regulations do not adopt this recommendation and additional guidance on these issues is beyond the scope of this document. They do, however, provide that the section 6038 reporting requirements do not apply to any United States person with respect to a foreign partnership that has validly elected (or is deemed to have elected) to be excluded from the application of subchapter K. See §1.6038-3(e). Additionally, a taxpayer that does not comply with section 6038 because it mistakenly concluded that its arrangement was not a partnership, or that it was not a foreign partnership, may apply for a reasonable cause determination. See §1.6038-3(k)(4).

*E. Section 6038 (CFPs) Effective Date.*

Section 1.6038-3 is applicable to CFP tax years ending on or after December 31, 2000. United States persons are not required to report under section 6038 for CFP tax years ending before December 31, 2000.

*F. Availability of Form 8865.*

A United States person required to report information pursuant to section 6038 must do so by completing and filing Form 8865. A final version of Form 8865 will be released prior to January 1, 2000. Taxpayers will be able to download a copy of the form and its instructions from the IRS Internet website located at [www.irs.us-treas.gov](http://www.irs.us-treas.gov).

*G. Clarification of Section 6501(c)(8).*

Section 6501(c)(8) provides that in the case of information required to be re-

ported under section 6038, 6038A, 6038B, 6046, 6046A, or 6048, the time for assessment of any tax imposed by Title 26 with respect to any event or period to which such information relates shall not expire before the date that is three years after the date on which the Secretary is furnished the information required to be reported under such section. Taxpayers have expressed uncertainty about the application of this rule in the context of a failure to properly report information required under sections 6038, 6038B, or 6046A, with respect to an interest in a foreign corporation or a foreign partnership, as applicable. The IRS and Treasury wish to clarify that if a U.S. person fails to comply with sections 6038, 6038B, or 6046A, the extended statute of limitations provided by section 6501(c)(8) shall apply only to the tax consequences related to the information required to be reported under the relevant reporting section and not to all transactions within the U.S. person's tax year at issue. For example, if a U.S. person with a calendar tax year fails to comply with section 6038 for a controlled foreign partnership's 2001 calendar tax year, section 6501(c)(8) will only extend the statute of limitations applicable to the U.S. person's 2001 tax year with respect to any tax consequences associated with the U.S. person's interest in the foreign partnership during the partnership's 2001 tax year.

*H. Amendment to Final Section 6038 Foreign Corporation Regulations*

In order to reduce the burden that section 6038 imposes on taxpayers, this document also amends the final regulations under section 6038 applicable to shareholders of certain foreign corporations. The regulations provide that if a United States person does not own a direct or indirect interest in the foreign corporation, but is attributed an interest from a nonresident alien, the person is not required to report under section 6038. This amendment is effective for tax years of foreign corporations ending on or after December 29, 1999.

*I. Amendments to Final Section 6038B Regulations Applicable to Transfers of Property to Foreign Partnerships*

On February 5, 1999, the IRS published in the **Federal Register** final regulations under section 6038B relating to the information reporting requirements

for certain contributions of property by United States persons to foreign partnerships. See T.D. 8817, 1999-8 I.R.B. 51 (64 FR 5713). This document makes several amendments to those final regulations. Each amendment either reduces the burden that section 6038B imposes on taxpayers, or does not affect the burden imposed by section 6038B.

First, the amount of information required to be submitted by a person reporting a transfer of property to a foreign partnership is reduced. Rather than submit the names and addresses of all the foreign partnership's partners, the person reporting the transfer (the transferor) must provide only the names and addresses of the United States partners that owned a ten-percent or greater direct interest in the foreign partnership during the transferor's tax year in which the reportable transfer occurred, and the names and addresses of any other United States or foreign persons that were direct partners in the partnership during that tax year and that were related to the transferor under section 6038B during that tax year. A person who transferred solely cash and who did not own a ten-percent or greater interest after the transfer is still not required to report the names and addresses of any of the foreign partnership's other partners. This amendment applies to tax years of U.S. persons required to report under section 6038B beginning on or after January 1, 2000.

Second, this document changes the time for filing Form 8865 to report a transfer to a foreign partnership in certain instances. Currently, §1.6038B-2(a)(5)(ii) provides that if a United States person required to report a transfer to a foreign partnership is also required to report pursuant to section 6038 for the period in which the transfer occurred, then the United States person must report the transfer on the Form 8865 completed for the partnership's tax year in which the transfer occurred. This document deletes the section 6038B/section 6038 overlap rule, so that a United States person must always report with its tax return for a particular tax year all of its section 6038B transfers that took place during that year, regardless of whether any of the transfers occurred during a period for which section 6038 reporting is also required. This amendment applies to tax years of U.S. persons required to report under section 6038B beginning on or after January 1, 2000.

The following example illustrates this amendment. Assume the tax year of *FPS*, a foreign partnership, ends on Sept 30. *US*, a United States person and calendar year taxpayer, owns a sixty-percent interest in *FPS* and therefore is a controlling fifty-percent partner of *FPS*. Accordingly, *US* must report under section 6038 with respect to *FPS*. On October 15, 2001, *US* transfers property to *FPS* in a section 721 transaction. *US* is required to report this transfer under section 6038B because *US* owns at least a ten-percent interest in the partnership immediately after the transfer. See §1.6038B-2(a)(1)(i). Under the existing section 6038B regulations, *US* is required to report the October 15, 2001 property transfer on the Form 8865 for *FPS*'s tax year ending September 30, 2002, that will be filed with *US*'s 2002 income tax return.

Under the amendments to section 6038B contained in this document, *US* must attach to its 2001 income tax return a Form 8865 on which is reported the October 15, 2001 property transfer and information about *FPS* for *FPS*'s tax year ending September 30, 2001. Assuming *US* is also a controlling fifty-percent partner during *FPS*'s tax year ending September 30, 2002, when *US* files its 2002 income tax return, *US* must attach to that return Form 8865 on which is reported information about *FPS* for *FPS*'s tax year ending September 30, 2002. *US* should not report the October 15, 2001, property transfer on the Form 8865 filed with *US*'s 2002 income tax return.

The third and final amendment to the section 6038B regulations provides an additional opportunity for United States persons to timely report certain transfers to foreign partnerships. Even if not reported in accordance with the rules provided in §1.6038B-2(a)(5) or (j)(1) or (2), a transfer to a foreign partnership that occurred before January 1, 2000, will nevertheless be considered timely reported if the transferor reports it on a Form 8865 attached to an amended tax return for the transferor's tax year in which the transfer occurred, provided such amended return is filed no later than September 15, 2000.

Additionally, since issuing the section 6038B regulations in February 1999,

certain tax-exempt organizations have contacted the IRS and Treasury to request that they be specifically excluded from the obligation under section 6038B to report their property transfers to foreign partnerships. The IRS and Treasury invite comments regarding the extent to which section 6038B reporting should be required of tax-exempt organizations.

#### *J. Amendment to Final Section 6038B Regulations Applicable to Transfers of Property to Foreign Corporations*

This document makes one amendment to the final section 6038B regulations governing the reporting requirements with respect to transfers to foreign corporations. The amendment reduces the burden that section 6038B imposes on taxpayers.

Pursuant to §1.367(a)-3(c)(8), section 367(a) does not apply to a domestic corporation's transfer of its own stock or securities in connection with the performance of services, if the transfer is considered to be to a foreign corporation solely by reason of §1.83-6(d)(1). Section 1.83-6(d)(1) provides that if a shareholder of a corporation transfers property to an employee of such corporation in consideration of services performed for the corporation, the transaction is considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the latter corporation to the employee.

The final regulations under section 6038B do not contain an exception to the reporting requirements that corresponds to the rule in §1.367(a)-3(c)(8). Therefore, a transfer by a domestic corporation of its stock or securities to an employee of the domestic corporation's foreign subsidiary may be excluded from the application of section 367(a), yet still reportable under section 6038B. This document provides that such a transfer is not required to be reported under section 6038B if the transfer is considered to be to a foreign corporation solely by reason of §1.83-6(d)(1) and the fair market value of the property transferred did not exceed \$100,000. This amendment is effective as if it had been included in TD 8770 (63 FR 33550), and therefore applies to transfers occurring on or after July 20, 1998.

## **Special Analyses**

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these final regulations. It is hereby certified that the collections of information contained in these final regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the number of small entities that will be required to file the form is not substantial. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

## **Drafting Information**

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

\* \* \* \* \*

## **Amendments to the Regulations**

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

### **PART 1—INCOME TAXES**

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

Authority: 26 U.S.C. 7805 \* \* \*  
Section 1.6038-2 also issued under 26 U.S.C. 6038.

Section 1.6038-3 also issued under 26 U.S.C. 6038. \* \* \*

Par. 2. In §1.367(a)-3, paragraph (c)(8) is amended by adding a sentence to the end of the paragraph to read as follows:

*§1.367(a)-3 Treatment of transfers of stock or securities to foreign corporations.*

\* \* \* \* \*

(c) \* \* \*

(8) \* \* \* The transfer may still, however, be reportable under section 6038B. See § 1.6038B-1(b)(2)(i)(A)(4) and (b)(2)(i)(B)(4).

\* \* \* \* \*

Par. 3. Section 1.6038-2 is amended as follows:

1. A sentence is added to the end of paragraph (j)(2)(i)(C).

2. Paragraph (l) is added.

The revised and added provisions read as follows:

*§ 1.6038-2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations beginning after December 31, 1962.*

\* \* \* \* \*

(j) \* \* \*

(2) \* \* \*

(i) \* \* \*

(C) \* \* \* (For a rule regarding attribution from a nonresident alien, see paragraph (l) of this section).

\* \* \* \* \*

(l) *Other persons excepted from filing.* For tax years of foreign corporations ending on or after December 29, 1999, any person required to furnish information under this section with respect to a foreign corporation does not have to furnish that information if the following conditions are met—

(1) Such person does not own a direct or indirect interest in the foreign corporation; and

(2) Such person is required to furnish information solely by reason of attribution of stock ownership from a nonresident alien(s) under paragraph (c) of this section.

Par. 4. Section 1.6038-3 is added to read as follows:

*§ 1.6038-3 Information returns required of certain United States persons with respect to controlled foreign partnerships (CFPs).*

(a) *Persons required to make return—*

(1) *Controlling fifty-percent partners.* The term *controlling fifty-percent partner* means a United States person that controlled (as defined in paragraph (b)(1) of this section) the foreign partnership at any time during the partnership's tax year (as defined in paragraph (b)(8) of this section). Except as provided in paragraph (c), (d), or (e) of this section, for each tax

year of a foreign partnership during which the partnership has one or more controlling fifty-percent partners, each controlling fifty-percent partner must complete and file Form 8865, "Return of U.S. Persons With Respect To Certain Foreign Partnerships," containing the information described in paragraph (g) of this section.

(2) *Controlling ten-percent partners.* If at any point during a foreign partnership's tax year (as defined in paragraph (b)(8) of this section) a United States person owned a ten-percent or greater interest in the partnership while the partnership was controlled by United States persons owning ten-percent or greater interests, such United States person is a controlling ten-percent partner. See paragraph (b)(1) of this section for the definition of control. However, a United States person is not a controlling ten-percent partner with respect to a particular foreign partnership for a particular tax year of the foreign partnership if at any point during that year the partnership had a controlling fifty-percent partner, as defined in paragraph (a)(1) of this section. Except as provided in paragraph (c), (d), or (e) of this section, for each tax year of a partnership during which the partnership has controlling ten-percent partners, each controlling ten-percent partner must complete and file Form 8865 containing the information described in paragraph (g)(1) of this section.

(3) *Separate returns for each partnership.* A United States person required to report under this paragraph (a) must file a separate Form 8865 for each foreign partnership with respect to which the person is a controlling fifty-percent partner or a controlling ten-percent partner.

(b) *Ownership determinations and definitions—*(1) *Control.* Control of a foreign partnership is ownership of more than a fifty-percent interest in the partnership.

(2) *Fifty-percent interest.* A fifty-percent interest in a partnership is an interest equal to fifty percent of the capital interest in such partnership, an interest equal to fifty percent of the profits interest in such partnership, or an interest to which fifty percent of the deductions or losses of such partnership are allocated.

(3) *Ten-percent interest.* A ten-percent interest in a partnership is an interest equal to ten percent of the capital interest in such partnership, an interest equal to

ten percent of the profits interest in such partnership, or an interest to which ten percent of the deductions or losses of such partnership are allocated.

(4) *Constructive ownership rules.* For purposes of determining an interest in a partnership, the constructive ownership rules of section 267(c) (other than section 267(c)(3)) apply, taking into account that such rules refer to corporations and not to partnerships. However, an interest will be attributed from a nonresident alien under the family attribution rules of section 267(c)(2) and (4) only if the person to whom the interest is attributed owns a direct or indirect (under the rules of 267(c)(1) or (5)) interest in the foreign partnership.

(5) *Determination of amount of interest.* Whether a person owns a fifty-percent interest, or a ten-percent interest, as described in paragraphs (b)(2) and (3) of this section, is determined for each tax year of the foreign partnership by reference to the agreement of the partners relating to such interests during that tax year.

(6) *Definition of United States person.* The term *United States person* is defined in section 7701(a)(30).

(7) *Definition of a foreign partnership.* A foreign partnership is a partnership described in section 7701(a)(5).

(8) *Tax year of a foreign partnership.* The tax year of a foreign partnership is determined under section 706.

(9) *Examples.* The rules of paragraph (a) of this section and this paragraph (b) are illustrated by the following examples:

*Example 1. Sole U.S. partner does not own more than a fifty-percent interest.* No United States person owns any interest (directly or constructively) in *FPS*, a foreign partnership whose tax year under section 706 is the calendar year. On January 1, 2001, *US*, a United States person with the calendar year as its tax year, contributes property to *FPS* in exchange for a 40% interest in a section 721 transaction. No United States persons acquire directly or constructively any other interests in *FPS* during *FPS*'s 2001 tax year. *US* is not a controlling fifty-percent partner during *FPS*'s 2001 tax year. *US* did not own during that tax year, either directly or constructively, more than a 50% interest in the partnership under paragraphs (b)(2) and (4) of this section. Also, *US* is not a controlling ten-percent partner; although *US* owned a 10% or greater interest, *US* persons owning at least 10% interests did not control *FPS*. Therefore, *US* does not have to file with its 2001 income tax return a Form 8865 with respect to *FPS* under

section 6038. (But see section 6038B for the reporting obligations of *US* with respect to its transfer of property to *FPS* and section 6046A for the reporting obligation of *US* with respect to its acquisition of an interest in *FPS*. See also § 1.6046A-1(e)(1) regarding the overlap between sections 6038B and 6046A).

*Example 2. Controlling ten-percent partners.* Assume the same facts as in *Example 1*. In addition, on January 1, 2002, *USI*, a United States person unrelated to *US* and a calendar year taxpayer, purchases a 15% interest in *FPS* from a foreign partner of *FPS*. Neither *US* nor *USI* is a controlling fifty-percent partner during *FPS*'s 2002 tax year because neither one owns more than a 50% percent interest in *FPS* during that year. However, *US* and *USI* are controlling ten-percent partners for that year because each owns at least a 10% interest (*US* owns a 40% interest and *USI* owns a 15% interest) and together they control *FPS* because collectively they own more than a 50% interest in *FPS*. As controlling ten-percent partners, under section 6038, each is required to file a Form 8865 with its 2002 income tax return. (*USI* must also report its acquisition of the 15% interest in *FPS* under section 6046A on its Form 8865 filed with its 2002 income tax return.)

*Example 3. Constructive ownership rules.* Assume the same facts as in *Example 2*. In addition, on January 1, 2003, *US2*, a United States person and the brother of *US*, purchases 50% of the stock of *FC*, a foreign corporation. *FC* owns a 20% interest in *FPS*. Thus, under sections 6038(e)(3) and 267(c)(1), *US2* indirectly owns a 10% interest in *FPS* (10% is *US2*'s proportionate share of *FC*'s 20% interest in *FPS*), and under sections 6038(e)(3) and 267(c)(2), *US2* is attributed *US*'s 40% interest. Additionally, *US* directly owns a 40% interest in *FPS* and is attributed *US2*'s 10% interest pursuant to section 6038(e)(3) and section 267(c)(2). Therefore, *US2* is considered to own a 50% interest (10% indirectly and 40% from *US*) in *FPS*, and *US* is considered to own a 50% interest in *FPS* (40% directly and 10% from *US2*). *FPS* has no controlling fifty-percent partners, because neither *US*, *USI*, nor *US2*, owns a greater than 50% interest. However, *US*, *USI*, and *US2* are each controlling ten-percent partners and each must file Form 8865 pursuant to section 6038 for *FPS*'s 2003 tax year ending December 31, 2003. Each must attach Form 8865 to its tax return for its 2003 tax year.

*Example 4. Controlling fifty-percent partners.* Assume the same facts as in *Example 3*. In addition, on June 1, 2004, *US* acquires an additional 1% direct interest in *FPS*. *US* is now a controlling fifty-percent partner of *FPS*, because *US* owns a 41% interest directly and a 10% interest constructively from *US2*. *US2* is also a controlling fifty-percent partner, because *US2* owns 10% indirectly and 41% con-

structively from *US*. Both *US* and *US2* are required to file Form 8865 containing all the information required to be submitted by controlling fifty-percent partners. (But see paragraph (c)(1) of this section, which contains filing exceptions when there are multiple controlling fifty-percent partners). *USI* is no longer a controlling ten-percent partner because *FPS* now has at least one controlling fifty-percent partner, and *USI* does not qualify as a controlling fifty-percent partner. Therefore, *USI* is not required to file Form 8865 under section 6038.

*Example 5. Constructive ownership from a non-resident alien.* *US*, a United States person, does not own directly or constructively an interest in *FPS*, a foreign partnership. The tax year of *FPS* is the calendar year. *NRA*, a nonresident alien, is the mother of *US*. In 2002, *NRA* acquires a 55% interest in *FPS*. Because *US* owns neither a direct nor a constructive interest in *FPS* under sections 6038(e)(3) and 267(c)(1) or (5), *NRA*'s interest is not attributed to *US* under sections 6038(e)(3) and 267(c)(2). If in 2003 *NRA* becomes a United States person, *NRA*'s interest will be attributed to *US*. However, *US* is excused from filing Form 8865 if *US* satisfies the requirements of the constructive owners exception in paragraph (c)(2) of this section. In 2003, *NRA* is a controlling fifty-percent partner and must file a Form 8865 under section 6038 for *FPS*'s 2003 tax year.

(c) *Exceptions when more than one United States person is required to file Form 8865 pursuant to section 6038—(1) Multiple controlling fifty-percent partners—(i) In general.* If, with respect to the same foreign partnership for the same tax year, more than one United States person is a controlling fifty-percent partner, then in lieu of each controlling fifty-percent partner filing a separate Form 8865, only one Form 8865 from one of the controlling fifty-percent partners is required, provided all of the requirements of paragraph (c)(1)(ii) of this section are satisfied. A person that is a controlling fifty-percent partner solely because of an interest to which deductions or losses are allocated may file the single return only if there is no United States person that is a controlling fifty-percent partner by reason of an interest in capital or profits.

(ii) *Requirements—(A)* The person undertaking the filing obligation must file Form 8865 with that person's income tax return in the manner provided by Form 8865 and the accompanying instructions. The return must contain all of the information that would have been required to be reported by this section if each controlling fifty-percent partner had filed its own

Form 8865.

(B) Any controlling fifty-percent partner not filing Form 8865 must file with its income tax return a statement titled "Controlled Foreign Partnership Reporting" containing the following information—

(1) A statement that the person qualified as a controlling fifty-percent partner, but is not submitting Form 8865 pursuant to the multiple controlling fifty-percent partners exception;

(2) The name, address, and taxpayer identification number (if any) of the foreign partnership of which the person qualified as a controlling fifty-percent partner;

(3) A representation that the filing requirement has been or will be satisfied;

(4) The name and address of the person filing the single return;

(5) The Internal Revenue Service Center where the single return is required to be filed; and

(6) Any additional information that Form 8865 and the accompanying instructions require.

(iii) *Penalties.* If the requirements listed in paragraph (c)(1)(ii) of this section are not satisfied, a United States person that did not file a Form 8865 pursuant to this paragraph will be subject to the penalties in paragraph (k) of this section, unless the reasonable cause provision in paragraph (k)(4) of this section is satisfied.

(2) *Certain constructive owners exempted from furnishing information—(i) In general.* A United States person that does not own a direct interest in the foreign partnership and that is required to file Form 8865 under this section solely by reason of constructive ownership from a United States person(s) pursuant to paragraph (b)(4) of this section (an indirect partner) is not required to file Form 8865 if all of the requirements listed in paragraph (c)(2)(ii) of this section are met.

(ii) *Requirements—(A)* The United States person(s) whose interest the indirect partner constructively owns reports all the information such person(s) is required to submit under this section, unless such person also is required to file solely by reason of constructive ownership from a United States person(s) pursuant to paragraph (b)(4) of this section, or another person reports the information pursuant to paragraph (c)(1) of this section.

(B) The indirect partner files with its income tax return a statement titled "Con-

trolled Foreign Partnership Reporting” containing the following information—

(1) A representation that the indirect partner was required to file Form 8865, but is not doing so pursuant to the constructive owners exception;

(2) The names and addresses of the United States persons whose interests the indirect partner constructively owns;

(3) The name and address of the foreign partnership with respect to which the indirect partner would have had to have filed Form 8865 but for this exception; and

(4) Any additional information that Form 8865 and the accompanying instructions require.

(iii) *Penalties.* A United States person that pursuant to this paragraph (c)(2) does not file a return will be subject to the penalties in paragraph (k) of this section if the requirements listed in paragraph (c)(2)(ii) of this section are not satisfied, unless such failure is due to reasonable cause, as defined in paragraph (k)(4) of this section.

(iv) *Overlap with multiple controlling fifty-percent partners exception—*(A) If a United States person qualifies for both the exception in paragraph (c)(1) of this section and the exception in this paragraph (c)(2), such person may only utilize the multiple controlling fifty-percent partners exception in paragraph (c)(1) of this section to avoid filing Form 8865.

(B) *Example.* The following example illustrates the operation of this paragraph (c)(2)(iv):

*Example.* US is a U.S. citizen. US owns 100% of the stock of DC, a domestic corporation. DC owns a 60% direct interest in FPS, a foreign partnership. DC and US are the only U.S. persons that own interests directly or constructively in FPS. DC owns directly a greater than 50% interest in FPS. US constructively owns DC’s interest pursuant to sections 6038(e)(3) and 267(c)(1). Therefore, both DC and US are controlling fifty-percent partners. US qualifies for both the exception in paragraph (c)(1) of this section (multiple controlling fifty-percent partners) and the exception in paragraph (c)(2) of this section (constructive owner exception). US may only utilize the paragraph (c)(1) exception to avoid its filing obligation. Accordingly, DC may file a single Form 8865 on behalf of US and itself. However, that form must contain all the information that would have been submitted had DC and US each submitted a separate Form 8865.

(3) *Members of an affiliated group of corporations filing a consolidated return.*

If one or more members of an affiliated group of corporations filing a consolidated return are required under section 6038 to file a Form 8865 for a particular foreign partnership, the common parent corporation may file one Form 8865 on behalf of all of the members of the group required to report under section 6038. Except with respect to group members who also qualify under the exception in paragraph (c)(2) of this section, the Form 8865 must contain all the information that would have been required to be submitted if each group member were required to file its own Form 8865.

(d) *Exception for certain trusts.* Trusts relating to state and local government employee retirement plans are not required to report under this section, unless the instructions to Form 8865 provide otherwise.

(e) *Reporting under this section not required with respect to partnerships excluded from the application of subchapter K.* The reporting requirements of this section will not apply to any United States person in respect of an eligible partnership as described in §1.761-2(a) if such partnership has validly elected to be excluded from all of the provisions of subchapter K of chapter 1 of the Internal Revenue Code in the manner specified in §1.761-2(b)(2)(i), or such partnership is deemed to have elected to be excluded from all of the provisions of subchapter K of chapter 1 of the Internal Revenue Code in accordance with the provisions of §1.761-2(b)(2)(ii).

(f) *Period covered by return.* The information required under this section must be furnished for the tax year of the foreign partnership ending with or within the United States person’s tax year. See section 706 for rules regarding tax years of partnerships.

(g) *Contents of return—*(1) *Information required to be submitted by controlling fifty-percent partners and controlling ten-percent partners.* All controlling fifty-percent partners and all controlling ten-percent partners must submit the following information on Form 8865 in the form and manner and to the extent prescribed by Form 8865 and its instructions—

(i) A statement of the income, gain, losses, deductions and credits allocated to the direct interest in the partnership of the

person reporting under section 6038;

(ii) A list of all partnerships (foreign or domestic) in which the foreign partnership owned a direct interest, or owned a constructive interest of ten percent of more under the rules of section 267(c)(1) or (5), during the partnership’s tax year for which the Form 8865 is being filed;

(iii) Information about all foreign entities that were disregarded as entities separate from their owner under §§301.7701-2 and 301.7701-3 that were owned by the foreign partnership during the partnership’s tax year for which the Form 8865 is being filed;

(iv) A summary of the transactions that took place during the partnership’s tax year between the partnership and the person filing the return, between the partnership and any other partnership of which the person filing the return is a controlling fifty-percent partner, and between the partnership and any corporation controlled (under section 6038(e)(2) and the regulations thereunder) by the person filing the return; and

(v) Any other information that Form 8865 or its accompanying instructions require to be submitted.

(2) *Additional information required to be submitted by controlling fifty-percent partners.* In addition to the information required pursuant to paragraph (g)(1) of this section, controlling fifty-percent partners must also submit the following information in the form and manner and to the extent required by Form 8865 and its instructions—

(i) A list of the names, addresses and tax identification numbers (if any) of each United States person that owned a direct interest of ten percent or more in the partnership during the partnership’s tax year, and of each United States and foreign person whose interests in the partnership the controlling fifty-percent partner constructively owned under paragraph (b)(4) of this section during the partnership’s tax year;

(ii) A list of transactions between the partnership and any United States person owning at the time of the transaction at least a 10-percent direct interest (as defined in paragraph (b)(3) of this section) in the foreign partnership;

(iii) A statement of the aggregate of the partners’ distributive shares of items of income, gain, losses, deductions and credits;

(iv) A statement of income, gain,



losses, deductions and credits allocated to each United States person holding a direct interest in the foreign partnership of ten percent or more; and

(v) Any other information Form 8865 or its accompanying instructions require controlling fifty-percent partners to submit.

(h) *Method of reporting.* Except as otherwise provided on Form 8865 or the accompanying instructions, all amounts required to be furnished on Form 8865 must be expressed in United States dollars. All statements required on or with Form 8865 pursuant to this section must be in English.

(i) *Time and place for filing return—*  
(1) *In general.* Form 8865 must be filed with the United States person's income tax return on or before the due date (including extensions) of that return. If the United States person is not required to file an income tax return for its tax year with which or within which the foreign partnership's tax year ends, but is required to file an information return for that year (for example, Form 1065, "U.S. Partnership Return of Income," or Form 990, "Return of Organization Exempt from Income Tax"), the Form 8865 must be filed with the United States person's information return filed on or before the due date (including extensions) of that return.

(2) *Duplicate return.* If required by the instructions to Form 8865, a duplicate Form 8865 (including attachments and schedules) must also be filed.

(j) *Overlap with section 6031—*(1) *In general.* A partner may be required to file Form 8865 under this section and the foreign partnership in which it is a partner may also be required to file a Form 1065 under section 6031(e) for the same partnership tax year. However, if a foreign partnership completes and files Form 1065, the United States partner must use a copy of the relevant parts of Form 1065 to fulfill certain of its filing obligations under section 6038. Specifically, instead of completing the Form 8865 schedules that the person would otherwise be required to complete as a controlling fifty-percent or a controlling ten-percent partner, the person must instead attach to its Form 8865 copies of the relevant schedules from Form 1065 that the instructions to Form 8865 state are considered equivalent to schedules on Form 8865. Should a

schedule on Form 8865 ask for information that is not required to be reported on the equivalent Form 1065 schedule, the partner is not required to report that information on its Form 8865 if a copy of the completed equivalent Form 1065 schedule is attached to its Form 8865. A person attaching copies of schedules from Form 1065 to its Form 8865 must still complete the parts of Form 8865 that the person is required to complete as a controlling fifty-percent partner, or a controlling ten-percent partner, and for which there is no equivalent Form 1065 schedule (for example, the first page of Form 8865).

(2) *Example.* The following example illustrates the application of this paragraph (j):

*Example.* US, a United States citizen, owns a 55% interest in FPS, a foreign partnership and calendar year taxpayer. Because US owns more than a 50% interest in FPS, US is a controlling fifty-percent partner of FPS and must file a Form 8865 with respect to FPS. During 2001, FPS earns gross income that is effectively connected with the conduct of a trade or business within the United States. Therefore, pursuant to section 6031(e)(2)(B), FPS must file Form 1065 for its 2001 tax year. If FPS completes and files Form 1065, US must use copies of the relevant schedules from Form 1065 to complete US's Form 8865 for FPS's 2001 tax year. If FPS instead had a September 30 tax year pursuant to section 706, then US must attach to its Form 1040 for US's 2001 tax year a Form 8865 completed with respect to FPS's tax year ending September 30, 2001. If FPS filed a Form 1065 for its tax year ending September 30, 2001, then US must use that Form 1065 to fulfill in part its reporting obligations under section 6038 by attaching the relevant schedules from the Form 1065 to US's Form 8865.

(k) *Failure to comply with reporting requirement—*(1) *In general.* Any United States person required to file Form 8865 under Section 6038 and this section that fails to comply (as defined in paragraph (k)(2) of this section) with the reporting requirements of this section, will be subject to the penalties described in paragraph (k)(3) of this section.

(2) *Failure to comply.* A failure to comply is separately determined for each foreign partnership for which a United States person has a section 6038 reporting obligation. A failure to comply with the requirements of section 6038 includes the following—

(i) The failure to report at the proper time and in the proper manner any information required to be reported under the

rules of this section; or

(ii) The provision of false or inaccurate information in purported compliance with the requirements of this section.

(3) *Penalties.* A United States person that fails to comply (as defined in paragraph (k)(2) of this section) with the reporting requirements of this section must pay the following penalties, subject to the reasonable cause exception in paragraph (k)(4) of this section:

(i) *Dollar amount penalty—*(A) *\$10,000 penalty.* A penalty of \$10,000 shall be imposed for each tax year of each foreign partnership with respect to which a failure to comply occurs.

(B) *Increase in penalty.* If a failure to comply with the applicable reporting requirements of section 6038 and this section continues for more than 90 days after the date on which the Commissioner or the Commissioner's delegate mails notice of the failure to the United States person required to file Form 8865, the person must pay an additional penalty of \$10,000 for each 30-day period (or fraction thereof) during which the failure continues after the 90-day period has expired.

(C) *Limitation.* The additional penalty imposed on any United States person by section 6038(b)(2) and paragraph (k)(3)(i)(B) of this section is limited to a maximum of \$50,000 for each partnership for each tax year with respect to which the failure occurs.

(ii) *Penalty of reducing foreign tax credit—*(A) *Effect on foreign tax credit.* Failure to comply with the reporting requirements of section 6038 and this section may cause a reduction of foreign tax credits under section 901 (taxes of foreign countries and of possessions of the United States). In applying section 901 to a United States person for any tax year with or within which its foreign partnership's tax year ended, the amount of taxes paid (and deemed paid under sections 902 and 960) by the United States person will be reduced by 10 percent if the person fails to comply. However, no tax deemed paid under section 904(c) will be reduced under the provisions of this paragraph (k)(3)(ii).

(B) *Reduction for continued failure.* If a failure to comply with the reporting requirements of section 6038 and this section continues for more than 90 days after the date on which the Commissioner or

the Commissioner's delegate mails notice of the failure to the person required to file Form 8865, then the amount of the reduction in paragraph (k)(3)(ii)(A) of this section will be 10 percent, plus an additional 5 percent for each 3-month period (or fraction thereof) during which the failure continues after the 90-day period has expired.

(C) *Limitation on reduction.* The amount of the reduction under paragraphs (k)(3)(ii)(A) and (B) of this section for each failure to furnish information required under this section will not exceed the greater of \$10,000, or the gross income of the foreign partnership for its tax year with respect to which the failure occurred.

(D) *Offset for dollar amount penalty imposed.* The total amount of the reduction which, but for this paragraph (k)(3)(ii)(D), may be made under this paragraph (k)(3)(ii) with respect to any separate failure, may not exceed the maximum amount of the reductions that may be imposed, reduced (but not below zero) by the dollar amount penalty imposed by paragraph (k)(3)(i) of this section with respect to the failure.

(4) *Reasonable cause limitation.* The time prescribed for filing a complete Form 8865, and the beginning of the 90-day period after the Commissioner or the Commissioner's delegate mails notice under paragraphs (k)(3)(i)(B) and (ii)(B) of this section, will be treated as being not earlier than the last day on which reasonable cause existed for failure to furnish the information. The United States person may show reasonable cause by providing a written statement to the Commissioner's delegate having jurisdiction over the person's return to which the Form 8865 should have been attached, setting forth the reasons for the failure to comply. Whether a failure to comply was due to reasonable cause will be determined by the Commissioner, or the Commissioner's delegate, under all the facts and circumstances.

(5) *Statute of limitations.* For exceptions to the limitations on assessment in the event of a failure to provide information under section 6038, see section 6501(c)(8).

(1) *Effective date.* This section applies to tax years of a foreign partnership ending on or after December 31, 2000.

Par. 5. Section 1.6038B-1 is amended as follows:

1. The heading is revised.
2. The first three sentences of paragraph (b)(1)(i) are removed and four sentences are added in their place.
3. Paragraph (b)(2)(i)(A)(4) is added.
4. Paragraph (b)(2)(i)(B)(3) is revised.
5. Paragraph (b)(2)(i)(B)(4) is added.
6. Paragraph (g) is revised.

The added and revised provisions read as follows:

*§1.6038B-1 Reporting of certain transfers to foreign corporations.*

\*\*\*\*\*

(b) \*\*\* (1) \*\*\* (i) *Reporting procedure.* Except for stock or securities qualifying under the special reporting rule of paragraph (b)(2) of this section, and certain exchanges described in section 354 (listed below), any U.S. person that makes a transfer described in section 6038B(a)(1)(A), 367(d) or (e), is required to report pursuant to section 6038B and the rules of this section and must attach the required information to Form 926, "Return by Transferor of Property to a Foreign Corporation." For special rules regarding cash transfers made in tax years beginning after February 5, 1999, see paragraphs (b)(3) and (g) of this section. For purposes of determining a U.S. transferor that is subject to section 6038B, the rules of §1.367(a)-1T(c) and §1.367(a)-3(d) shall apply with respect to a transfer described in section 367(a), and the rules of §1.367(a)-1T(c) shall apply with respect to a transfer described in section 367(d). Additionally, if in an exchange described in section 354, a U.S. person exchanges stock of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock of a domestic or foreign corporation pursuant to an asset reorganization described in section 368(a)(1)(C),(D), or (F), that is not treated as an indirect stock transfer under section 367(a), then the U.S. person exchanging stock is not required to report under section

6038B. \*\*\*

\*\*\*\*\*

(2) \*\*\*

(i) \*\*\*

(A) \*\*\*

(4) The transfer is considered to be to a foreign corporation solely by reason of

§1.83-6(d)(1) and the fair market

value of the property transferred did not exceed \$100,000; or

(B) \*\*\*

(3) The transferor properly reported the income from the transfer on its timely-filed (including extensions) Federal income tax return for the taxable year that includes the date of the transfer; or

(4) The transfer is considered to be to a foreign corporation solely by reason of §1.83-6(d)(1) and the fair market value of the property transferred did not exceed \$100,000.

\*\*\*\*\*

(g) This section applies to transfers occurring on or after July 20, 1998, except for transfers of cash made in tax years beginning on or before February 5, 1999, which are not required to be reported under section 6038B, and except for paragraph (e) of this section, which applies to transfers that are subject to §§1.367(e)-1(f) and 1.367(e)-2(e). See §1.6038B-1T for transfers occurring prior to July 20, 1998. See also §1.6038B-1T(e) in effect prior to August 9, 1999, (as contained in 26 CFR part 1 revised April 1, 1999) for transfers described in section 367(e) that are not subject to §§1.367(e)-1(f) and 1.367(e)-2(e).

Par. 6. Section 1.6038B-2 is amended as follows:

1. Paragraph (a)(5) is revised.

2. Paragraph (c)(4) is revised.

3. Paragraph (c)(6) is amended by removing the period at the end and adding "and" in its place.

4. Paragraph (j)(1) introductory text is amended by revising the first sentence.

5. Paragraph (j)(3) is added.

The revised and added provisions read as follows:

*§1.6038B-2 Reporting of certain transfers to foreign partnerships.*

(a) \*\*\*

(5) *Time for filing Form 8865.* The Form 8865 on which a transfer is reported must be attached to the transferor's timely filed (including extensions) income tax return for the tax year that includes the date of the transfer. If the person required to report under this section is not required to file an income tax return for its tax year during which the transfer occurred, but is required to file an information return for that year (for example, Form 1065, "U.S. Partnership Return of Income," or Form

990, "Return of Organization Exempt from Income Tax"), the person should attach the Form 8865 to its information return.

\*\*\*\*\*

(c) \*\*\*

(4) The names and addresses of the other partners in the foreign partnership, unless the transfer is solely of cash and the transferor holds less than a ten-percent interest in the transferee foreign partnership immediately after the transfer. However, for tax years of U.S. persons beginning on or after January 1, 2000, the person reporting pursuant to section 6038B (the transferor) must provide the names and addresses of each United States person that owned a ten-percent or greater direct interest in the foreign partnership during the transferor's tax year in which the transfer occurred, and the names and addresses of any other United States or foreign persons that were direct partners in the foreign partnership during that tax year and that were related to the transferor during that tax year. See para-

graph (i)(4) of this section for the definition of a related person;

\*\*\*\*\*

(j) \*\*\* (1) *In general.* Except as otherwise provided in this section, this section applies to transfers made on or after January 1, 1998. \*\*\*

\*\*\*\*\*

(3) *Special rule for transfers made before January 1, 2000.* Even if not reported in accordance with the rules provided in paragraph (a)(5) of this section, or paragraph (j)(1) or (2) of this section, a transfer that occurred before January 1, 2000 will nevertheless be considered timely reported if the transferor reports it on a Form 8865 attached to an amended tax return for the transferor's tax year in which the transfer occurred, provided such amended return is filed no later than September 15, 2000.

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 7. The authority citation for part

602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In §1.602.101, paragraph (b) is amended by revising the entries for §1.6038-2, §1.6038(B)-1, and §1.6038B-2 and adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

\*\*\*\*\*

(b) \*\*\*

Robert Wenzel,  
Deputy Commissioner  
of Internal Revenue.

Approved December 9, 1999.

Jonathan Talisman,  
Acting Assistant Secretary  
of the Treasury.

(Filed by the Office of the Federal Register on December 27, 1999, 8:45 a.m., and published in the issue of the Federal Register for December 28, 1999, 64 F.R. 72545)

| CFR part or section where identified and described | Current OMB control No. |
|--|-------------------------|
| *****  |                         |
| 1.6038-2 .....                                     | 1545-1617               |
| 1.6038-3 .....                                     | 1545-1617               |
| *****  |                         |
| 1.6038B-1 .....                                    | 1545-1617               |
| *****  |                         |
| 1.6038B-2 .....                                    | 1545-1617               |
| *****  |                         |

**Section 6046A.—Returns As To Interests In Foreign Partnerships**

*26 CFR 1.6046A-1: Return requirement for United States persons who acquire or dispose of an interest in a foreign partnership, or whose proportional interest in a foreign partnership changes substantially.*

**T.D. 8851**

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

**2000-2 I.R.B.**

**Return Requirement for United States Persons Acquiring or Disposing of an Interest in a Foreign Partnership, or Whose Proportional Interest in a Foreign Partnership Changes**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains

final regulations under section 6046A of the Internal Revenue Code relating to the requirement that United States persons, in certain circumstances, file a return if they acquire or dispose of an interest in a foreign partnership, or if their proportional interest in a foreign partnership changes.

DATES: *Effective Date:* December 29, 1999.

*Applicability Dates:* For dates of applicability of §1.6046A-1, see §1.6046A-1(j).

FOR FURTHER INFORMATION CONTACT: Eliana Dolgoff, (202) 622-3860 (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 of 1995 (44 U.S.C. 3507(d)) under control number 1545-1646. Responses to this collection of information are mandatory.

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

The burden of complying with the collection of information required to be reported on Form 8865 is reflected in the burden for Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships."

Suggestions for reducing the burden associated with this rule should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer of the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

### **Background**

On September 9, 1998, the IRS published in the **Federal Register** (63 FR 48154(REG-209060-86, 1998-39 I.R.B. 18)) proposed regulations under section 6046A. A public hearing on the proposed regulations was held on November 10, 1998, even though no requests to speak at the hearing were received. Though no comments were made at the hearing, written comments were received. After consideration of all of the written comments, the proposed regulations under section 6046A are adopted as revised by this Treasury decision. The revisions are discussed below.

### **Explanation of Provisions and Summary of Comments**

Commentators requested that section 6046A reporting not be required of United States persons that are indirect partners in a partnership. For example, a United States person would not be required to report under section 6046A with respect to an interest in a foreign partnership that the person owned indirectly through another partnership. Unlike section 6038, section 6046A reporting may apply with respect to any foreign partnership, not just foreign partnerships controlled by U.S. persons. Accordingly, the IRS agrees that reporting should not be required for indirect acquisitions, dispositions, and changes in proportional foreign partnership interests, because it would be burdensome and difficult for some partners to discover and keep track of such events. Additionally, if section 6046A reporting were required for changes in indirectly owned foreign partnership interests, then a transfer of an interest in one entity in a chain of entities at the bottom of which is a foreign partnership could result in multiple, duplicative, section 6046A reporting obligations.

Thus, the final regulations substantially reduce the burden section 6046A would have imposed on taxpayers under the proposed regulations. The final regulations provide that under §1.6046A-1(a)(1), a United States person is only required to report pursuant to section 6046A if that person has a "reportable event." A person can only have a reportable event with respect to a particular foreign partnership if that person owns a direct interest in the partnership. More specifically, the United States person must acquire or dispose of a direct interest in the foreign partnership, or have a change in its direct proportional interest, in order to have a reportable event under section 6046A. See §1.6046A-1(b)(1).

Some commentators also requested that the final regulations exempt state and local government employee retirement plans from the section 6046A reporting requirements. The final regulations provide that trusts relating to state and local government employee retirement plans are not required to report under section 6046A, unless required to do so in the instructions to Form 8865, "Return of U.S. Persons With Respect To Certain Foreign Partnerships." The IRS and Treasury invite com-

ments regarding whether the section 6046A reporting obligation should also be reduced for other tax-exempt entities.

A United States person required to report information pursuant to section 6046A must do so by completing and filing Form 8865. A final version of Form 8865 will be released prior to January 1, 2000. Taxpayers will be able to download a copy of the form and its instructions from the IRS Internet website located at [www.irs.ustreas.gov](http://www.irs.ustreas.gov).

The final regulations apply to reportable events that occur on or after January 1, 2000. Acquisitions and dispositions of foreign partnership interests, and changes in proportional foreign partnership interests, occurring before January 1, 2000, are not required to be reported under section 6046A.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required.

This Treasury decision finalizes a notice of proposed rulemaking published September 9, 1998. It has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the final regulations issued pursuant to the notice of proposed rulemaking published on September 9, 1998. It is hereby certified that this Treasury decision will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time required to complete the form and file the information required under these regulations is brief and will not have a significant impact on those small entities that are required to provide notification. Furthermore, the number of small entities that will be required to file the form is not substantial. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, 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 Eliana Dolgoff of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

\* \* \* \* \*

## Amendments to the Regulations

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

### PART 1—INCOME TAXES

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

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

Section 1.6046A-1 also issued under 26 U.S.C. 6046A. \* \* \*

Par. 2. Section 1.6046A-1 is added to read as follows:

*§1.6046A-1 Return requirement for United States persons who acquire or dispose of an interest in a foreign partnership, or whose proportional interest in a foreign partnership changes substantially.*

(a) *Return requirement*—(1) *General rule.* If a United States person has a reportable event (as defined in paragraph (b)(1) of this section) during the person's tax year, then, except as provided in paragraph (f) of this section, the United States person is required to complete and file Form 8865, "Return of U.S. Persons With Respect To Certain Foreign Partnerships," containing the information described in paragraph (c) of this section.

(2) *Separate return for each partnership.* If a United States person has a reportable event with respect to an interest in more than one foreign partnership, the United States person must file a separate Form 8865 for each foreign partnership.

(b) *Definitions*—(1) *Reportable event.* There are three categories of reportable events under section 6046A: acquisitions, dispositions, and changes in proportional interests.

(i) *Acquisitions.* A United States person that acquires a foreign partnership interest has a reportable event if—

(A) The person did not own a ten-percent or greater direct interest in the partnership and as a result of the acquisition the person owns a ten-percent or greater

direct interest in the partnership. For purposes of this paragraph (b)(1)(i)(A), an acquisition includes an increase in a person's direct proportional interest; or

(B) Subject to paragraph (b)(2) of this section, compared to the person's direct interest when the person last had a reportable event, after the acquisition the person's direct interest has increased by at least a ten-percent interest.

(ii) *Dispositions.* A United States person that disposes of a foreign partnership interest has a reportable event if—

(A) The person owned a ten-percent or greater direct interest in the partnership before the disposition and as a result of the disposition the person owns less than a ten-percent direct interest. For purposes of this paragraph (b)(1)(ii)(A), a disposition includes a decrease in a person's direct proportional interest; or

(B) Subject to paragraph (b)(2) of this section, compared to the person's direct interest when the person last had a reportable event, after the disposition the person's direct interest has decreased by at least a ten-percent interest.

(iii) *Changes in proportional interests not otherwise reportable as acquisitions or dispositions under paragraph (b)(1)(i)(A) or (b)(1)(ii)(A) of this section.* A United States person has a reportable event if, subject to paragraph (b)(2) of this section, compared to the person's direct proportional interest the last time the person had a reportable event, the person's direct proportional interest has increased or decreased by at least the equivalent of a ten-percent interest.

(2) *Special rule for foreign partnership interests owned on December 31, 1999.* If a United States person owned a ten-percent or greater direct interest in a foreign partnership on December 31, 1999, then to determine whether the person has a reportable event under paragraph (b)(1)(i)(B), (b)(1)(ii)(B), or (b)(1)(iii) of this section, the comparison should be made to the person's direct interest on December 31, 1999. Once the person has a reportable event after December 31, 1999, future comparisons should be made by reference to the last reportable event.

(3) *Change in a proportional interest.* A partner's proportional interest in a foreign partnership may change for a number of reasons, for example, the change may be caused by changes in other partners'

interests resulting from a partner withdrawing from the partnership. A proportional change may also occur by operation of the partnership agreement, for example, if the partnership agreement provides that a partner's interest in profits will change on a set date or when the partnership has earned a specified amount of profits and one of those events occurs.

(4) *Ten-percent interest.* Under section 6046A(d) and this section, a *ten-percent interest* in a foreign partnership, as described in section 6038(e)(3)(C) and the regulations thereunder, means an interest equal to ten percent of the capital interest in such partnership, an interest equal to ten percent of the profits interest in such partnership, or an interest to which ten percent of the deductions or losses of such partnership are allocated.

(5) *United States person.* *United States person* means a person described in section 7701(a)(30).

(6) *Foreign partnership.* *Foreign partnership* means any partnership that is a foreign partnership under sections 7701(a)(2) and (5).

(7) *Examples.* The rules of paragraph (a) of this section and this paragraph (b) are illustrated by the following examples:

*Example 1. Acquisition of an indirect interest.* *FP*, a foreign partnership, has two partners, *FC1* and *FC2*, both foreign corporations. *FC1* owns a 40% interest in *FP*, and *FC2* owns a 60% interest in *FP*. No United States person owns an interest in *FP*, either directly, or constructively under section 6038(e)(3)(C) and section 267(c). On January 1, 2001, *US*, a United States person and calendar year taxpayer, acquires by purchase 100% of *FC2*'s stock. *US* has acquired an indirect interest of 60% in *FP*. See sections 6038(e)(3)(C) and 267(c)(1). However, *US* is not required to report the January 1, 2001 indirect acquisition under section 6046A. *US* did not own a 10% or greater direct interest in *FP* before the acquisition, and *US* does not own a 10% or greater direct interest as a result of the acquisition. (*US* must, however, comply with the reporting requirements under section 6038 (controlled foreign corporation and controlled foreign partnership reporting) with respect to *FC2* and *FP*.)

*Example 2. Acquisition of direct interests.* (i) Assume the same facts as *Example 1*. In addition, on June 1, 2001, *US* purchases a 5% direct interest in *FP* from *FC1*. *US* did not own a 10% or greater direct interest in *FP* before the acquisition. After the acquisition, *US* does not own a direct interest of 10% or more. *US* owns a 10% or greater total interest (direct and indirect), but only a 5% direct interest. Therefore, *US* is not required to report the June

1, 2001, acquisition under section 6046A.

(ii) On September 1, 2001, *US* purchases a 7% direct interest in *FP* from *FC1*. The September 1, 2001 acquisition constitutes a reportable event under paragraph (b)(1)(i)(A) of this section. Before the September 1 acquisition, *US* did not own a 10% or greater direct interest in *FP*. After the September 1 acquisition, *US* owns a 12% direct interest, and therefore, as a result of the September 1 acquisition, *US* now owns a 10% or greater direct interest in *FP*. Consequently, *US* must report its September 1 acquisition under section 6046A on Form 8865 filed with *US*'s 2001 income tax return.

(iii) On December 1, 2001, *US* acquires an additional 4% direct interest in *FP* from *FC1*, so that *US*'s total direct interest has increased from 12% to 16%. This acquisition does not constitute a reportable event. Compared to *US*'s direct interest when *US* last had a reportable event (12% on September 1, 2001), after acquiring the 4% interest *US*'s direct interest has not increased by at least a 10% direct interest (i.e., its direct interest increased by only 4%). Therefore, *US* does not have to report the December 1, 2001, acquisition under section 6046A. On April 1, 2002, *FC2* distributes a 6% direct interest in *FP* to *US*. *US* now owns a 22% direct interest in *FP*. Compared to *US*'s direct interest when *US* last had a reportable event (12% on September 1, 2001), after the April 1 acquisition *US*'s direct interest has increased by at least a 10% interest (12% to 22%). *US* must report the April 1, 2002 acquisition on a Form 8865 attached to *US*'s 2002 income tax return.

*Example 3. Change in proportional interest resulting from withdrawal of a partner.* Assume the same facts as *Example 3*. In addition, on January 5, 2003, *FC2* withdraws entirely from *FP*. As a result, the direct interests of *US* and *FC1* in *FP* each increase by at least the equivalent of 10% interests. Compared to *US*'s direct interest the last time *US* had a reportable event (22% on April 1, 2002), *US*'s direct interest has increased by at least the equivalent of a ten percent interest. Therefore, *US* has had a reportable event pursuant to paragraph (b)(1)(iii) of this section, and *US* must report the change in its interest resulting from *FC2*'s withdrawal from the partnership on *US*'s Form 8865 filed with *US*'s 2003 tax year income tax return.

*Example 4. Change in proportional interest constituting an acquisition.* *FP* is a foreign partnership that has no United States persons as direct or constructive partners. *US* is a United States person and a calendar year taxpayer. On January 1, 2001, *US* purchases an 8% direct interest in *FP*. *US* is not required to report this acquisition. *US* did not own a 10% or greater direct interest in *FP*, and *US* does not own a 10% or greater direct interest as a result of the acquisition. On March 1, 2001, *FC*, a foreign part-

ner of *FP*, withdraws from *FP*, and as result, *US*'s direct interest in *FP* increases by a 7% interest. The increase in *US*'s direct interest is considered an acquisition of an interest under paragraph (b)(1)(i)(A) of this section. *US* did not own a 10% or greater direct interest in *FP* before *FC* withdrew, and as a result of the increase in *US*'s direct interest because of *FC*'s withdrawal from *FP*, *US* now owns a 10% or greater direct interest in *FP*. Therefore, *US* must report under section 6046A the increase in *US*'s direct interest resulting from the withdrawal of *FC* from *FP* on Form 8865 filed with *US*'s tax return for *US*'s 2001 tax year.

(c) *Content of return.* The Form 8865 that must be filed under paragraph (a)(1) of this section must contain the following information in such form and manner and to the extent that Form 8865 and its instructions prescribe—

(1) The name, address, and taxpayer identification number of the United States person required to file the return;

(2) Information about other persons (foreign or domestic) whose interests in the foreign partnership the person reporting under section 6046A is considered to own under section 6038(e)(3)(C) and section 267(c);

(3) Information about all foreign entities that were disregarded as entities separate from their owners under §§301.7701-2 and 301.7701-3 of this chapter that were owned by the foreign partnership during the partnership's tax year ending with or within the tax year of the person filing Form 8865 pursuant to section 6046A;

(4) For each reportable event, the date of the event, the type of event (acquisition, disposition, or change in proportional interest), and the United States person's direct percentage interest in the foreign partnership immediately before and immediately after the event;

(5) The fair market value of the interest acquired or disposed of;

(6) Information about partnerships (foreign and domestic) in which the foreign partnership owned a direct interest, or a constructive interest of ten percent or more under sections section 267(c)(1) and (5) and the regulations thereunder, during the partnership's tax year ending with or within the tax year of the person filing Form 8865 pursuant to section 6046A; and

(7) Any other information required to be submitted by Form 8865 and its instructions.

(d) *Time and manner for filing returns.* The Form 8865 must be filed with the timely filed (including extensions) income tax return of the United States person for the tax year in which the reportable event occurs. If the United States person is not required to file an income tax return for its tax year in which the reportable event occurs, but is required to file an information return for that year (for example, Form 1065, "U.S. Partnership Return of Income," or Form 990, "Return of Organization Exempt from Income Tax"), the United States person should attach the Form 8865 to its information return filed for that tax year.

(e) *Duplicate returns.* If required by the instructions to Form 8865, a duplicate Form 8865 (including attachments and schedules) must also be filed.

(f) *Persons excepted from filing return—(1) Section 6038B overlap.* If a United States person acquires an interest in a foreign partnership as a result of a section 721 contribution required to be reported under section 6038B, and the person properly reports the contribution under section 6038B, then the United States person is not required to report the acquisition of the partnership interest under section 6046A(a) should it constitute a reportable event under paragraph (b)(1) of this section. The acquisition will still constitute a reportable event for purposes of making future comparisons pursuant to paragraphs (b)(1)(i)(B), (b)(1)(ii)(B) and (b)(1)(iii) of this section. A person that fails to properly report the section 721 contribution under section 6038B and the regulations thereunder and that fails to properly report the acquisition of the partnership interest under section 6046A may be subject to the penalties applicable to a failure to comply with the requirements of section 6038B, as well as the penalties applicable for a failure to comply with the requirements of section 6046A. See paragraph (h) of this section for more information about the penalties for failure to comply with the requirements of section 6046A.

(2) *Trusts relating to state and local government employee retirement plans.* The return requirement of section 6046A does not apply to trusts relating to state and local government employee retirement plans, unless the instructions to Form 8865 provide otherwise.

(3) *Reporting under this section not required of partnerships excluded from the application of subchapter K.* The reporting requirements of this section will not apply to any United States person in respect of an eligible partnership as described in §1.761-2(a) in which that United States person is a partner, if such partnership has validly elected to be excluded from all of the provisions of subchapter K of chapter 1 of the Internal Revenue Code in the manner specified in §1.761-2(b)(2)(i), or is deemed to have elected to be excluded from all of the provisions of subchapter K of chapter 1 of the Internal Revenue Code in accordance with the provisions of §1.761-2(b)(2)(ii).

(4) *Exclusion for satellite organizations.* The return requirement of section 6046A does not apply to the International Telecommunications Satellite Organization (or a successor organization) or the International Maritime Satellite Organization (or a successor organization).

(g) *Method of reporting.* Except as oth-

erwise provided on Form 8865, or the accompanying instructions, any amounts required to be reported under section 6046A and this section must be expressed in United States dollars, with a statement of the exchange rates used. All statements required on or with Form 8865 pursuant to this section must be in English.

(h) *Penalties for violating section 6046A.* For penalties for violating section 6046A, see sections 6679 and 7203.

(i) *Statute of limitations.* For exceptions to the limitations on assessment in the event of a failure to provide information under section 6046A, see section 6501(c)(8).

(j) *Effective date.* This section applies to reportable events occurring after December 31, 1999. No reporting under section 6046A is required for reportable events occurring on or before December 31, 1999.

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 3 The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4 In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

*§602.101 OMB Control numbers.*

\* \* \* \* \*

(b) \* \* \*

Robert Wenzel,  
Deputy Commissioner  
of Internal Revenue.

Approved December 9, 1999.

Jonathan Talisman,  
Acting Assistant Secretary  
of the Treasury.

(Filed by the Office of the Federal Register on December 27, 1999, 8:45 a.m., and published in the issue of the Federal Register for December 28, 1999, 64 F.R. 72555)

| CFR part or section where identified and described | Current OMB control No. |
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| 1.6046A .....                                      | 1545-1646               |
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**Section 7520.—Valuation Tables**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2000. See Rev. Rul. 2000-1, page 250.

**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 January 2000. See Rev. Rul. 2000-1, page 250.

## Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, §§ 62, 162, 267, 274; 1.62-2, 1.162-17, 1.267(a)-1, 1.274-5T, 1.274(d)-1T.)

### Rev. Proc. 2000-9

#### SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 98-64, 1998-52 I.R.B. 32, by providing rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home will be deemed substantiated under § 1.274-5T of the temporary Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. This revenue procedure also provides an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. Use of a method described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under which the amount of an employee's lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.

#### SECTION 2. BACKGROUND AND CHANGES

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct expenses paid or incurred while traveling away from home in pursuit of a trade or business. However, under § 262, no portion of such travel expenses that is attributable to personal, living, or family expenses is de-

ductible.

.02 Section 274(n) generally limits the amount allowable as a deduction under § 162 for any expense for food, beverages, or entertainment to 50 percent of the amount of the expense that otherwise would be allowable as a deduction. In the case of any expenses for food or beverages consumed while away from home (within the meaning of § 162(a)(2)) by an individual during, or incident to, the period of duty subject to the hours of service limitations of the Department of Transportation, § 274(n)(3) gradually increases the deductible percentage to 80 percent for taxable years beginning in 2008. For taxable years beginning in 2000, the deductible percentage for these expenses is 60 percent.

.03 Section 274(d) provides, in part, that no deduction shall be allowed under § 162 for any traveling expense (including meals and lodging while away from home) unless the taxpayer complies with certain substantiation requirements. The section further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by such regulations.

.04 Section 1.274(d)-1T(a) of the regulations, in part, grants the Commissioner the authority to prescribe rules relating to reimbursement arrangements or per diem allowances for ordinary and necessary expenses paid or incurred while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which such arrangements or allowances, if in accordance with reasonable business practice, will be regarded (1) as equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of such travel expenses for purposes of § 1.274-5T(c), and (2) as satisfying the requirements of an adequate accounting to the employer of the amount of such travel expenses for purposes of § 1.274-5T(f).

.05 For purposes of determining adjusted gross income, § 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection

with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein shall not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for such expense.

.07 Under § 1.62-2(c)(1) a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62-2T(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274(d)-1T(a) or 1.274-5T(j) will be treated as substantiation of the amount of such expenses for purposes of § 1.62-2. Under § 1.62-2(f)(2), the Commissioner may prescribe rules under which an arrangement providing per diem allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of such an allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of such an allowance that relates to days of travel not substantiated.

.08 Section 1.62-2(h)(2)(i)(B) provides



that if a payor pays a per diem allowance that meets the requirements of § 1.62-2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62-2(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under § 274(d) and § 1.274(d)-1(a) or § 1.274-5T(j), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)-3, 31.3231(e)-1(a)(5), 31.3306(b)-2, and 31.3401(a)-4. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62-2(g) (relating to the return of excess amounts) do not apply to this portion.

.09 Under § 1.62-2(h)(2)(i)(B)(4), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on per diem allowances.

.10 Section 1.274-5T(j) grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for meals paid or incurred while traveling away from home in lieu of substantiating the actual cost of meals.

.11 Section 5.04 of this revenue procedure contains revisions to the list of high-cost localities and to the high-low rates for purposes of section 5.

### SECTION 3. DEFINITIONS

.01 *Per diem allowance.* The term "per diem allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62-2(c)(1) and that is

(1) paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses or for meal and incidental expenses for travel away from home in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at or below the applicable

Federal per diem rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

#### .02 *Federal per diem rate.*

(1) *General rule.* The Federal per diem rate is equal to the sum of the Federal lodging expense rate and the Federal meal and incidental expense (M&IE) rate for the locality of travel. Each of these rates for a particular locality in the continental United States ("CONUS") is set forth in Appendix A of 41 C.F.R., Chapter 301, as amended. See 41 C.F.R. Part 301-7 (1999), as amended, for specific rules regarding these Federal rates. Each of these rates is established by the Secretary of Defense for a particular nonforeign locality outside the continental United States ("OCONUS") (including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States), and by the Secretary of State for a particular foreign OCONUS locality. Each of these OCONUS rates is published in the Per Diem Supplement to the Standardized Regulations (Government Civilians, Foreign Areas). See, e.g., Maximum Travel Per Diem Allowances for Foreign Areas, PD Supplement 427, issued December 1, 1999.

(2) *Locality of travel.* The term "locality of travel" means the locality where an employee traveling away from home in connection with the performance of services as an employee of the employer stops for sleep or rest.

(3) *Incidental expenses.* The term "incidental expenses" includes, but is not limited to, expenses for laundry, cleaning and pressing of clothing, and fees and tips for services, such as for porters and baggage carriers. The term "incidental expenses" does not include taxicab fares, lodging taxes, or the costs of telegrams or telephone calls.

#### .03 *Flat rate or stated schedule.*

(1) *In general.* Except as provided in section 3.03(2) of this revenue procedure, an allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 3.01 of this revenue procedure. Such allowance may be paid with respect to the number of days away from home in connection with the performance of services as an employee or on any other basis that is consistently applied and in accordance with rea-

sonable business practice. Thus, for example, an hourly payment to cover meal and incidental expenses paid to a pilot or flight attendant who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule. Likewise, a payment based on the number of miles traveled (e.g., cents per mile) to cover meal and incidental expenses paid to an over-the-road truck driver who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

(2) *Limitation.* For purposes of this revenue procedure, an allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced) does not meet the business connection requirement of § 1.62-2(d), is not a per diem allowance, and is not paid at a flat rate or stated schedule, unless, as of December 12, 1989, (a) the allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the allowance, or (b) an allowance computed on that basis was commonly used in the industry in which the employee is employed. See § 1.62-2(d)(3)(ii).

### SECTION 4. PER DIEM SUBSTANTIATION METHOD

.01 *Per diem allowance.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal per diem rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure).

.02 *Meals only per diem allowance.* If a payor pays a per diem allowance only for meal and incidental expenses in lieu of reimbursing actual expenses for meal and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the per

diem allowance for such day or the amount computed at the Federal M&IE rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure). A per diem allowance is treated as paid only for meal and incidental expenses if (1) the payor pays the employee for actual expenses for lodging based on receipts submitted to the payor, (2) the payor provides the lodging in kind, (3) the payor pays the actual expenses for lodging directly to the provider of the lodging, (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee, or (5) the allowance is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced).

.03 *Optional method for meals only deduction.* In lieu of using actual expenses, employees and self-employed individuals, in computing the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred for travel away from home, may use an amount computed at the Federal M&IE rate for the locality of travel for each calendar day (or partial day, see section 6.04 of this revenue procedure) the employee or self-employed individual is away from home. Such amount will be deemed substantiated for purposes of paragraphs (b)(2) (travel away from home) and (c) of § 1.274-5T, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel expenses in accordance with those regulations.

.04 *Special rules for transportation industry.*

(1) *In general.* This section 4.04 applies to (a) a payor that pays a per diem allowance only for meal and incidental expenses for travel away from home as described in section 4.02 of this revenue procedure to an employee in the transportation industry, or (b) an employee or self-employed individual in the transportation industry who computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 of this revenue procedure.

(2) *Rates.* A taxpayer described in

section 4.04(1) of this revenue procedure may treat \$38 as the Federal M&IE rate for any locality of travel in CONUS, and/or \$42 as the Federal M&IE rate for any locality of travel OCONUS. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts subject to section 4.02 of this revenue procedure paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. Similarly, an employee or self-employed individual that uses either (or both) of these special rates must use the special rate(s) for all amounts computed pursuant to section 4.03 of this revenue procedure for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year.

(3) *Periodic rule.* A payor described in section 4.04(1) of this revenue procedure may compute the amount of the employee's expenses that is deemed substantiated under section 4.02 of this revenue procedure periodically (not less frequently than monthly), rather than daily, by comparing the total per diem allowance paid for the period to the sum of the amounts computed at the Federal M&IE rate(s) for the localities of travel for the days (or partial days, see section 6.04 of this revenue procedure) the employee is away from home during the period. For example, assume an employee in the transportation industry travels away from home within CONUS on 17 days (including partial days, see section 6.04 of this revenue procedure) during a calendar month and receives a per diem allowance only for meal and incidental expenses from a payor that uses the special rule under section 4.04(2) of this revenue procedure. The amount deemed substantiated under section 4.02 of this revenue procedure is equal to the lesser of the total per diem allowance paid for the month or \$646 (17 days at \$38 per day).

(4) *Transportation industry defined.* For purposes of this section 4.04 of this revenue procedure, an employee or self-employed individual is "in the transportation industry" only if the employee's or individual's work (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel

away from home which, during any single trip away from home, usually involves travel to localities with differing Federal M&IE rates. For purposes of the preceding sentence, a payor must determine that an employee or a group of employees is "in the transportation industry" by using a method that is consistently applied and in accordance with reasonable business practice.

## SECTION 5. HIGH-LOW SUBSTANTIATION METHOD

.01 *General rule.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home and the payor uses the high-low substantiation method described in this section 5 for travel within CONUS, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at the rate set forth in section 5.02 of this revenue procedure for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure). This high-low substantiation method may be used in lieu of the per diem substantiation method provided in section 4.01 of this revenue procedure, but may not be used in lieu of the meals only substantiation method provided in section 4.02 or 4.03 of this revenue procedure.

.02 *Specific high-low rates.* The per diem rate set forth in this section 5.02 is \$201 for travel to any "high-cost locality" specified in section 5.03 of this revenue procedure, or \$124 for travel to any other locality within CONUS. Whichever per diem rate applies, it is applied as if it were the Federal per diem rate for the locality of travel. For purposes of applying the high-low substantiation method and the § 274(n) limitation on meal expenses (see section 6.05 of this revenue procedure), the Federal M&IE rate shall be treated as \$42 for a high-cost locality and \$34 for any other locality within CONUS.

.03 *High-cost localities.* The following localities have a Federal per diem rate of \$163 or more for all or part of the calendar year, and are high-cost localities for all of the calendar year or the portion of the calendar year specified in parenthesis under the key city name:

| <i>Key city</i>  | <i>County or other defined location</i>   |
|--|---|
| California   |   |
| San Francisco  | San Francisco   |
| Sunnyvale/Palo Alto/San Jose   | Santa Clara   |
| Tahoe City   | Placer  |
| Colorado   |   |
| Aspen  | Pitkin  |
| (December 1-June 30)   |   |
| Silverthorne/Keystone  | Summit  |
| Telluride  | San Miguel  |
| (November 1-March 31)  |   |
| Vail   | Eagle   |
| (December 1-March 31)  |   |
| District of Columbia   |   |
| Washington, D.C.   | Washington, D.C.; the cities of Alexandria, Fairfax, and Falls Church, and the counties of Arlington, Fairfax, and Loudoun, in Virginia; and the counties of Montgomery and Prince George's in Maryland |
| Florida  |   |
| Key West   | Monroe  |
| (December 15-April 30)   |   |
| Idaho  |   |
| Sun Valley   | City limits of Sun Valley   |
| (June 1-September 30)  |   |
| Illinois   |   |
| Chicago  | Cook and Lake   |
| Maryland   |   |
| (For the counties of Montgomery and Prince George's, see District of Columbia) |   |
| Ocean City   | Worcester   |
| (June 1-September 15)  |   |
| Massachusetts  |   |
| Boston   | Suffolk   |
| Cambridge  | Middlesex County (except Lowell)  |
| Martha's Vineyard  | Dukes   |
| (June 1-September 30)  |   |
| Michigan   |   |
| Charlevoix   | Charlevoix  |
| (July 1-September 30)  |   |
| Mackinac Island  | Mackinac  |
| Montana  |   |
| Big Sky  | Gallatin (except West Yellowstone Park)   |
| New Jersey   |   |
| Cape May   | Cape May (except Ocean City)  |
| (June 1-September 30)  |   |
| Ocean City   | City limits of Ocean City   |
| (June 15-September 15)   |   |
| Piscataway/Bellemead   | Somerset and Middlesex  |
| Princeton  | City limits of Princeton  |
| Union County   | Union County  |

|  |  |
|--|--|
| New York   |  |
| The Bronx/Brooklyn/Queens<br>Manhattan   | The boroughs of The Bronx, Brooklyn, and Queens<br>Manhattan |
| Nassau County/Great Neck   | Nassau County  |
| Suffolk County   | Suffolk County   |
| White Plains   | City limits of White Plains                                  |
| Pennsylvania   |  |
| Hershey  | City limits of Hershey                                       |
| (June 1-September 15)  |  |
| Philadelphia   | Philadelphia   |
| Utah   |  |
| Park City  | Summit   |
| (December 20-March 31)   |  |
| Virginia   |  |
| (For the cities of Alexandria, Fairfax, and Falls Church, and the counties of Arlington, Fairfax, and Loudoun, see District of Columbia) |  |

*.04 Changes in high-cost localities.* The list of high-cost localities in section 5.03 of this revenue procedure differs from the list of high-cost localities in section 5.03 of Rev. Proc. 98-64.

(1) The following localities (generally listed by key cities) have been added to the list of high-cost localities: Santa Clara County, California; Tahoe City, California; Silverthorne/Keystone, Colorado; Prince George's County, Maryland; Middlesex County, Massachusetts (except the city limits of Lowell); Big Sky, Montana; Bellemead, New Jersey; Middlesex County, New Jersey; Princeton, New Jersey; Nassau County/Great Neck, New York; Suffolk County, New York; and Loudoun County, Virginia.

(2) The portion of the year for which the following are high-cost localities (listed by key cities) has been changed: Aspen, Colorado; Vail, Colorado; Key West, Florida; Sun Valley, Idaho, Ocean City, Maryland; Ocean City, New Jersey; Hershey, Pennsylvania; and Park City, Utah.

(3) The following localities (generally listed by key cities) have been removed from the list of high-cost localities: Gulf Shores, Alabama; Gualala, California; Yosemite National Park, California; Delray Beach, Florida; Jupiter, Florida; Palm Beach, Florida; Singer Island, Florida; Bar Harbor, Maine; Baltimore, Maryland; Stateline, Nevada; Saratoga Springs, New York; Westchester County, New York (except the city limits of White Plains); West Point, New York; Kill Devil Hills, North Carolina; Bala

Cynwyd, Pennsylvania; Newport, Rhode Island; Hilton Head, South Carolina; Myrtle Beach, South Carolina; Wintergreen, Virginia; and Seattle, Washington.

*.05 Specific limitation.*

(1) Except as provided in section 5.05(2) of this revenue procedure, a payor that uses the high-low substantiation method with respect to an employee must use that method for all amounts paid to that employee for travel away from home within CONUS during the calendar year.

(2) With respect to an employee described in section 5.05(1) of this revenue procedure, the payor may reimburse actual expenses or use the meals only per diem method described in section 4.02 of this revenue procedure for any travel away from home, and may use the per diem substantiation method described in section 4.01 of this revenue procedure for any OCONUS travel away from home.

## SECTION 6. LIMITATIONS AND SPECIAL RULES

*.01 In general.* The Federal per diem rate and the Federal M&IE rate described in section 3.02 of this revenue procedure for the locality of travel will be applied in the same manner as applied under the Federal Travel Regulations, 41 C.F.R. Part 301-7 (1999), except as provided in sections 6.02 through 6.04 of this revenue procedure.

*.02 Federal per diem rate.* A receipt for lodging expenses is not required in determining the amount of expenses deemed substantiated under section 4.01 or 5.01 of this revenue procedure. See section

7.01 of this revenue procedure for the requirement that the employee substantiate the time, place, and business purpose of the expense.

*.03 Federal per diem or M&IE rate.* A payor is not required to reduce the Federal per diem rate or the Federal M&IE rate for the locality of travel for meals provided in kind, provided the payor has a reasonable belief that meal and incidental expenses were or will be incurred by the employee.

*.04 Proration of the Federal per diem or M&IE rate.* Pursuant to the Federal Travel Regulations, in determining the Federal per diem rate or the Federal M&IE rate for the locality of travel, the full applicable Federal M&IE rate is available for a full day of travel from 12:01 a.m. to 12:00 midnight. For purposes of determining the amount deemed substantiated under section 4 or 5 of this revenue procedure with respect to partial days of travel away from home, either of the following methods may be used to prorate the Federal M&IE rate to determine the Federal per diem rate or the Federal M&IE rate for the partial days of travel:

(1) Such rate may be prorated using the method prescribed by the Federal Travel Regulations. Currently the Federal Travel Regulations allow three-fourths of the applicable Federal M&IE rate for each partial day during which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual; or

(2) Such rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to 2 times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1 \_ times the Federal M&IE rate would be allowed under the Federal Travel Regulations).

.05 *Application of the appropriate § 274(n) limitation on meal expenses.* All or part of the amount of an expense deemed substantiated under this revenue procedure is subject to the appropriate limitation under § 274(n) (see section 2.02 of this revenue procedure) on the deductibility of food and beverage expenses.

(1) When an amount for meal and incidental expenses is computed pursuant to section 4.03 of this revenue procedure, the taxpayer must treat such amount as an expense for food and beverages.

(2) When a per diem allowance is paid only for meal and incidental expenses, the payor must treat an amount equal to the lesser of the allowance or the Federal M&IE rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure) as an expense for food and beverages.

(3) When a per diem allowance is paid for lodging, meal, and incidental expenses, the payor must treat an amount equal to the Federal M&IE rate for the locality of travel for each calendar day (or partial day, see section 6.04 of this revenue procedure) the employee is away from home as an expense for food and beverages. For purposes of the preceding sentence, when a per diem allowance for lodging, meal, and incidental expenses is paid at a rate that is less than the Federal per diem rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure), the payor may treat an amount equal to 40 percent of such allowance as the Federal M&IE rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure).

.06 *No double reimbursement or deduction.* If a payor pays a per diem allowance in lieu of reimbursing actual ex-

penses for lodging, meal, and incidental expenses or for meal and incidental expenses in accordance with section 4 or 5 of this revenue procedure, any additional payment with respect to such expenses is treated as paid under a nonaccountable plan, is included in the employee's gross income, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. Similarly, if an employee or self-employed individual computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 or 4.04 of this revenue procedure, no other deduction is allowed to the employee or self-employed individual with respect to such expenses. For example, assume an employee receives a per diem allowance from a payor for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home. During that trip, the employee pays for dinner for the employee and two business associates. The payor reimburses as a business entertainment meal expense the meal expense for the employee and the two business associates. Because the payor also pays a per diem allowance to cover the cost of the employee's meals, the amount paid by the payor for the employee's portion of the business entertainment meal expense is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes.

.07 *Related parties.* Sections 4.01, 4.02, 4.04 (to the extent it relates to section 4.02), and 5 of this revenue procedure will not apply in any case in which a payor and an employee are related within the meaning of § 267(b), but for this purpose the percentage of ownership interest referred to in § 267(b)(2) shall be 10 percent.

## SECTION 7. APPLICATION

.01 If the amount of travel expenses is deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure, and the employee actually substantiates to the payor the elements of time, place, and business purpose of the travel expenses in accordance with para-

graphs (b)(2) (travel away from home) and (c) (other than subparagraph (2)(iii)(A) thereof) of § 1.274-5T, the employee is deemed to satisfy the adequate accounting requirements of § 1.274-5T(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274-5T(c). See § 1.62-2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.02 An arrangement providing per diem allowances will be treated as satisfying the requirement of § 1.62-2(f)(2) with respect to returning amounts in excess of expenses if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) any portion of such an allowance that relates to days of travel not substantiated, even though the arrangement does not require the employee to return the portion of such an allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance per diem allowance for meal and incidental expenses of \$200, based on an anticipated 5 days of business travel at \$40 per day to a locality for which the Federal M&IE rate is \$34, and the employee substantiates 3 full days of business travel. The requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) the portion of the allowance that is attributable to the 2 unsubstantiated days of travel (\$80), even though the employee is not required to return the portion of the allowance (\$18) that exceeds the amount of the employee's expenses deemed substantiated under section 4.02 of this revenue procedure (\$102) for the 3 substantiated days of travel. However, the \$18 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 7.04 of this revenue procedure.

.03 An employee is not required to include in gross income the portion of a per diem allowance received from a payor that is less than or equal to the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the

per diem allowance in accordance with section 7.01 of this revenue procedure. See § 1.274-5T(f)(2)(i). In addition, such portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W-2, and is exempt from the withholding and payment of employment taxes. See § 1.62-2(c)(2) and (c)(4).

.04 An employee is required to include in gross income only the portion of the per diem allowance received from a payor that exceeds the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the per diem allowance in accordance with section 7.01 of this revenue procedure. See § 1.274-5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. See § 1.62-2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.05 If the amount of the expenses that is deemed substantiated under the rules provided in section 4.01, 4.02, or 5 of this revenue procedure is less than the amount of the employee's business expenses for travel away from home, the employee may claim an itemized deduction for the amount by which the business travel expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business travel expenses, includes on Form 2106, Employee Business Expenses, the deemed substantiated portion of the per diem allowance received from the payor, and includes in gross income the portion (if any) of the per diem allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274-5T(f)(2)(iii). However, for purposes of claiming this itemized deduction with respect to meal and incidental expenses, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the amount computed under section 4.03 of this revenue procedure minus the amount deemed substantiated under sections 4.02 and 7.01 of this revenue procedure. The itemized deduction is subject to the appropriate

limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.06 An employee who does not receive a per diem allowance for meal and incidental expenses may deduct an amount computed pursuant to section 4.03 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the appropriate limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.07 A self-employed individual may deduct an amount computed pursuant to section 4.03 of this revenue procedure in determining adjusted gross income under § 62(a)(1). This deduction is subject to the appropriate limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n).

.08 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, such payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62-2(c)(3), (c)(5), and (h)(2).

#### SECTION 8. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES.

.01 The portion of a per diem allowance, if any, that relates to the days of business travel substantiated and that exceeds the amount deemed substantiated for those days under section 4.01, 4.02, or 5 of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

.02 In the case of a per diem allowance paid as a reimbursement, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days of travel sub-

stantiated. See § 1.62-2(h)(2)(i)(B)(2).

.03 In the case of a per diem allowance paid as an advance, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the days of travel with respect to which the advance was paid are substantiated. See § 1.62-2(h)(2)(i)(B)(3). If some or all of the days of travel with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those days within a reasonable period of time, the portion of the allowance that relates to those days is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

.04 In the case of a per diem allowance only for meal and incidental expenses for travel away from home paid to an employee in the transportation industry by a payor that uses the rule in section 4.04(3) of this revenue procedure, the excess of the per diem allowance paid for the period over the amount deemed substantiated for the period under section 4.02 of this revenue procedure (after applying section 4.04(3) of this revenue procedure), is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62-2(h)(2)(i)(B)(4).

.05 For example, assume that an employer pays an employee a per diem allowance to cover business expenses for meals and lodging for travel away from home at a rate of 120 percent of the Federal per diem rate for the localities to which the employee travels. The employer does not require the employee to return the 20 percent by which the reimbursement for those expenses exceeds the Federal per diem rate. The employee substantiates 6 days of travel away from home: 2 days in a locality in which the Federal per diem rate is \$100 and 4 days in a locality in which the Federal per diem rate is \$125. The employer reimburses the employee \$840 for the 6 days of travel away from home ( $2 \times (120\% \times \$100) + 4 \times (120\% \times \$125)$ ), and does not require

the employee to return the excess payment of \$140 (2 days x \$20 (\$120-\$100) + 4 days x \$25 (\$150-\$125)). For the payroll period in which the employer reimburses the expenses, the employer must withhold and pay employment taxes on \$140. See section 8.02 of this revenue procedure.

#### SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 98-64 is hereby superseded for per diem allowances that are paid both (1) to an employee on or after January 1, 2000, and (2) with respect to lodging, meal, and incidental expenses or with respect to meal and incidental expenses paid or incurred for travel while away from home on or after January 1, 2000. Rev. Proc. 98-64 is also hereby superseded for purposes of computing the amount allowable as a deduction for meal and incidental expenses paid or incurred by an employee or self-employed individual for travel while away from home on or after January 1, 2000.

#### DRAFTING INFORMATION

The principal author of this revenue procedure is Edwin B. Cleverdon of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Cleverdon at (202) 622-4920 (not a toll-free call).

26 CFR 601.601: Rules and regulations.  
(Also Part I, § 1397E)

### Rev. Proc. 2000-10

#### SECTION 1. PURPOSE

This revenue procedure sets forth the maximum face amount of Qualified Zone Academy Bonds (“Bond” or “Bonds”) that may be issued for each State during 2000. For this purpose “State” includes the District of Columbia and the possessions of the United States.

#### SECTION 2. BACKGROUND

.01 Section 226 of the Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 821 (1997), added § 1397E to the Internal Revenue Code to provide a credit to holders of Bonds under certain circumstances so that the Bonds generally can be issued without discount or interest. Ninety-five percent of Bond proceeds are to be used for qualified purposes, as defined by § 1397E(d)(5), with respect to a qualified zone academy, as defined by § 1397E(d)(4).

.02 Section 1397E(e)(1), as amended by § 509 of the Tax Relief Extension Act of 1999, Pub. L. 106-170, 113 Stat. 1860 (1999) provides that the aggregate amount of Bonds that may be issued for the States is limited to \$400 million for each of the years, 1998, 1999, 2000, and 2001 (the “national limitation”). This

amount is to be allocated among the States by the Secretary on the basis of their respective populations below the poverty level (as defined by the Office of Management and Budget) and is to be further allocated by the State to qualified zone academies within the State or possession.

.03 Section 1397E(e)(4), as amended, by § 509 of the Tax Relief Extension Act of 1999, Pub. L. 106-170, 113 Stat. 1860 (1999) provides that any carryforward of a limitation amount may be carried only to the first 2 years (3 years for carryforwards from 1998 or 1999) following the unused limitation year. For this purpose a limitation amount shall be treated as used on a first-in first-out basis.

.04 Rev. Proc. 98-9, 1998-3 I.R.B. 56, and Rev. Proc. 98-57, 1998-48 I.R.B. 5, respectively, allocated the national limitation for 1998 and 1999 among the States and possessions.

#### SECTION 3. SCOPE

This revenue procedure applies to Bonds issued under § 1397E during 2000.

#### SECTION 4. NATIONAL QUALIFIED ZONE ACADEMY BOND LIMITATION FOR 2000

The total face amount of Bonds that may be issued in 2000 is \$400 million. This amount is allocated among the States as follows:

#### MAXIMUM FACE AMOUNT OF BONDS THAT MAY BE ISSUED DURING 2000 (thousands of dollars)

| STATE                | MAXIMUM FACE AMOUNT OF BONDS THAT MAY BE ISSUED DURING 2000 (thousands of dollars) |
|----------------------|--|
| ALABAMA              | \$ 6,612   |
| ALASKA               | 651  |
| ARIZONA              | 8,816  |
| ARKANSAS             | 4,093  |
| CALIFORNIA           | 55,570   |
| COLORADO             | 3,941  |
| CONNECTICUT          | 3,366  |
| DELAWARE             | 869  |
| DISTRICT OF COLUMBIA | 1,238  |
| FLORIDA              | 20,879   |
| GEORGIA              | 11,227   |
| HAWAII               | 1,422  |
| IDAHO                | 1,792  |
| ILLINOIS             | 13,398   |
| INDIANA              | 5,939  |
| IOWA                 | 2,790  |
| KANSAS               | 2,714  |

MAXIMUM FACE AMOUNT OF  
BONDS THAT MAY BE  
ISSUED DURING 2000  
(thousands of dollars)

| STATE             |          |
|-------------------|----------|
| KENTUCKY          | \$ 5,657 |
| LOUISIANA         | 8,914    |
| MAINE             | 1,422    |
| MARYLAND          | 3,898    |
| MASSACHUSETTS     | 5,733    |
| MICHIGAN          | 11,911   |
| MINNESOTA         | 5,407    |
| MISSISSIPPI       | 5,277    |
| MISSOURI          | 5,765    |
| MONTANA           | 1,661    |
| NEBRASKA          | 2,291    |
| NEVADA            | 2,117    |
| NEW HAMPSHIRE     | 1,292    |
| NEW JERSEY        | 7,524    |
| NEW MEXICO        | 4,028    |
| NEW YORK          | 33,311   |
| NORTH CAROLINA    | 11,281   |
| NORTH DAKOTA      | 1,053    |
| OHIO              | 13,605   |
| OKLAHOMA          | 4,973    |
| OREGON            | 5,461    |
| PENNSYLVANIA      | 14,528   |
| RHODE ISLAND      | 1,216    |
| SOUTH CAROLINA    | 5,722    |
| SOUTH DAKOTA      | 836      |
| TENNESSEE         | 8,132    |
| TEXAS             | 32,508   |
| UTAH              | 2,063    |
| VERMONT           | 630      |
| VIRGINIA          | 6,395    |
| WASHINGTON        | 5,559    |
| WEST VIRGINIA     | 3,388    |
| WISCONSIN         | 4,875    |
| WYOMING           | 554      |
| AMERICAN SAMOA    | 389      |
| GUAM              | 229      |
| NORTHERN MARIANAS | 360      |
| PUERTO RICO       | 24,378   |
| VIRGIN ISLANDS    | 337      |

**SECTION 6. EFFECTIVE DATE**

This revenue procedure applies to Bonds issued after December 31, 1999.

**DRAFTING INFORMATION**

The principal author of this revenue procedure is Allan Seller of the Office of Assistant Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure contact Mr. Seller on (202) 622-3980 (not a toll free call).

**Effective Date of Proposed Regulations under § 1.368-2(d)(4)**

**Notice 2000-1**

This document contains information regarding a Notice of Proposed Rulemaking relating to the solely for voting stock requirement in reorganizations under § 368(a)(1)(C) of the Internal Revenue Code, which was published in the Federal Register on June 14, 1999 (64 Fed. Reg.

31770 (1999)) (the “proposed regulations”). See 1999-26 I.R.B. 6. The proposed regulations, under § 1.368-2(d)(4), provide that preexisting ownership of a portion of a target corporation’s stock by an acquiring corporation will not, in and of itself, prevent the solely for voting stock requirement in a “C” reorganization from being satisfied. The regulations propose to reverse the Internal Revenue Service’s previous position that the acquisition of assets of a partially controlled subsidiary does not qualify as a tax-free “C” reorganization. See Rev. Rul. 54-



396, 1954-2 C.B. 147. This position subsequently was sustained in litigation in *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir.), *cert. denied*, 361 U.S. 835 (1959). The regulations are proposed to apply to transactions occurring after the date that a Treasury decision adopting the regulations is published in the Federal Register, except that they do not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on the date that the regulations are published as final regulations in the Federal Register, and at all times thereafter.

Comments were received requesting that taxpayers be allowed to apply the proposed regulations to transactions occurring before the proposed regulations are published as final regulations. The In-

ternal Revenue Service and Treasury Department have determined that the increased flexibility that results from the proposed regulations should be available to taxpayers in structuring transactions before the publication as final regulations. Accordingly, the proposed regulations, when finalized, will be modified to provide that the regulations apply to transactions occurring after December 31, 1999, unless the transaction occurs pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter. Taxpayers may rely on this Notice until final regulations are issued.

In addition, taxpayers may request a private letter ruling permitting them to apply the final regulations to transactions occurring on or after June 11, 1999 (the

date the proposed regulations were filed with the Federal Register) to which the final regulations would not otherwise apply, and for which there was not a written agreement (subject to customary conditions) binding on June 11, 1999 and at all times thereafter. A private letter ruling will not be issued unless the taxpayer establishes to the satisfaction of the Service that there is not a significant risk of different parties to the transaction taking inconsistent positions, for U.S. tax purposes, with respect to the applicability of the final regulations to the transaction.

The principal author of this notice is Marnie Rapaport of the Office of the Assistant Chief Counsel (Corporate). For further information regarding this notice, contact Ms. Rapaport on (202) 622-7550 (not toll-free call).

## Part IV. Items of General Interest

### Notice of Proposed Rulemaking and Notice of Public Hearing

#### Definition of Contribution in Aid of Construction Under Section 118(c)

REG-106012-98

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations concerning the definition of a contribution in aid of construction under section 118(c) and the adjusted basis of any property acquired with a contribution in aid of construction. The proposed regulations affect a regulated public utility that provides water or sewerage services because a qualifying contribution in aid of construction is treated as a contribution to the capital of the utility and excluded from gross income. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by March 22, 2000. Outlines of topics to be discussed at the public hearing scheduled for April 27, 2000, must be received by April 6, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-106012-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-106012-98), 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.us-treas.gov/tax\\_regs/regslst.html](http://www.irs.us-treas.gov/tax_regs/regslst.html). The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Paul

Handleman, (202) 622-3040; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

#### Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by February 18, 2000. Comments are specifically requested concerning:

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

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

How the quality, utility, and clarity of the information to be collected may be enhanced; How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

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

The requirement for the collection of information in this notice of proposed rulemaking is in §1.118-2(e). The information is required by the IRS to establish that a taxpayer has notified the IRS of amounts to be treated as a contribution to capital under section 118(c). This information will be used to determine when the statu-

tory period for the assessment of any deficiency attributable to any contribution to capital under section 118(c) expires. The collection of information is mandatory. The likely respondents are businesses and other for-profit organizations.

Estimated total annual reporting burden: 100 hours.

The estimated annual burden per respondent varies from .5 hours to 5 hours, depending on individual circumstances, with an estimated average of 1 hour.

Estimated number of respondents : 100.

Estimated annual frequency of responses: annually.

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

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

#### Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) to provide regulations under section 118(c) of the Internal Revenue Code of 1986. Section 118(c) was added to the Code by section 1613(a)(1)(B) of the Small Business Job Protection Act of 1996 (SBJPA of 1996), 1996-3 C.B. 155, 248-250. Under section 1613(a)(3) of the SBJPA of 1996, the amendments made by section 1613(a) apply to amounts received after June 12, 1996.

#### Explanation of Provisions

##### *Contribution to Capital*

Section 118(a) generally provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Under section 118(b), a contribution in aid of construction generally is not a contribution to the capital of the taxpayer and is not excluded from gross income under section 118(a).

However, for amounts received after June 12, 1996, section 118(c) provides an exception to this rule.

Under section 118(c)(1), the term “contribution to the capital of the taxpayer” includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility that provides water or sewerage disposal services if the amount is a contribution in aid of construction. In the case of a contribution of property other than water or sewerage disposal facilities, the amount must meet the requirements of the expenditure rule of section 118(c)(2) (which generally requires that the amount is expended to acquire or construct water or sewerage disposal facilities within the specified time period). Moreover, the amount (or any property acquired or constructed with the amount) cannot be included in the taxpayer’s rate base for rate-making purposes.

#### *Contribution in Aid of Construction*

Section 118(c)(3)(A) provides that, for purposes of section 118(c), the term “contribution in aid of construction” shall be defined by regulations prescribed by the Secretary, except that such term shall not include amounts paid as service charges for starting or stopping services.

Section 118(c) was added by the SBJPA of 1996 “to restore the contribution in aid of construction provision that was repealed by the Tax Reform Act of 1986 (1986 Act) for regulated public utilities that provide water or sewerage disposal services.” H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 316 (1996), 1996-3 C.B. 741, 1056. Before the 1986 Act, former section 118(b) generally provided that a contribution in aid of construction received by a regulated public utility was treated as a contribution to the capital of the taxpayer and was excluded from gross income. However, former section 118(b)(3)(A) provided that the term “contribution in aid of construction” did not include amounts paid as customer connection fees (including amounts paid to connect the customer’s line to an electric line, a gas main, a steam line, or a main water or sewer line and amounts paid as service charges for starting or stopping services). The legislative history of the SBJPA of 1996 also states that “[p]rior to the enactment of the Tax Re-

form Act of 1986 ... [a nontaxable] contribution in aid of construction did not include a connection fee.” *Id.*

The nontaxable contribution in aid of construction provision in former section 118(b) is derived from a line of cases, including several Supreme Court cases, beginning with *Edwards v. Cuba R.R.*, 268 U.S. 628 (1925), IV-2 C.B. 122. In *Edwards*, the Supreme Court held that subsidy payments by the Republic of Cuba to a railroad company to induce the construction and operation of a railroad in Cuba were not included in the recipient corporation’s gross income because the payments were not made for services rendered or to be rendered. In *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943), 1943 C.B. 1019, the Supreme Court looked at the contributors’ motivation to determine whether payments by customers for extending electrical service lines were nonshareholder contributions to capital. Because the transferors received direct benefits in the form of services as a result of the contributions, the Court held that the payments were not contributions to capital, but the price for receiving service.

The Supreme Court elaborated on the contributor’s motivation in *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), 1950-1 C.B. 38, when it held that, if the transferor did not anticipate any direct benefit from the contribution, such as the receipt of services, but expected only that the transaction would benefit the community at large, the funds were contributions to capital. The lack of a direct benefit to the transferor was considered indicative of an intent to increase the transferee’s capital. In *United States v. Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1973), 1973-2 C.B. 428, the Supreme Court held that government payments received by a railroad company for improvements at grade crossing and intersections were not contributions to capital. In reaching its holding, the Court set forth five characteristics of a nonshareholder contribution to capital, including that the amounts received must not constitute payments for specific, quantifiable services provided for the transferor by the transferee.

Consistent with the above Supreme Court cases, a customer connection fee would not have qualified as a nonshare-

holder contribution to the capital of the utility under section 118(a) because the fee clearly is paid as a prerequisite for obtaining services. In addition, the IRS’ position prior to the enactment of former section 118(b) as articulated in Rev. Rul. 75-557, 1975-2 C.B. 33, was that customer connection fees charged by a water utility were not excludable from income. In 1976, Congress enacted former section 118(b) to treat contributions in aid of construction to water or sewerage disposal facilities as excludable contributions to capital. This legislation specifically excluded customer connection fees from the definition of nontaxable contributions in aid of construction. As explained by the court in *Florida Progress Corp. v. United States*, M.D. Fla., No. 93-246-CIV-T-25A, 9/2/98, Congress enacted former section 118(b) in 1976 to codify the already existing case law with regard to contributions in aid of construction to water and sewerage disposal facilities. Thereafter, payments made to a utility to encourage the extension of facilities into new areas benefiting a large number of people would be given tax free status; however, as held by the Supreme Court in *Detroit Edison*, payments made to a utility as a prerequisite to receiving water or sewerage service would be treated as taxable income to the utility.

The proposed regulations define the term “contribution in aid of construction,” for purposes of section 118(c), as meaning any amount of money or other property contributed to a regulated public utility that provides water or sewerage disposal services to the extent that the purpose of the contribution is to provide for the expansion, improvement, or replacement of the utility’s water or sewerage disposal facilities. However, to restore the contribution in aid of construction provision that existed before the 1986 Act for regulated public utilities providing water and sewerage disposal services as well as to be consistent with the Supreme Court cases discussed above, the proposed regulations exclude customer connection fees from the definition of contribution in aid of construction.

A customer connection fee is defined in the proposed regulations as any amount of money or property contributed to the utility representing the cost of installing a connection or service line (including the

cost of meters and piping) from the utility's main water or sewer lines to the line owned by the customer or potential customer. However, money or property contributed for a connection or service line from the utility's main line to the customer's or potential customer's line is not a customer connection fee if the connection or service line does serve, or is designed to serve, more than one customer. The proposed regulations also define a customer connection fee as including any amount paid as a service charge for stopping or starting service.

The proposed regulations indicate that a contribution in aid of construction may include an amount of money or other property contributed to a regulated public utility for a water or sewerage disposal facility subject to a contingent obligation to repay, in whole or in part, the amount to the contributor (commonly referred to as an "advance"). However, no inference is intended as to whether an amount subject to such a repayment obligation is a contribution or loan. Whether an advance is a contribution or a loan is determined under general principles of federal tax law based on all the facts and circumstances.

#### *Adjusted Basis*

Section 118(c)(4) provides that notwithstanding any other provision of subtitle A, no deduction or credit shall be allowed for, or by reason of, any expenditure which constitutes a contribution in aid of construction to which section 118(c) applies. The adjusted basis of any property acquired with a contribution in aid of construction to which section 118(c) applies shall be zero.

Consistent with section 118(c)(4), the proposed regulations provide rules for adjusting the basis of water or sewerage disposal facilities acquired as, or acquired or constructed with any money received as, a contribution in aid of construction.

#### *Statute of Limitations*

Section 118(d)(1) provides that if the taxpayer for any taxable year treats an amount as a contribution to the capital of the taxpayer described in section 118(c), then the statutory period for the assessment of any deficiency attributable to any part of the amount does not expire before the expiration of 3 years from the

date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of the amount of the expenditure referred to in section 118(c)(2)(A), of the taxpayer's intention not to make the expenditures referred to in section 118(c)(2)(A), or of a failure to make the expenditure within the period described in section 118(c)(2)(B). Section 118(d)(2) provides that the deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent assessment. The proposed regulations provide the time and manner for taxpayers to notify the Secretary with respect to its contributions in aid of construction under section 118(d)(1).

#### **Proposed Effective Date**

The regulations are proposed to be applicable for any money or other property received by a regulated public utility that provides water or sewerage disposal services on or after the date final regulations are published in the **Federal Register**.

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that any burden on taxpayers is minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8)

copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, April 27, 2000, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington DC. Due to building security procedures, visitors must enter at the 10<sup>th</sup> Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

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

Persons who wish to present oral comments at the hearing must submit 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 6, 2000.

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 Paul F. Handleman, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

#### **Proposed Amendments to the Regulations**

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

## PART 1—INCOME TAXES

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

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

Section 1.118-2 also issued under 26 U.S.C. 118(c)(3)(A); \* \* \*

Par. 2. Section 1.118-2 is added to read as follows:

*§1.118-2 Contribution in aid of construction.*

(a) *Special rule for water and sewerage disposal utilities—(1) In general.* For purposes of section 118, the term “contribution to the capital of the taxpayer” includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility that provides water or sewerage disposal services if—

(i) The amount is a contribution in aid of construction under paragraph (b) of this section;

(ii) In the case of a contribution of property other than water or sewerage disposal facilities, the amount satisfies the expenditure rule under paragraph (c) of this section; and

(iii) The amount (or any property acquired or constructed with the amount) is not included in the taxpayer’s rate base for ratemaking purposes.

(2) *Definitions—(i) Regulated public utility* has the meaning given such term by section 7701(a)(33), except that such term does not include any utility which is not required to provide water or sewerage disposal services to members of the general public in its service area.

(ii) *Water or sewerage disposal facility* is defined as tangible property described in section 1231(b) that is used predominately (i.e., 80% or more) in the trade or business of furnishing water or sewerage disposal services.

(b) *Contribution in aid of construction—(1) In general.* For purposes of section 118(c) and this section, the term “contribution in aid of construction” means any amount of money or other property contributed to a regulated public utility that provides water or sewerage disposal services to the extent that the purpose of the contribution is to provide for the expansion, improvement, or replacement of the utility’s water or sewerage disposal facilities.

(2) *Advances.* A contribution in aid of

construction may include an amount of money or other property contributed to a regulated public utility for a water or sewerage disposal facility subject to a contingent obligation to repay the amount, in whole or in part, to the contributor (commonly referred to as an “advance”). For example, an amount received by a utility from a developer to construct a water facility pursuant to an agreement under which the utility will pay the developer a percentage of the receipts from the facility over a fixed period may constitute a contribution in aid of construction. Whether an advance is a contribution or a loan is determined under general principles of federal tax law based on all the facts and circumstances. For the treatment of any amount of a contribution in aid of construction that is repaid by the utility to the contributor, see paragraphs (c)(2)(ii) and (d)(2) of this section.

(3) *Customer connection fee.* A customer connection fee is not a contribution in aid of construction under this paragraph (b) and is includible in income. The term “customer connection fee” includes any amount of money or other property transferred to the utility representing the cost of installing a connection or service line (including the cost of meters and piping) from the utility’s main water or sewer lines to the line owned by the customer or potential customer. However, money or other property contributed for a connection or service line from the utility’s main line to the customer’s or potential customer’s line is not a customer connection fee if the connection or service line does serve, or is designed to serve, more than one customer. A customer connection fee also includes any amount paid as a service charge for stopping or starting service.

(4) *Binding agreement to reimburse utility for a facility previously placed in service.* If a water or sewerage disposal facility is placed in service by the utility before an amount is contributed to the utility, the contribution is not a contribution in aid of construction under this paragraph (b) with respect to the cost of the facility unless, at the time the facility is placed in service by the utility, there is an agreement, binding under local law between the prospective contributor and the utility, that the utility is to receive the amount as reimbursement for the cost of

acquiring or constructing the facility. If such an agreement exists, the basis of the facility must be reduced by the amount of the contribution at the time the facility is placed in service.

(5) *Classification by ratemaking authority.* The fact that the applicable ratemaking authority classifies any money or other property received by a utility as a contribution in aid of construction is not conclusive as to its treatment under this paragraph (b).

(c) *Expenditure rule—(1) In general.* An amount satisfies the expenditure rule of section 118(c)(2) if the amount is expended for the acquisition or construction of property described in section 118(c)(2)(A), the amount is paid or incurred before the end of the second taxable year after the taxable year in which the amount was received as required by section 118(c)(2)(B), and accurate records are kept of contributions and expenditures as provided in section 118(c)(2)(C).

(2) *Excess amount—(i) Includible in the utility’s income.* An amount received by a utility as a contribution in aid of construction that is not expended for the acquisition or construction of water or sewerage disposal facilities as required by paragraph (c)(1) of this section (the excess amount) is not a contribution to the capital of the taxpayer under paragraph (a) of this section. Except as provided in paragraph (c)(2)(ii) of this section, such excess amount is includible in the utility’s income in the taxable year in which the amount was received.

(ii) *Repayment of excess amount.* If the excess amount described in paragraph (c)(2)(i) of this section is repaid, in whole or in part, either—

(A) Before the end of the time period described in paragraph (c)(1) of this section, the repayment amount is not includible in the utility’s income; or

(B) After the end of the time period described in paragraph (c)(1) of this section, the repayment amount may be deducted by the utility in the taxable year in which it is paid or incurred to the extent such amount was included in income.

(3) *Example.* The application of this paragraph (c) is illustrated by the following example:

*Example.* M, a calendar year regulated public utility that provides water services, received a \$1,000,000 contribution in aid of construction in

1999 for the purpose of constructing a water facility. To the extent that the \$1,000,000 exceeded the actual cost of the facility, the contribution was subject to being returned. In 2000, M built the facility at a cost of \$700,000 and returned \$200,000 to the contributor. As of the end of 2001, M had not returned the remaining \$100,000. Assuming accurate records are kept, the requirement under section 118(c)(2) is satisfied for \$700,000 of the contribution. Because \$200,000 of the contribution was returned within the time period during which qualifying expenditures could be made, this amount is not includible in M's income. However, the remaining \$100,000 is includible in M's income for its 1999 taxable year (the taxable year in which the amount was received) because the amount was neither spent nor repaid during the prescribed time period. To the extent M repays the remaining \$100,000 after year 2001, M would be entitled to a deduction in the year such repayment is paid or incurred.

(d) *Adjusted basis*—(1) *Exclusion from basis*. Except for a repayment described in paragraph (d)(2) of this section, to the extent that a water or sewerage disposal facility is acquired or constructed with an amount received as a contribution to the capital of the taxpayer under paragraph (a) of this section, the basis of the facility is reduced by the amount of the contribution. To the extent the water or sewerage disposal facility is acquired as a contribution to the capital of the taxpayer under paragraph (a) of this section, the basis of the contributed facility is zero.

(2) *Repayment of contribution*. If a contribution to the capital of the taxpayer under paragraph (a) of this section is repaid to the contributor, either in whole or in part, then the repayment amount is a capital expenditure in the taxable year in which it is paid or incurred, resulting in an increase in the property's adjusted basis in such year.

(3) *Allocation of contributions*. An amount treated as a capital expenditure under this paragraph (d) is to be allocated proportionately to the adjusted basis of each property acquired or constructed with the contribution based on the relative cost of such property.

(4) *Example*. The application of this paragraph (d) is illustrated by the following example:

*Example*. A, a calendar year regulated public utility that provides water services, received a \$1,000,000 contribution in aid of construction in 1999 as an advance from B, a developer, for the purpose of constructing a water facility. To the extent

that the \$1,000,000 exceeds the actual cost of the facility, the contribution is subject to being returned. Under the terms of the advance, A agrees to pay to B a percentage of the receipts from the facility over a fixed period, but limited to the cost of the facility. In 2000, A builds the facility at a cost of \$700,000 and returns \$300,000 to B. In 2001, A pays \$20,000 to B out of the receipts from the facility. Assuming accurate records are kept, the \$700,000 advance is a contribution to the capital of A under paragraph (a) of this section and is excludable from A's income. The basis of the \$700,000 facility constructed with this contribution to capital is zero. The \$300,000 excess amount is not a contribution to the capital of A under paragraph (a) of this section because it does not meet the expenditure rule described in paragraph (c)(1) of this section. However, this excess amount is not includible in A's income pursuant to paragraph (c)(2)(ii) of this section since the amount is repaid to B within the required time period. The repayment of the \$300,000 excess amount to B in 2000 is not treated as a capital expenditure by A. The \$20,000 payment to B in 2001 is treated as a capital expenditure by A in 2001 resulting in an increase in the adjusted basis of the water facility from zero to \$20,000.

(e) *Statute of limitations*—(1) *Extension of statute of limitations*. Under section 118(d)(1), the statutory period for assessment of any deficiency attributable to a contribution to capital under paragraph (a) of this section does not expire before the expiration of 3 years after the date the taxpayer notifies the Secretary in the time and manner prescribed in paragraph (e)(2) of this section.

(2) *Time and manner of notification*. Notification is made by attaching a statement to the taxpayer's federal income tax return for the taxable year in which any of the reportable items in paragraphs (e)(2)(i) through (iii) of this section occur. The statement must contain the taxpayer's name, address, employer identification number, taxable year and the following information with respect to contributions of property other than water or sewerage disposal facilities that are subject to the expenditure rule described in paragraph (c) of this section:

(i) The amount of contributions in aid of construction expended during the taxable year for property described in section 118(c)(2)(A) (qualified property) as required under paragraph (c)(1) of this section, identified by taxable year in which the contributions were received.

(ii) The amount of contributions in aid

of construction that the taxpayer does not intend to expend for qualified property as required under paragraph (c)(1) of this section, identified by taxable year in which the contributions were received.

(iii) The amount of contributions in aid of construction that the taxpayer failed to expend for qualified property as required under paragraph (c)(1) of this section, identified by taxable year in which the contributions were received.

(f) *Effective date*. This section is applicable for any money or other property received by a regulated public utility that provides water or sewerage disposal services on or after the date final regulations are published in the **Federal Register**.

Robert E. Wenzel,  
Deputy Commissioner of  
Internal Revenue.

(Filed by the Office of the Federal Register on December 17, 1999, 8:45 a.m., and published in the issue of the Federal Register for December 20, 1999, 64 F.R. 71082)

## Announcement and Request for Comments on Certain Plans of State and Local Government Employers under Section 457

### Announcement 2000-1

#### Purpose

The Internal Revenue Service (IRS) is considering the proper treatment of amounts under certain plans of state and local governments. This announcement provides interim information about the reporting requirements that apply to these plans. The information contained in this announcement will apply until further guidance is issued by the Service.

#### Background

Section 457 plans are nonqualified deferred compensation plans established by state and local government and tax-exempt employers. Under section 457(e)(11) of the Internal Revenue Code, certain bona fide sick, vacation, compensatory time, severance pay, disability pay or death benefit plans are treated as not providing for the deferral of compensation and are therefore excluded from section 457.

If a plan is not a bona fide plan described in section 457(e)(11), the proper reporting of amounts under the plan generally depends on whether the plan is an eligible plan that meets the requirements of section 457(b) or an ineligible section 457(f) plan that does not meet these requirements. In order to be an eligible plan under section 457(b), the plan must meet a number of requirements, including the requirement that the amounts deferred for each year must generally not exceed the lesser of \$8000 (for 1999) or 33 1/3 percent of compensation and must be subject to restrictions on the time of distribution.

Under section 457(a), compensation deferred under an eligible plan, and the income attributable to that deferred compensation, is not includible in gross income until the taxable year in which the amounts are actually paid or made available to the plan participant or other beneficiary. Similarly, if a plan is a bona fide severance pay plan described in section 457(e)(11), amounts under the plan are generally not includible in gross income until paid or made available. In contrast, amounts under a plan described in section 457(f) are included in the participant or beneficiary's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation.

#### **Timing of reporting of payments under certain plans**

Under this interim guidance by the Service, state and local governments should not report amounts, on either a Form 1099 or a Form W-2, for any year prior to the year in which the participant or beneficiary is in actual or constructive receipt of these amounts, if the amounts are provided under the following type of plan:

- The plan was in existence on December 22, 1999.
- The plan is a broad-based plan maintained by a state or local government employer primarily for non-highly compensated employees.
- The plan is nonelective. That is, the plan must not provide the participant with a choice between current and future compensation.
- The plan has been treated by the state or local government as a bona fide severance pay plan under section 457(e)(11) for those years before calendar year 1999 in which the plan was in existence.

• The plan satisfies the following three requirements:

- a. Payments under the plan are designed to provide supplemental income for a transitional period, rather than to provide retirement income.
- b. Payments under the plan are made only after separation from service with the employer, including retirement.
- c. Payments are completed within a short period of time, not to exceed 5 years, after separation from service.

Solely for purposes of this announcement, a plan that provides severance pay benefits as described in §31.3121(v)(2)-1(b)(4)(iv)(B) of the Regulations will be treated as satisfying (a), (b) and (c) above.

#### **REQUEST FOR PUBLIC COMMENT**

The Service and the Treasury Department understand that, in the absence of formal guidance, many state and local governments maintain plans with the above characteristics under the belief that these plans are "bona fide severance pay plans" within the meaning of section 457(e)(11), and accordingly would not be subject to the income inclusion provisions applicable to ineligible section 457(f) plans. The Service and the Treasury Department are now considering guidance under section 457 with respect to certain plans of state and local government and tax-exempt employers and are requesting comments on what types of plans maintained by state and local government and tax exempt employers are properly considered bona fide severance pay plans for purposes of section 457. Send written comments to: Internal Revenue Service, Attn: CC:DOM:CORP:R (Section 457 Plans), Room 5201, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Written comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: Internal Revenue Service, Courier's Desk, Attn: CC:DOM:CORP:R (Section 457 Plans), 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Alternatively, written comments may be submitted electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting them directly to the IRS Internet site at: [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html).

Comments should be received by February 20, 2000.

**FOR FURTHER INFORMATION**

**CONTACT:** Cheryl Press of the Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations) at (202) 622-4606 (not a toll-free number).

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### **Internal Revenue Service to Make Information Letters Available for Public Inspection**

#### **Announcement 2000-2**

The Internal Revenue Service will make information letters written by the National Office of Chief Counsel and the Commissioner, Tax Exempt and Government Entities Division, to members of the public in response to inquiries postmarked or, if not mailed, received after January 1, 2000, available for public inspection quarterly beginning March 31, 2000, and on a continuing quarterly basis. These documents provide general statements of well-defined law without applying them to a specific set of facts. Before any information letter is made available for public inspection, the Service will delete any name, address, and other identifying information as appropriate under the Freedom of Information Act (FOIA) (for example, FOIA personal privacy exemption of 5 U.S.C. § 552(b)(6) and tax details exempt pursuant to I.R.C. § 6103, as incorporated into FOIA by 5 U.S.C. § 552(b)(3)). This approach appropriately balances various privacy interests and the public's interest in understanding the internal revenue laws. Because information letters do not constitute written determinations (including Chief Counsel Advice) as defined in I.R.C. § 6110, these documents are not subject to disclosure under § 6110.

Information letters are advisory only and have no binding effect on the Service.

Information letters will be found in the Freedom of Information Room, 1111 Constitution Ave., N.W., Washington, DC 20224, where they may be read and copied by the public during the hours 9:00 a.m. to 4:00 p.m., and posted to the Service Website at [www.irs.gov/prod/news/efoia](http://www.irs.gov/prod/news/efoia).

The principal author of this announcement is Andrea Tucker of the Office of the Associate Chief Counsel (Domestic). For further information regarding this announcement contact Andrea Tucker on (202) 622-4940 (not a toll-free call).

# Deductions for Transfers for Public, Charitable, and Religious Uses; In General Marital Deduction; Valuation of Interest Passing to Surviving Spouse; Correction

## Announcement 2000-3

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains corrections to final regulations (T.D. 8846, 1999-51 I.R.B. 679) which were published in the **Federal Register** on Friday, December 3, 1999, 64 FR 67763, relating to the effect of certain administration expenses on the valuation of property for marital and charitable deduction purposes.

DATES: This correction is effective December 3, 1999.

FOR FURTHER INFORMATION CONTACT: Deborah Ryan, (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

### Background

The final regulations that are subject to these corrections are under section 2055

and 2056 of the Internal Revenue Code.

### Need for Correction

As published, final regulations (TD 8846) contain errors that may prove to be misleading and are in need of clarification.

### Correction of Publication

Accordingly, the publication of the final regulations (TD 8846), which were the subject of FR Doc. 99-31094, is corrected as follows:

#### §20.2055-3 [Corrected]

1. On page 67765, column 1, §20.2055-3(b)(1)(ii), line 5 from bottom of the paragraph, the language “related to investment, preservation, and” is corrected to read “related to investment, preservation, or”.

#### §20.2056(b)-4 [Corrected]

2. On page 67765, column 3, §20.2056(b)-4(d)(1)(ii), line 5 from the bottom of the paragraph, the language “related to investment, preservation, and” is corrected to read “related to investment, preservation, or”.

3. On page 67766, column 3, §20.2056(b)-4(d)(5), Example 5, line 6 from the bottom of the paragraph, the language “remains \$1,800,000. The applicable” is corrected to read “is \$2,000,000.

The applicable”.

4. On page 67766, column 3, §20.2056(b)-4(d)(5), Example 5, lines 2 and 3 from the bottom of the paragraph, the language “trust and \$200,000 of the \$2,000,000 passing to the marital trust so that the amount of” is corrected to read “trust so that the amount of”.

5. On page 67766, column 3, §20.2056(b)-4(d)(5), Example 7, line 7, the language “decendent’s child. Under the terms of the” is corrected to read “decendent’s child. Under the terms of the governing instrument and”.

Cynthia E. Grigsby,  
*Chief, Regulations Unit*  
*Assistant Chief Counsel (Corporate).*

(Filed by the Office of the Federal Register on December 17, 1999, 8:45 a.m., and published in the issue of the Federal Register for December 20, 1999, 64 F.R. 71021)



## 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 ap-

plies 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<sup>1</sup>

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 1999-27 through 1999-52 is in Internal Revenue Bulletin 2000-1, dated January 3, 2000.

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<sup>1</sup> A cumulative list of previously published items in Internal Revenue Bulletins 1999-27 through 1999-52 is in Internal Revenue Bulletin 2000-1, dated January 3, 2000.



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