

## 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

**PS-7-89, page 24.**

Proposed regulations under section 1254 of the Code relating to the treatment of gain from the disposition of interest in certain natural resource recapture property by S corporations and their shareholders.

**T.D. 8645, page 4.**

Final regulations under section 469 of the Code providing rules for rental real estate activities of taxpayers engaged in certain real property trades or businesses.

**T.D. 8646, page 10.**

Final regulations under section 861 of the Code provides guidance concerning the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from sources inside and outside the U.S.

### EMPLOYEE PLANS

**Notice 96-11, page 19.**

Guidelines are set forth for determining for February 1996, the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code as amended by the Omnibus Budget Reconciliation Act of 1987 and by the Uruguay Round Agreements Act (GATT).

### EXEMPT ORGANIZATIONS

**Announcement 96-10, page 30.**

A list is provided of organizations that no longer qualify as organizations to which contributions are deductible under section 170 of the Code.

### EXCISE TAXES

**Announcement 96-9, page 30.**

Effective after December 31, 1995, the rates for fuel taxes and the base amount not subject to the luxury tax have changed. Also, excise taxes on transportation and on the superfund expired December 31, 1995.

### ADMINISTRATIVE

**Rev. Proc. 96-25, page 19.**

**Automobile owners and lessees.** This procedure provides owners and lessees of passenger automobiles with tables detailing the limitations on depreciation deductions for automobiles first placed in service during calendar year 1996 and the amounts to be included in income for automobiles first leased during calendar year 1996.

**Rev. Proc. 96-26, page 22.**

**Backup withholding; substitute Form W-9.** The requirements for payors that want to use a substitute Form W-9, Request for Taxpayer Identification Number and Certification, are clarified.

Finding Lists begin on page 00.

Announcement of Disbarments and Suspensions begin on page 00.

Announcement of Declaratory Judgment Proceeding Under Section 7428 on page 00.

# Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the

quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

## Statement of Principles of Internal Revenue Tax Administration

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

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

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

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

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

# Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

## **Part I.—1986 Code.**

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

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

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

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

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

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

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

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

The Bulletin Index-Digest System, a research and reference service supplementing the Bulletin, may be obtained from the Superintendent of Documents on a subscription basis. It consists of four Services: Service No. 1, Income Tax; Service No. 2, Estate and Gift Taxes; Service No. 3, Employment Taxes; Service No. 4, Excise Taxes. Each Service consists of a basic volume and a cumulative supplement that provides (1) finding lists of items published in the Bulletin, (2) digests of revenue rulings, revenue procedures, and other published items, and (3) indexes of Public Laws, Treasury Decisions, and Tax Conventions.

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

## Section 280F.—Limitation on Depreciation for Luxury Automobiles; Limitation where Certain Property Used for Personal Purposes

26 CFR 280F–5T: *Leased Property* (temporary).

This procedure provides owners and lessees of passenger automobiles with tables detailing the limitations on depreciation deductions for automobiles first placed in service during calendar year 1996 and the amounts to be included in income for automobiles first leased during calendar year 1996. See Rev. Proc. 96–25, page 19.

26 CFR 280F–7: *Property leased after December 31, 1986.*

This procedure provides owners and lessees of passenger automobiles with tables detailing the limitations on depreciation deductions for automobiles first placed in service during calendar year 1996 and the amounts to be included in income for automobiles first leased during calendar year 1996. See Rev. Proc. 96–25, page 19.

## Section 469.—Passive Activity Losses and Credits Limited

26 CFR 1.469–4: *Definition of activity.*

T.D. 8645

DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Part 1

### Rules for Certain Rental Real Estate Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

**SUMMARY:** This document contains final regulations providing rules for rental real estate activities of taxpayers engaged in certain real property trades or businesses. The regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993, and affect taxpayers subject to the limitations on passive activity losses and passive activity credits.

**DATES:** These regulations are effective on January 1, 1995. See §1.469–11 for applicability.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:T:R (TD 8645), Room

5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to: CC:DOM:CORP:T:R (TD 8645), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** William M. Kostak at (202) 622-3080 (not a toll-free number).

### SUPPLEMENTARY INFORMATION:

#### *Paperwork Reduction Act*

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545–AS38. The estimated annual burden per respondent varies from 0.10 hours to 0.25 hours, depending on individual circumstances, with an estimated average of 0.15 hours.

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, IT: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.

#### *Background*

This document amends 26 CFR part 1 to provide rules relating to the treatment of rental real estate activities of certain taxpayers under the passive activity loss and credit limitations of section 469. Section 469 disallows losses from passive activities to the extent they exceed income from passive activities and similarly disallows credits from passive activities to the extent they exceed tax liability allocable to passive activities. In general, passive activities are activities in which the taxpayer does not materially participate. In addition, until the enactment of

the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), all rental activities (including those in which a taxpayer materially participated) were passive.

OBRA 1993 added section 469(c)(7), which provides that rental real estate activities of qualifying taxpayers are not subject to the rule that treats all rental activities as passive. Thus, a rental real estate activity of a qualifying taxpayer is not passive if the taxpayer materially participates in the activity. Further, section 469(c)(7) provides that each of a qualifying taxpayer's interests in rental real estate is treated as a separate activity unless the taxpayer elects to treat all interests in rental real estate as a single activity.

On January 10, 1995, the IRS published in the Federal Register a notice of proposed rulemaking (60 FR 2557 [PS–80–93, 1995–1 C.B. 1015]) to provide guidance regarding section 469(c)(7). A number of public comments were received concerning the proposed regulations, and a public hearing was held on May 11, 1995. After consideration of the comments received, the proposed regulations are adopted as revised by this Treasury decision.

#### *Explanation of provisions*

##### I. General Background

The proposed regulations provide rules for determining whether a taxpayer qualifies for treatment under section 469(c)(7). The proposed regulations also provide rules for determining the rental real estate activities of qualifying taxpayers for purposes of section 469. Except for modifications in response to comments received on the proposed regulations, the final regulations generally adopt the rules contained in the proposed regulations.

##### II. Public Comments

Several comments requested that the Service reconsider the rule in the proposed regulations prohibiting qualifying taxpayers from grouping rental real estate activities with other activities in determining whether the taxpayers materially participate in the rental real estate activities. After care-

ful consideration, the final regulations adopt the rule in the proposed regulations because that position is consistent with the statutory language and the legislative history.

Several comments suggested that the rule in the proposed regulations prohibiting the grouping of rental real estate activities with other activities be modified to allow qualifying taxpayers to group the activities of development or construction of rental real estate with rental real estate activities. The final regulations do not adopt this modification because in most cases development and construction activities are separate and distinct from rental activities. In addition, this modification would introduce significant administrative difficulties in determining which development activities or construction activities qualify. However, the IRS and Treasury Department invite comments concerning whether the material participation tests in §1.469-5T(a) should be amended to include a look-back material participation test for taxpayers significantly involved in the development or construction of their rental real estate interests.

Several comments requested clarification regarding whether a qualifying taxpayer's participation in a management activity may count towards material participation in a rental real estate activity if the management activity includes the management of rental real estate owned by the taxpayer. The final regulations clarify that a qualifying taxpayer may participate in a rental real estate activity through participation in a management activity. In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate. The final regulations also clarify that a qualifying taxpayer who owns rental real estate through an entity, including a C corporation that is subject to section 469, may count work performed by the taxpayer in managing the rental real estate of the entity in establishing material participation in the taxpayer's rental real estate activities. Thus, if a qualifying taxpayer owns some interests in rental real estate through a closely held C corporation and makes the election to treat all interests in rental real estate as a single activity, the aggregate rental real estate activity will include those

interests held through the closely held C corporation for purposes of material participation.

One comment requested that the regulations modify the definition of trade or business to clarify that a taxpayer's real property trades or businesses are determined without regard to the taxpayer's grouping of activities under §1.469-4. The final regulations clarify that a taxpayer's grouping of activities under §1.469-4 does not control the determination of the taxpayer's real property trades or businesses for purposes of this section.

Several comments requested that the regulations provide a detailed definition of real property trades or businesses beyond the cross-reference to section 469(c)(7)(C). However, to avoid complex and mechanical rules, the final regulations do not adopt a detailed definition of real property trades or businesses. Instead, the regulations provide that taxpayers may use any reasonable method for determining their real property trades or businesses.

Several comments requested that the final regulations modify the rule in the proposed regulations providing that only employees who are five-percent owners of their employer at all times during the taxable year may treat personal services performed as an employee as services performed in a real property trade or business. The comments suggested that the regulations should take into account personal services performed by employees that are five-percent owners for a significant portion of a taxable year. In response to these comments, the final regulations are modified to provide that an employee may count services performed in a real property trade or business during the portion of the taxable year that the employee is a five-percent owner in the employer.

Several comments requested clarification concerning whether a qualifying taxpayer that makes an election to treat all interests in rental real estate as a single activity will be treated as having a single rental real estate activity for purposes of the former passive activity rule under section 469(f). In addition, comments requested that the regulations be modified to provide that qualifying taxpayers that make the aggregation election will be treated as having separate activities for purposes of the disposition rules under section 469(g) and §1.469-4(g). In re-

sponse to these comments, the final regulations clarify that a qualifying taxpayer that makes the election to treat all interests in rental real estate as a single rental real estate activity will be treated as having a single activity for all purposes of section 469, including sections 469(f) and (g). The statutory language and the legislative history do not support a rule allowing a qualifying taxpayer to treat all interests in rental real estate as a single activity for purposes of material participation and section 469(f), but as separate activities for purposes of section 469(g).

In addition, in response to comments, the final regulations provide an example illustrating the operation of the former passive activity rule for qualifying taxpayers that make the election to treat all interests in rental real estate as a single activity. This example illustrates that qualifying taxpayers that make the aggregation election may use current net income from the aggregate rental real estate activity to offset the prior-year disallowed passive losses of the aggregate rental real estate activity, regardless of which rental real estate interests within that activity produced the income or prior-year losses.

Some comments requested that the regulations permit qualifying taxpayers to make or revoke the aggregation election on an amended income tax return. After careful consideration of this issue, the final regulations adopt the rule in the proposed regulations that aggregation elections must be made or revoked on an original return. The final regulations provide, however, that the election may be revoked in any year in which the facts are materially changed from those in the taxable year for which the election was made.

In addition, one comment requested clarification as to what constitutes a material change in the facts and circumstances that would allow a taxpayer to revoke an aggregation election. However, the final regulations do not provide an example or bright-line rule for determining when a material change in the facts and circumstances has occurred, because this determination is intended to be a broad factual inquiry. Providing an example or bright-line rule may inappropriately restrict the scope of that inquiry.

One comment requested the modification of the rule in the proposed

regulations that the aggregation election has no effect in years the taxpayer is not a qualifying taxpayer. Instead, the comment suggested that, for ease of administration and compliance, the aggregation election should be binding and irrevocable for all future years, including years in which the taxpayer is not a qualifying taxpayer. However, the final regulations adopt the rule in the proposed regulations because the position advocated by the comment would be unfavorable to many taxpayers and would not significantly improve administration.

Several comments requested that the regulations modify the rule in the proposed regulations treating each rental real estate interest of a pass-through entity as a separate interest of a person owning a fifty-percent or greater interest in the capital, gain, loss, income, deduction, or credit of the entity at any time during a taxable year. A commentator stated that this rule is burdensome on many pass-through entities and should be eliminated or modified. The final regulations modify this rule so that it applies only when a qualifying taxpayer owns a fifty-percent or greater interest in the capital, profits, or losses of a pass-through entity for a taxable year. Accordingly, this rule will not apply if a qualifying taxpayer owns a fifty-percent or greater interest in a single item of income or deduction but does not own a fifty-percent or greater interest in the overall capital, profits, or losses of the passthrough entity.

In response to one comment, the final regulations also clarify the application of the fifty-percent ownership rule to tiered passthrough entities. The final regulations provide that if a passthrough entity owns a fifty-percent or greater interest in the capital, profits, or losses of another passthrough entity for a taxable year, each interest in rental real estate of the lower-tier entity will be a separate interest in rental real estate of the upper-tier entity.

In response to another comment, the final regulations clarify that section 469(i) applies after the rules of section 469(c)(7) are applied. Accordingly, the \$25,000 offset will be applied only against passive losses from rental real estate activities, and not against losses that are allowable as a result of section 469(c)(7). In addition, the final regulations clarify that adjusted gross income for purposes of section 469(i) is not reduced by any losses from rental real

estate that are allowable as a result of section 469(c)(7).

Several comments requested a modification to the effective date provision, to provide that aggregation elections made for taxable years beginning before January 1, 1995, are not binding for future years. Because taxpayers had sufficient notice of the rules of section 469(c)(7) and these regulations, this modification is unnecessary and would add administrative complexity. Accordingly, the final regulations adopt the effective date provision of the proposed regulations.

Finally, in response to a comment, the activity regrouping rule of §1.469-4(e)(2) is clarified to provide that a taxpayer may not regroup activities unless the taxpayer's original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate.

### III. Effective Dates

In general, section 469(c)(7) applies for taxable years beginning after December 31, 1993. These regulations are effective for taxable years beginning on or after January 1, 1995. These regulations are also effective for elections under section 469(c)(7)(A) and paragraph (g) of these regulations that are made with returns filed on or after January 1, 1995.

### *Special Analyses*

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

### *Drafting Information*

The principal author of these regulations is William M. Kostak, Office of

Assistant Chief Counsel (Passthroughs and Special Industries), IRS. 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 part 1 is amended as follows:

## PART I—INCOME TAXES

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

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

Section 1.469-9 also issued under 26 U.S.C. 469(c)(6), (h)(2), and (l)(1).

Par. 2. Section 1.469-0 is amended by:

1. Revising the entry for §1.469-4(h).
2. Revising the heading for §1.469-9 and adding entries for paragraphs (a) through (j) of §1.469-9.
3. Revising the entry for §1.469-11(b)(2) and removing the entries for §1.469-11(b)(2)(i) and (ii).
4. Revising the entry for §1.469-11(b)(3).
5. Adding an entry for §1.469-11(b)(4).
6. The revisions and additions read as follows:

### *§1.469-0 Table of contents.*

\* \* \* \* \*

### *§1.469-4 Definition of Activity.*

\* \* \* \* \*

(h) Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7).

\* \* \* \* \*

### *§1.469-9 Rules for certain rental real estate activities.*

- (a) Scope and purpose.
- (b) Definitions.
  - (1) Trade or business.
  - (2) Real property trade or business.
  - (3) Rental real estate.
  - (4) Personal services.

- (5) Material participation.
- (6) Qualifying taxpayer.
- (c) Requirements for qualifying taxpayers.
  - (1) In general.
  - (2) Closely held C corporations.
  - (3) Requirement of material participation in the real property trades or businesses.
  - (4) Treatment of spouses.
  - (5) Employees in real property trades or businesses.
- (d) General rule for determining real property trades or businesses.
  - (1) Facts and circumstances.
  - (2) Consistency requirement.
- (e) Treatment of rental real estate activities of a qualifying taxpayer.
  - (1) In general.
  - (2) Treatment as a former passive activity.
  - (3) Grouping rental real estate activities with other activities.
    - (i) In general.
    - (ii) Special rule for certain management activities.
  - (4) Example.
- (f) Limited partnership interests in rental real estate activities.
  - (1) In general.
  - (2) *De minimis* exception.
- (g) Election to treat all interests in rental real estate as a single rental real estate activity.
  - (1) In general.
  - (2) Certain changes not material.
  - (3) Filing a statement to make or revoke the election.
- (h) Interests in rental real estate held by certain passthrough entities.
  - (1) General rule.
  - (2) Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity.
  - (3) Special rule for interests held in tiered passthrough entities.
- (i) [Reserved].
- (j) \$25,000 offset for rental real estate activities of qualifying taxpayers.
  - (1) In general.
  - (2) Example.

\* \* \* \* \*

*§1.469-11 Effective date and transition rules.*

\* \* \* \* \*

- (b) \* \* \*
- (2) Additional transition rule for 1992 amendments.
- (3) Fresh starts under consistency rules.
  - (i) Regrouping when tax liability is first determined under Project PS-1-89.
  - (ii) Regrouping when tax liability is first determined under §1.469-4.
  - (iii) Regrouping when taxpayer is first subject to section 469(c)(7).
  - (4) Certain investment credit property.

\* \* \* \* \*

Par. 3. Section 1.469-4 is amended by revising paragraphs (e)(1) and (2) and (h). The revisions read as follows:

*§1.469-4 Definition of Activity.*

\* \* \* \* \*

- (e) \* \* \*
- (1) *Original groupings.* Except as provided in paragraph (e)(2) of this section and §1.469-11, once a taxpayer has grouped activities under this section, the taxpayer may not regroup those activities in subsequent taxable years. Taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years.
- (2) *Regroupings.* If it is determined that a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and must comply with disclosure requirements that the Commissioner may prescribe.

\* \* \* \* \*

(h) *Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7).* See §1.469-9 for rules for certain rental real estate activities.

Par. 4. Section 1.469-9 is revised to read as follows:

*§1.469-9 Rules for certain rental real estate activities.*

(a) *Scope and purpose.* This section provides guidance to taxpayers engaged in certain real property trades or businesses on applying section 469(c)(7) to their rental real estate activities.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) *Trade or business.* A *trade or business* is any trade or business determined by treating the types of activities in §1.469-4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212.

(2) *Real property trade or business.* *Real property trade or business* is defined in section 469(c)(7)(C).

(3) *Rental real estate.* *Rental real estate* is any real property used by customers or held for use by customers in a rental activity within the meaning of §1.469-1T(e)(3). However, any rental real estate that the taxpayer grouped with a trade or business activity under §1.469-4(d)(1)(i)(A) or (C) is not an interest in rental real estate for purposes of this section.

(4) *Personal services.* *Personal services* means any work performed by an individual in connection with a trade or business. However, personal services do not include any work performed by an individual in the individual's capacity as an investor as described in §1.469-5T(f)(2)(ii).

(5) *Material participation.* *Material participation* has the same meaning as under §1.469-5T. Paragraph (f) of this section contains rules applicable to limited partnership interests in rental real estate that a qualifying taxpayer elects to aggregate with other interests in rental real estate of that taxpayer.

(6) *Qualifying taxpayer.* A *qualifying taxpayer* is a taxpayer that owns at least one interest in rental real estate and meets the requirements of paragraph (c) of this section.

(c) *Requirements for qualifying taxpayers—*(1) *In general.* A qualifying taxpayer must meet the requirements of section 469(c)(7)(B).

(2) *Closely held C corporations.* A closely held C corporation meets the requirements of paragraph (c)(1) of this section by satisfying the requirements

of section 469(c)(7)(D)(i). For purposes of section 469(c)(7)(D)(i), gross receipts do not include items of portfolio income within the meaning of §1.469-2T(c)(3).

(3) *Requirement of material participation in the real property trades or businesses.* A taxpayer must materially participate in a real property trade or business in order for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the requirements of paragraph (c)(1) of this section.

(4) *Treatment of spouses.* Spouses filing a joint return are qualifying taxpayers only if one spouse separately satisfies both requirements of section 469(c)(7)(B). In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose under this paragraph (c)), work performed by the taxpayer's spouse in a trade or business is treated as work performed by the taxpayer under §1.469-5T(f)(3), regardless of whether the spouses file a joint return for the year.

(5) *Employees in real property trades or businesses.* For purposes of paragraph (c)(1) of this section, personal services performed during a taxable year as an employee generally will be treated as performed in a trade or business but will not be treated as performed in a real property trade or business, unless the taxpayer is a five-percent owner (within the meaning of section 416(i)(1)(B)) in the employer. If an employee is not a five-percent owner in the employer at all times during the taxable year, only the personal services performed by the employee during the period the employee is a five-percent owner in the employer will be treated as performed in a real property trade or business.

(d) *General rule for determining real property trades or businesses—(1) Facts and circumstances.* The determination of a taxpayer's real property trades or businesses for purposes of paragraph (c) of this section is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services. Depending on the facts and circumstances, a real property trade or business consists either of one or more

than one trade or business specifically described in section 469(c)(7)(C). A taxpayer's grouping of activities under §1.469-4 does not control the determination of the taxpayer's real property trades or businesses under this paragraph (d).

(2) *Consistency requirement.* Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of paragraph (c) of this section, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate.

(e) *Treatment of rental real estate activities of a qualifying taxpayer—(1) In general.* Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity. Each interest in rental real estate of a qualifying taxpayer will be treated as a separate rental real estate activity, unless the taxpayer makes an election under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity. Each separate rental real estate activity, or the single combined rental real estate activity if the taxpayer makes an election under paragraph (g), will be an activity of the taxpayer for all purposes of section 469, including the former passive activity rules under section 469(f) and the disposition rules under section 469(g). However, section 469 will continue to be applied separately with respect to each publicly traded partnership, as required under section 469(k), notwithstanding the rules of this section.

(2) *Treatment as a former passive activity.* For any taxable year in which a qualifying taxpayer materially participates in a rental real estate activity, that rental real estate activity will be treated as a former passive activity under section 469(f) if disallowed deductions or credits are allocated to the activity under §1.469-1(f)(4).

(3) *Grouping rental real estate activities with other activities—(i) In*

*general.* For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under §1.469-5T.

(ii) *Special rule for certain management activities.* A qualifying taxpayer may participate in a rental real estate activity through participation, within the meaning of §§1.469-5(f) and 5T(f), in an activity involving the management of rental real estate (even if this management activity is conducted through a separate entity). In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate interests.

(4) *Example.* The following example illustrates the application of this paragraph (e).

*Example.* (i) Taxpayer *B* owns interests in three rental buildings, *U*, *V* and *W*. In 1995, *B* has \$30,000 of disallowed passive losses allocable to Building *U* and \$10,000 of disallowed passive losses allocable to Building *V* under §1.469-1(f)(4). In 1996, *B* has \$5,000 of net income from building *U*, \$5,000 of net losses from building *V*, and \$10,000 of net income from building *W*. Also in 1996, *B* is a qualifying taxpayer within the meaning of paragraph (c) of this section. Each building is treated as a separate activity of *B* under paragraph (e)(1) of this section, unless *B* makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. If the buildings are treated as separate activities, material participation is determined separately with respect to each building. If *B* makes the election under paragraph (g) to treat the buildings as a single activity, all participation relating to the buildings is aggregated in determining whether *B* materially participates in the combined activity.

(ii) Effective beginning in 1996, *B* makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. *B* works full-time managing the three buildings and thus materially participates in the combined activity in 1996 (even if *B* conducts this management function through a separate entity, including a closely held C corporation). Accordingly, the combined activity is not a passive activity of *B* in 1996. Moreover, as a result of the election under paragraph (g), disallowed



passive losses of \$40,000 (\$30,000 + \$10,000) are allocated to the combined activity. *B*'s net income from the activity for 1996 is \$10,000 (\$5,000 – \$5,000 + \$10,000). This net income is nonpassive income for purposes of section 469. However, under section 469(f), the net income from a former passive activity may be offset with the disallowed passive losses from the same activity. Because Buildings *U*, *V* and *W* are treated as one activity for all purposes of section 469 due to the election under paragraph (g), and this activity is a former passive activity under section 469(f), *B* may offset the \$10,000 of net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses. As a result, *B* has \$30,000 (\$40,000 – \$10,000) of disallowed passive losses remaining from the buildings after 1996.

(f) *Limited partnership interests in rental real estate activities*—(1) *In general*. If a taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest (within the meaning of §1.469–5T(e)(3)), the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation. Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in §1.469–5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).

(2) *De minimis exception*. If a qualifying taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than ten percent of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year, paragraph (f)(1) of this section does not apply. Thus the taxpayer may determine material participation under any of the tests listed in §1.469–5T(a) that apply to rental real estate activities.

(g) *Election to treat all interests in rental real estate as a single rental real estate activity*—(1) *In general*. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election

is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year. In years in which the taxpayer is not a qualifying taxpayer, the election will not have effect and the taxpayer's activities will be those determined under §1.469–4. If there is a material change in the taxpayer's facts and circumstances, the taxpayer may revoke the election using the procedure described in paragraph (g)(3) of this section.

(2) *Certain changes not material*. The fact that an election is less advantageous to the taxpayer in a particular taxable year is not, of itself, a material change in the taxpayer's facts and circumstances. Similarly, a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances.

(3) *Filing a statement to make or revoke the election*. A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). The taxpayer may make this election for any taxable year in which section 469(c)(7) is applicable. A taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation. This statement must contain a declaration that the taxpayer is revoking the election under section 469(c)(7)(A) and an explanation of the nature of the material change.

(h) *Interests in rental real estate held by certain passthrough entities*—

(1) *General rule*. Except as provided in paragraph (h)(2) of this section, a qualifying taxpayer's interest in rental real estate held by a partnership or an S corporation (passthrough entity) is treated as a single interest in rental real estate if the passthrough entity grouped its rental real estate as one rental activity under §1.469–4(d)(5). If the passthrough entity grouped its rental real estate into separate rental activities under §1.469–4(d)(5), each rental real estate activity of the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer. However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(2) *Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity*. If a qualifying taxpayer owns, directly or indirectly, a fifty-percent or greater interest in the capital, profits, or losses of a passthrough entity for a taxable year, each interest in rental real estate held by the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer, regardless of the passthrough entity's grouping of activities under §1.469–4(d)(5). However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(3) *Special rule for interests held in tiered passthrough entities*. If a passthrough entity owns a fifty-percent or greater interest in the capital, profits, or losses of another passthrough entity for a taxable year, each interest in rental real estate held by the lower-tier entity will be treated as a separate interest in rental real estate of the upper-tier entity, regardless of the lower-tier entity's grouping of activities under §1.469–4(d)(5).

(i) [Reserved].

(j) *\$25,000 offset for rental real estate activities of qualifying taxpayers*—(1) *In general*. A qualifying taxpayer's passive losses and credits from rental real estate activities (including prior-year disallowed passive activity losses and credits from rental real estate activities in which the

taxpayer materially participates) are allowed to the extent permitted under section 469(i). The amount of losses or credits allowable under section 469(i) is determined after the rules of this section are applied. However, losses allowable by reason of this section are not taken into account in determining adjusted gross income for purposes of section 469(i)(3).

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

*Example.* (i) Taxpayer A owns building X and building Y, both interests in rental real estate. In 1995, A is a qualifying taxpayer within the meaning of paragraph (c) of this section. A does not elect to treat X and Y as one activity under section 469(c)(7)(A) and paragraph (g) of this section. As a result, X and Y are treated as separate activities pursuant to section 469(c)(7)(A)(ii). A materially participates in X which has \$100,000 of passive losses disallowed from prior years and produces \$20,000 of losses in 1995. A does not materially participate in Y which produces \$40,000 of income in 1995. A also has \$50,000 of income from other nonpassive sources in 1995. A otherwise meets the requirements of section 469(i).

(ii) Because X is not a passive activity in 1995, the \$20,000 of losses produced by X in 1995 are nonpassive losses that may be used by A to offset part of the \$50,000 of nonpassive income. Accordingly, A is left with \$30,000 (\$50,000 - \$20,000) of nonpassive income. In addition, A may use the prior year disallowed passive losses of X to offset any income from X and passive income from other sources. Therefore, A may offset the \$40,000 of passive income from Y with \$40,000 of passive losses from X.

(iii) Because A has \$60,000 (\$100,000 - \$40,000) of passive losses remaining from X and meets all of the requirements of section 469(i), A may offset up to \$25,000 of nonpassive income with passive losses from X pursuant to section 469(i). As a result, A has \$5,000 (\$30,000 - \$25,000) of nonpassive income remaining and disallowed passive losses from X of \$35,000 (\$60,000 - \$25,000) in 1995.

Par. 5. Section 1.469-11 is amended as follows:

1. Paragraph (a)(2) is amended by removing “; and” and adding “;” in its place.

2. Paragraph (a)(3) is redesignated as paragraph (a)(4) and a new paragraph (a)(3) is added.

3. Paragraph (b)(1) is revised.

4. The heading for paragraph (b)(2) is revised; the headings for paragraphs (b)(2)(i) and (b)(2)(ii) are removed; paragraph (b)(2)(ii) is removed, and paragraph (b)(2)(i) is redesignated as paragraph (b)(2).

5. Paragraph (b)(3) is redesignated as paragraph (b)(4).

6. A new paragraph (b)(3) is added.

The added and revised provisions read as follows:

*§1.469-11 Effective date and transition rules.*

(a) \* \* \*

(3) The rules contained in §1.469-9 apply for taxable years beginning on or after January 1, 1995, and to elections made under §1.469-9(g) with returns filed on or after January 1, 1995; and

\* \* \* \* \*

(b) \* \* \* (1) *Application of 1992 amendments for taxable years beginning before October 4, 1994.* Except as provided in paragraph (b)(2) of this section, for taxable years that end after May 10, 1992, and begin before October 4, 1994, a taxpayer may determine tax liability in accordance with Project PS-1-89 published at 1992-1 C.B. 1219 (see §601.601(d)(2)-(ii)(b) of this chapter).

(2) *Additional transition rule for 1992 amendments.* \* \* \*

(3) *Fresh starts under consistency rules—(i) Regrouping when tax liability is first determined under Project PS-1-89.* For the first taxable year in which a taxpayer determines its tax liability under Project PS-1-89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of Project PS-1-89.

(ii) *Regrouping when tax liability is first determined under §1.469-4.* For the first taxable year in which a taxpayer determines its tax liability under §1.469-4, rather than under the rules of Project PS-1-89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of §1.469-4.

(iii) *Regrouping when taxpayer is first subject to section 469(c)(7).* For the first taxable year beginning after December 31, 1993, a taxpayer may regroup its activities to the extent necessary or appropriate to avail itself of the provisions of section 469(c)(7) and without regard to the manner in which

the activities were grouped in the preceding taxable year.

\* \* \* \* \*

Margaret Milner Richardson,  
*Commissioner of  
Internal Revenue.*

Approved December 12, 1995.

Leslie Samuels,  
*Assistant Secretary of  
the Treasury (Tax Policy).*

(Filed by the Office of the Federal Register on December 21, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 22, 1995, 60 F.R. 66496)

**Section 861.—Income From Sources Within the United States**

*26 CFR 1.861-8: Computation of taxable income from sources within the United States and from other sources and activities.*

T.D. 8646

DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Part 1

Allocation and Apportionment of  
Research and Experimental  
Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document provides guidance concerning the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from sources within and without the United States. This document affects taxpayers that have income from United States and foreign sources and that have made expenditures for research and experimentation that the taxpayer deducts under section 174 of the Internal Revenue Code of 1986.

EFFECTIVE DATE: January 1, 1996.

FOR FURTHER INFORMATION CONTACT: Carl Cooper at (202) 622-3840 (not a toll-free number).

## SUPPLEMENTARY INFORMATION:

### *Background and Explanation of Provisions*

On May 24, 1995, the IRS published a notice of proposed rulemaking and notice of public hearing in the Federal Register (60 FR 27453 [INTL-23-95, 1995-1 C.B. 987]) proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 861 of the Internal Revenue Code of 1986. Section 1.861-8(e)(3) of the Income Tax Regulations provides rules regarding the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from sources inside and outside the United States.

The notice of proposed rulemaking proposed three principal changes to the existing regulations. First, allocation of research and experimental expenditures to three digit SIC code product categories of gross income would be permitted. Second, the percentage of research and experimental expenditures that may be exclusively apportioned to United States source income under the sales method of apportionment under §1.861-8(e)(3)(ii) would be increased from 30 percent to 50 percent. Third, use of the optional gross income methods of apportionment would constitute a binding election to use such methods in subsequent years. The election would not be revocable without the prior consent of the Commissioner. The three changes were proposed in part on the basis of an economic study performed by the Treasury Department pursuant to Rev. Proc. 92-56 (1992-2 C.B. 409), "The Relationship between U.S. Research and Development and Foreign Income," which was published by the Treasury Department simultaneously with the proposed regulations.

Written comments responding to the notice were received, and a public hearing was held on September 8, 1995.

Regarding the determination of product categories under §1.861-8(e)(3)(i)(B) of the proposed regulations, commenters suggested that the rule requiring a taxpayer to determine relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual should be modified to allow determinations by reference to the five digit

classifications of the Manual. This suggestion was not adopted, because such a rule would too narrowly restrict the necessarily broad scope of the deduction. The IRS continues to believe that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation.

Commenters suggested that the regulations permit taxpayers to determine product categories by reference to two or three digit categories at the annual election of the taxpayer. This suggestion was not adopted. The regulations provide that a taxpayer may determine product categories by reference to two or three digit categories. A taxpayer may aggregate, disaggregate or change a previously selected SIC code category if the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in product category is appropriate. This rule provides a simple and workable format for balancing the need for consistency with the desire for flexibility.

Referring to current §1.861-8(g) *Example 6* (which has been redesignated §1.861-17(h) *Example 4*), commenters suggested that the regulations allow the use of the Wholesale Trade SIC code category with respect to sales from any other category. The current §1.861-8(g) *Example 6* was not correct on this point and does not override the rule stated parenthetically in the list of two digit SIC code categories in present §1.861-8(e)(3)(i)(A) that wholesale trade may not be combined with other product categories. The final regulations include this rule along with *Example 6* corrected to conform to the rule.

Regarding the exclusive place of performance apportionment rule under §1.861-8(e)(3)(ii)(A) of the proposed regulations, commenters suggested adding a rule providing that if the ratio of foreign research and experimental expenditures in a three digit SIC code category of all foreign affiliates of a United States consolidated group over foreign affiliate sales in that SIC code category exceed fifty percent of the ratio of United States consolidated group research and experimental expenditures in that SIC code category over United States consolidated group sales in that SIC code category, then the

United States consolidated group research and experimental expenditures should be exclusively apportioned to United States source gross income. This suggestion has not been adopted. Although a foreign affiliate may incur substantial research and experimental expenditures in a given product category, the foreign affiliate may still benefit from the research and experimental expenditures of the United States consolidated group. See *Perkin-Elmer Corporation v. Commissioner*, 103 T.C. 464 (1994).

Regarding the optional gross income methods of apportionment under §1.861-8(e)(3)(iii) of the proposed regulations, commenters suggested that the final regulations include a fifty percent exclusive place of performance apportionment under the optional gross income methods to be parallel with §1.861-8(e)(3)(ii)(A). This suggestion has been adopted in part. Section (b)(1)(ii) of the final regulations includes a twenty-five percent exclusive place of performance apportionment under the optional gross income methods. This twenty-five percent exclusive apportionment ensures that taxpayers electing to use one of the optional gross income methods also obtain results comparable to those obtained by taxpayers electing to use the sales method, *i.e.*, an overall allocation that is twenty-five percent lower on average than the allocation to foreign source income resulting from the current regulations. The Treasury Department study does not support a greater exclusive apportionment.

Commenters suggested that the proposed regulations should be modified to reduce the floor on the amount of research and experimental expenditures that must be apportioned to foreign source income under the optional gross income methods from fifty percent to thirty percent of the amount that would have been apportioned under the sales method. This suggestion has not been adopted. The adoption of this suggested rule in addition to the twenty-five percent exclusive apportionment rule is not supported by the Treasury Department study.

Commenters suggested the elimination of the binding election to use the optional gross income methods under §1.861-8(e)(3)(iii)(C) of the proposed regulations. Commenters also suggested that the binding election rule should be modified to provide for a change of method without the prior consent of the

Commissioner after five years' use of one method. This suggestion, which recognizes the need for consistency while reducing the administrative burden on taxpayers, has been adopted.

Commenters suggested that the effective date election under §1.861-8(e)(3)(vi) of the proposed regulations permit election by fiscal year taxpayers whose taxable years begin after August 1, 1994, but before January 1, 1995. This suggestion has been adopted.

Finally, these provisions, which were previously published as §1.861-8(e)(3), have been renumbered and will now be published as §1.861-17. This change has been made solely for the purpose of achieving greater clarity in formatting and is not intended to result in any additional substantive changes.

*Special Analyses*

It has been determined that these final regulations are not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these final regulations has been 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 Carl Cooper, Office of the Associate Chief Counsel (International). However, other personnel from IRS and Treasury participated in their development.

\* \* \* \* \*

*Amendments to the Regulations*

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 \* \* \*  
Par. 2. Section 1.861-8 is amended by:

- 1. Revising paragraph (e)(3) to read as set forth below.
- 2. Removing and reserving paragraph (g), *Examples 3 through 16 and 23.*

*§1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.*

\* \* \* \* \*

(e) \* \* \*  
(3) *Research and experimental expenditures.* For rules regarding the allocation and apportionment of research and experimental expenditures, see §1.861-17.

\* \* \* \* \*

Par. 3. Section 1.861-17 is added to read as follows:

*§1.861-17 Allocation and apportionment of research and experimental expenditures.*

(a) *Allocation*—(1) *In general.* The methods of allocation and apportionment of research and experimental expenditures set forth in this section recognize that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. Expenditures for research and experimentation that a taxpayer deducts under section 174 ordinarily shall be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) that a taxpayer may be considered to have shall be determined in accordance with the provisions of paragraph (a)(2) of this section.

(2) *Product categories*—(i) *Allocation based on product categories.* Ordinarily, a taxpayer's research and experimental expenditures may be divided between the relevant product categories. Where research and experi-

mentation is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories. Where research and experimentation is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories.

(ii) *Use of three digit standard industrial classification codes.* A taxpayer shall determine the relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual (SIC code). A copy may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, 1987 (or later edition, as available).

(iii) *Consistency.* Once a taxpayer selects a product category for the first taxable year for which this section is effective with respect to the taxpayer, it must continue to use that product category in following years, unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the product category is appropriate. For this purpose, a change in the taxpayer's selection of a product category shall include a change from a three digit SIC code category to a two digit SIC code category, a change from a two digit SIC code category to a three digit SIC code category, or any other aggregation, disaggregation or change of a previously selected SIC code category.

(iv) *Wholesale trade category.* The two digit SIC code category "Wholesale trade" is not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories and is not applicable with respect to a domestic international sales corporation (DISC) or foreign sales corporation (FSC) for which the taxpayer is a related supplier of goods and services from any of the taxpayer's product categories.

(v) *Retail trade category.* The two digit SIC code category "Retail trade" is not applicable with respect to sales

by the taxpayer of goods and services from any other of the taxpayer's product categories, except wholesale trade, and is not applicable with respect to a DISC or FSC for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories, except wholesale trade.

(3) *Affiliated Groups*—(i) *In general*. Except as provided in paragraph (a)(3)(ii) of this section, the allocation and apportionment required by this section shall be determined as if all members of the affiliated group (as defined in §1.861-14T(d)) were a single corporation. See §1.861-14T.

(ii) *Possessions corporations*. (A) For purposes of the allocation and apportionment required by this section, sales and gross income from products produced in whole or in part in a possession by an electing corporation (within the meaning of section 936(h)(5)(E)), and dividends from an electing corporation, shall not be taken into account, except that this paragraph (a)(3)(ii) shall not apply to sales of (and gross income and dividends attributable to sales of) products with respect to which an election under section 936(h)(5)(F) is not in effect.

(B) The research and experimental expenditures taken into account for purposes of this section shall be reduced by the amount of such expenditures included in computing the cost-sharing amount (determined under section 936(h)(5)(C)(i)).

(4) *Legally mandated research and experimentation*. Where research and experimentation is undertaken solely to meet legal requirements imposed by a political entity with respect to improvement or marketing of specific products or processes, and the results cannot reasonably be expected to generate amounts of gross income (beyond *de minimis* amounts) outside a single geographic source, the deduction for such research and experimentation shall be considered definitely related and therefore allocable only to the grouping (or groupings) of gross income within that geographic source as a class (and apportioned, if necessary, between such groupings as set forth in paragraphs (c) and (d) of this section). For example, where a taxpayer performs tests on a product in response to a requirement imposed by the U.S. Food and Drug Administration, and the test results cannot reasonably be expected to gen-

erate amounts of gross income (beyond *de minimis* amounts) outside the United States, the costs of testing shall be allocated solely to gross income from sources within the United States.

(b) *Exclusive apportionment*—(1) *In general*. An exclusive apportionment shall be made under this paragraph (b), where an apportionment based upon geographic sources of income of a deduction for research and experimentation is necessary (after applying the exception in paragraph (a)(4) of this section).

(i) *Exclusive apportionment under the sales method*. If the taxpayer apportions on the sales method under paragraph (c) of this section, an amount equal to fifty percent of such deduction for research and experimentation shall be apportioned exclusively to the statutory grouping of gross income or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than fifty percent of the amount of such deduction were performed.

(ii) *Exclusive apportionment under the optional gross income methods*. If the taxpayer apportions on the optional gross income methods under paragraph (d) of this section, an amount equal to twenty-five percent of such deduction for research and experimentation shall be apportioned exclusively to the statutory grouping or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than fifty percent of the amount of such deduction were performed.

(iii) *Exception*. If the applicable fifty percent geographic source test of the preceding paragraph (b)(1)(i) or (ii) is not met, then no part of the deduction shall be apportioned under this paragraph (b)(1).

(2) *Facts and circumstances supporting an increased exclusive apportionment*—(i) *In general*. The exclusive apportionment provided for in paragraph (b)(1) of this section reflects the view that research and experimentation is often most valuable in the country where it is performed, for two reasons. First, research and experimentation often benefits a broad product category, consisting of many individual products, all of which may be sold in the nearest market but only some of

which may be sold in foreign markets. Second, research and experimentation often is utilized in the nearest market before it is used in other markets, and in such cases, has a lower value per unit of sales when used in foreign markets. The taxpayer may establish to the satisfaction of the Commissioner that, in its case, one or both of the conditions mentioned in the preceding sentences warrant a significantly greater exclusive allocation percentage than allowed by paragraph (b)(1) of this section because the research and experimentation is reasonably expected to have very limited or long delayed application outside the geographic source where it was performed. Past experience with research and experimentation may be considered in determining reasonable expectations.

(ii) *Not all products sold in foreign markets*. For purposes of establishing that only some products within the product category (or categories) are sold in foreign markets, the taxpayer shall compare the commercial production of individual products in domestic and foreign markets made by itself, by uncontrolled parties (as defined under paragraph (c)(2)(i) of this section) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as defined under paragraph (c)(3)(ii) of this section) that can reasonably be expected to benefit directly or indirectly from any of the taxpayer's research expense connected with the product category (or categories). The individual products compared for this purpose shall be limited, for nonmanufactured categories, solely to those enumerated in Executive Office of the President, Office of Management and Budget Standard Industrial Classification Manual, 1987 (or later edition, as available), and, for manufactured categories, solely to those enumerated at a 7-digit level in the U.S. Bureau of the Census, Census of Manufacturers: 1992, Numerical List of Manufactured Products, 1993, (or later edition, as available). Copies of both of these documents may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

(iii) *Delayed application of research findings abroad*. For purposes of establishing the delayed application of research findings abroad, the taxpayer shall compare the commercial introduction of its own particular products and

processes (not limited by those listed in the Standard Industrial Classification Manual or the Numerical List of Manufactured Products) in the United States and foreign markets, made by itself, by uncontrolled parties (as defined under paragraph (c)(2)(i) of this section) of products involving intangible property that was licensed or sold by the taxpayer, and by those controlled corporations (as defined under paragraph (c)(3)(i) of this section) that can reasonably be expected to benefit, directly or indirectly, from the taxpayer's research expense. For purposes of evaluating the delay in the application of research findings in foreign markets, the taxpayer shall use a safe haven discount rate of 10 percent per year of delay unless he is able to establish to the satisfaction of the Commissioner, by reference to the cost of money and the number of years during which economic benefit can be directly attributable to the results of the taxpayer's research, that another discount rate is more appropriate.

(c) *Sales method*—(1) *In general.* The amount equal to the remaining portion of such deduction for research and experimentation, not apportioned under paragraph (a)(4) or (b)(1)(i) of this section, shall be apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions that the amount of sales from the product category (or categories) that resulted in such gross income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to the total amount of sales from the product category (or categories).

(i) *Apportionment in excess of gross income.* Amounts apportioned under this section may exceed the amount of gross income related to the product category within the statutory grouping. In such case, the excess shall be applied against other gross income within the statutory grouping. See §1.861-8(d)(1) for instances where the apportionment leads to an excess of deductions over gross income within the statutory grouping.

(ii) *Leased property.* For purposes of this paragraph (c), amounts received from the lease of equipment during a taxable year shall be regarded as sales receipts for such taxable year.

(2) *Sales of uncontrolled parties.* For purposes of the apportionment under

paragraph (c)(1) of this section, the sales from the product category (or categories) by each party uncontrolled by the taxpayer, of particular products involving intangible property that was licensed or sold by the taxpayer to such uncontrolled party shall be taken fully into account both for determining the taxpayer's apportionment and for determining the apportionment of any other member of a controlled group of corporations to which the taxpayer belongs if the uncontrolled party can reasonably be expected to benefit directly or indirectly (through any member of the controlled group of corporations to which the taxpayer belongs) from the research expense connected with the product category (or categories) of such other member. An uncontrolled party can reasonably be expected to benefit from the research expense of a member of a controlled group of corporations to which the taxpayer belongs if such member can reasonably be expected to license, sell, or transfer intangible property to that uncontrolled party or transfer secret processes to that uncontrolled party, directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and experimentation shall be considered in determining reasonable expectations.

(i) *Definition of uncontrolled party.* For purposes of this paragraph (c)(2) the term *uncontrolled party* means a party that is not a person with a relationship to the taxpayer specified in section 267(b), or is not a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3) or 927(d)(4)).

(ii) *Licensed products.* In the case of licensed products, if the amount of sales of such products is unknown (for example, where the licensed product is a component of a large machine), a reasonable estimate based on the principles of section 482 should be made.

(iii) *Sales of intangible property.* In the case of sales of intangible property, regardless of whether the consideration received in exchange for the intangible is a fixed amount or is contingent on the productivity, use, or disposition of the intangible, if the amount of sales of products utilizing the intangible property is unknown, a reasonable estimate of sales shall be made annually. If necessary, appropriate economic analyses shall be used to estimate sales.

(3) *Sales of controlled parties.* For purposes of the apportionment under paragraph (c)(1) of this section, the sales from the product category (or categories) of the taxpayer shall be taken fully into account and the sales from the product category (or categories) of a corporation controlled by the taxpayer shall be taken into account to the extent provided in this paragraph (c)(3) for determining the taxpayer's apportionment, if such corporation can reasonably be expected to benefit directly or indirectly (through another member of the controlled group of corporations to which the taxpayer belongs) from the taxpayer's research expense connected with the product category (or categories). A corporation controlled by the taxpayer can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be expected to license, sell, or transfer intangible property to that corporation or transfer secret processes to that corporation, either directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and experimentation shall be considered in determining reasonable expectations.

(i) *Definition of a corporation controlled by the taxpayer.* For purposes of this paragraph (c)(3), the term *a corporation controlled by the taxpayer* means any corporation that has a relationship to the taxpayer specified in section 267(b) or is a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3) or 927(d)(4)).

(ii) *Sales to be taken into account.* The sales from the product category (or categories) of a corporation controlled by the taxpayer taken into account shall be equal to the amount of sales that bear the same proportion to the total sales of the controlled corporation as the total value of all classes of the stock of such corporation owned directly or indirectly by the taxpayer, within the meaning of section 1563, bears to the total value of all classes of stock of such corporation.

(iii) *Sales not to be taken into account more than once.* Sales from the product category (or categories) between or among such controlled corporations or the taxpayer shall not be taken into account more than once; in such a situation, the amount sold by the selling corporation to the buying corpo-

ration shall be subtracted from the sales of the buying corporation.

(iv) *Effect of cost-sharing arrangements.* If the corporation controlled by the taxpayer has entered into a bona fide cost-sharing arrangement, in accordance with the provisions of §1.482-7, with the taxpayer for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the research expense.

(d) *Gross income methods*—(1)(i) *In general.* In lieu of applying the sales method of paragraph (c) of this section, the remaining amount of the deduction for research and experimentation, not apportioned under paragraph (a)(4) or (b)(1)(ii) of this section, shall be apportioned as prescribed in paragraphs (d)(2) and (3) of this section, between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income.

(ii) *Optional methods to be applied to all research and experimental expenditures.* These optional methods must be applied to the taxpayer's entire deduction for research and experimental expense remaining after applying the exception in paragraph (a)(4) of this section, and may not be applied on a product category basis. Thus, after the allocation of the taxpayer's entire deduction for research and experimental expense under paragraph (a)(2) of this section (by attribution to SIC code categories), the taxpayer must then apportion as necessary the entire deduction as allocated by separate amounts to various product categories, using only the sales method under paragraph (c) of this section or only the optional gross income methods under this paragraph (d). The taxpayer may not use the sales method for a portion of the deduction and optional gross income methods for the remainder of the deduction separately allocated.

(2) *Option one.* The taxpayer may apportion its research and experimental expenditures ratably on the basis of gross income between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions that the amount of gross income in the statutory grouping (or groupings) and the amount of gross income in the residual grouping bear, respectively, to the total amount

of gross income, if the conditions described in paragraph (d)(2)(i) and (ii) of this section are both met.

(i) The amount of research and experimental expense ratably apportioned to the statutory grouping (or groupings in the aggregate) is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the method described in paragraph (c) of this section; and

(ii) The amount of research and experimental expense ratably apportioned to the residual grouping is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the method described in paragraph (c) of this section.

(3) *Option two.* If, when the amount of research and experimental expense is apportioned ratably on the basis of gross income, either of the conditions described in paragraph (d)(2)(i) or (ii) of this section is not met, the taxpayer may either—

(i) Where the condition of paragraph (d)(2)(i) of this section is not met, apportion fifty percent of the amount of research and experimental expense that would have been apportioned to the statutory grouping (or groupings in the aggregate) under paragraph (c) of this section to such statutory grouping (or to such statutory groupings in the aggregate and then among such groupings on the basis of gross income within each grouping), and apportion the balance of the amount of research and experimental expenses to the residual grouping; or

(ii) Where the condition of paragraph (d)(2)(ii) of this section is not met, apportion fifty percent of the amount of research and experimental expense that would have been apportioned to the residual grouping under paragraph (c) of this section to such residual grouping, and apportion the balance of the amount of research and experimental expenses to the statutory grouping (or to the statutory groupings in the aggregate and then among such groupings ratably on the basis of gross income within each grouping).

(e) *Binding election*—(1) *In general.* A taxpayer may choose to use either the sales method under paragraph (c) of this section or the optional gross income methods under paragraph (d) of this section for its original return for its first taxable year to which this section

applies. The taxpayer's use of either the sales method or the optional gross income methods for its return filed for its first taxable year to which this section applies shall constitute a binding election to use the method chosen for that year and for four taxable years thereafter.

(2) *Change of method.* The taxpayer's election of a method may not be revoked during the period referred to in paragraph (e)(1) of this section without the prior consent of the Commissioner. After the expiration of that period, the taxpayer may change methods without the prior consent of the Commissioner. However, the taxpayer's use of the new method shall constitute a binding election to use the new method for its return filed for the first year for which the taxpayer uses the new method and for four taxable years thereafter. The taxpayer's election of the new method may not be revoked during that period without the prior consent of the Commissioner.

(i) *Short taxable years.* For purposes of this paragraph (e), the term *taxable year* includes a taxable year of less than twelve months.

(ii) *Affiliated groups.* In the case of an affiliated group, the period referred to in paragraph (e)(1) of this section shall commence as of the latest taxable year in which any member of the group has changed methods.

(f) *Special rules for partnerships*—(1) *Research and experimental expenditures.* For purposes of applying this section, if research and experimental expenditures are incurred by a partnership in which the taxpayer is a partner, the taxpayer's research and experimental expenditures shall include the taxpayer's distributive share of the partnership's research and experimental expenditures.

(2) *Purpose and location of expenditures.* In applying the exception for expenditures undertaken to meet legal requirements under paragraph (a)(4) of this section and the exclusive apportionment for the sales method and the optional gross income methods under paragraph (b) of this section, a partner's distributive share of research and experimental expenditures incurred by a partnership shall be treated as incurred by the partner for the same purpose and in the same location as incurred by the partnership.

(3) *Apportionment under the sales method.* In applying the remaining

apportionment for the sales method under paragraph (c) of this section, a taxpayer's sales from a product category shall include the taxpayer's share of any sales from the product category of any partnership in which the taxpayer is a partner. For purposes of the preceding sentence, a taxpayer's share of sales shall be proportionate to the taxpayer's distributive share of the partnership's gross income in the product category.

(g) *Effective date.* This section applies to taxable years beginning after December 31, 1995. However, a taxpayer may at its option, apply this section in its entirety to all taxable years beginning after August 1, 1994.

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

*Example 1—(i) Facts.* X, a domestic corporation, is a manufacturer and distributor of small gasoline engines for lawn mowers. Gasoline engines are a product within the category, Engines and Turbines (SIC Industry Group 351). Y, a wholly owned foreign subsidiary of X, also manufactures and sells these engines abroad. During 1996, X incurred expenditures of \$60,000 on research and experimentation, which it deducts as a current expense, to invent and patent a new and improved gasoline engine. All of the research and experimentation was performed in the United States. In 1996, the domestic sales by X of the new engine total \$500,000 and foreign sales by Y total \$300,000. X provides technology for the manufacture of engines to Y via a license that requires the payment of an arm's length royalty. In 1996, X's gross income is \$160,000, of which \$140,000 is U.S. source income from domestic sales of gasoline engines and \$10,000 is foreign source royalties from Y, and \$10,000 is U.S. source interest income.

(ii) *Allocation.* The research and experimental expenditures were incurred in connection with small gasoline engines and they are definitely related to the items of gross income to which the research gives rise, namely gross income from the sale of small gasoline engines in the United States and royalties received from subsidiary Y, a foreign manufacturer of gasoline engines. Accordingly, the expenses are allocable to this class of gross income. The U.S. source interest income is not within this class of gross income and, therefore, is not taken into account.

(iii) *Apportionment.* (A) For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources without the United States and the residual grouping is gross income from sources within the United States. Since the related class of gross income derived from the use of engine technology consists of both gross income from sources without the United States (royalties from Y) and gross income from sources within the United States (gross income from engine sales), X's deduction of \$60,000 for its research and experimental expenditure must be apportioned between the statutory and residual grouping before the foreign tax credit limitation

may be determined. Because more than 50 percent of X's research and experimental activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping of gross income, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales of small gasoline engines by X and Y. Alternatively, X's deduction for research and experimentation can be apportioned under the optional gross income method. The apportionment for 1996 is as follows:

(1) *Tentative Apportionment on the Basis of Sales.*

(i) Research and experimental expense to be apportioned between residual and statutory groupings of gross income: \$60,000

(ii) Less: Exclusive apportionment of research and experimental expense to the residual grouping of gross income ( $\$60,000 \times 50$  percent): \$30,000

(iii) Research and experimental expense to be apportioned between residual and statutory groupings of gross income on the basis of sales: \$30,000

(iv) Apportionment of research and experimental expense to the residual grouping of gross income ( $\$30,000 \times \$500,000/(\$500,000 + \$300,000)$ ): \$18,750

(v) Apportionment of research and experimental expense to the statutory grouping of gross income ( $\$30,000 \times \$300,000/(\$500,000 + \$300,000)$ ): \$11,250

(vi) Total apportioned deduction for research and experimentation: \$60,000

(vii) Amount apportioned to the residual grouping ( $\$30,000 + \$18,750$ ): \$48,750

(viii) Amount apportioned to the statutory grouping: \$11,250

(2) *Tentative Apportionment on the Basis of Gross Income.*

(i) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ( $\$60,000 \times 25$  percent): \$15,000

(ii) Research and experimental expense apportioned to sources within the United States (residual grouping) ( $\$45,000 \times \$140,000/(\$140,000 + \$10,000)$ ): \$42,000

(iii) Research and experimental expense apportioned to sources within country Y (statutory grouping) ( $\$45,000 \times \$10,000/(\$140,000 + \$10,000)$ ): \$3,000

(iv) Amount apportioned to the residual grouping: \$57,000

(v) Amount apportioned to the statutory grouping: \$3,000

(B) The total research and experimental expense apportioned to the statutory grouping (\$3,000) under the gross income method is approximately 26 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use option two of the gross income method (paragraph (d)(3) of this section) and apportion to the statutory grouping fifty percent (50%) of the \$11,250 apportioned to

that grouping under the sales method. Thus, X apportions \$5,625 of research and experimental expense to the statutory grouping. X's use of the optional gross income methods will constitute a binding election to use the optional gross income methods for 1996 and four taxable years thereafter.

*Example 2—(i) Facts.* Assume the same facts as in *Example 1* except that X also spends \$30,000 in 1996 for research on steam turbines, all of which is performed in the United States, and X has steam turbine sales in the United States of \$400,000. X's foreign subsidiary Y neither manufactures nor sells steam turbines. The steam turbine research is in addition to the \$60,000 in research which X does on gasoline engines for lawnmowers. X thus has a deduction of \$90,000 for its research activity. X's gross income is \$200,000, of which \$140,000 is U.S. source income from domestic sales of gasoline engines, \$50,000 is U.S. source income from domestic sales of steam turbines, and \$10,000 is foreign source royalties from Y.

(ii) *Allocation.* X's research expenses generate income from sales of small gasoline engines and steam turbines. Both of these products are in the same three digit SIC code category, Engines and Turbines (SIC Industry Group 351). Therefore, the deduction is definitely related to this product category and allocable to all items of income attributable to it. These items of X's income are gross income from the sale of small gasoline engines and steam turbines in the United States and royalties from foreign subsidiary Y, a foreign manufacturer and seller of small gasoline engines.

(iii) *Apportionment.* (A) For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of \$90,000 must be apportioned between the statutory and residual groupings. Because more than 50 percent of X's research and experimental activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of total sales of small gasoline engines and steam turbines by X and Y. Alternatively, X's deduction for research and experimentation can be apportioned under the optional gross income methods. The apportionment for 1996 is as follows:

(1) *Tentative Apportionment on the Basis of Sales.*

(i) Research and experimental expense to be apportioned between residual and statutory groupings of gross income: \$90,000

(ii) Less: Exclusive apportionment of the research and experimental expense to the residual grouping of gross income ( $\$90,000 \times 50$  percent): \$45,000

(iii) Research and experimental expense to be apportioned between the residual and statutory groupings of gross income on the basis of sales: \$45,000

(iv) Apportionment of research and experimental expense to the residual grouping of gross income ( $\$45,000 \times (\$500,000 + \$400,000)/(\$500,000 + \$400,000 + \$300,000)$ ): \$33,750



(v) Apportionment of research and experimental expense to the statutory grouping of gross income ( $\$45,000 \times \$300,000 / (\$500,000 + \$400,000 + \$300,000)$ ):	\$11,250
(vi) Total apportioned deduction for research and experimentation:	\$90,000
(vii) Amount apportioned to the residual grouping ( $\$45,000 + \$33,750$ ):	\$78,750
(viii) Amount apportioned to the statutory grouping:	\$11,250
<b>(2) Tentative Apportionment on the Basis of Gross Income.</b>	

(i) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ( $\$90,000 \times 25$ percent):	\$22,500
(ii) Research and experimental expense apportioned to sources within the United States (residual grouping) ( $\$67,500 \times \$190,000 / (\$140,000 + \$50,000 + \$10,000)$ ):	\$64,125
(iii) Research and experimental expense apportioned to sources within country Y (statutory grouping) ( $\$67,500 \times \$10,000 / (\$140,000 + \$50,000 + \$10,000)$ ):	\$3,375
(iv) Amount apportioned to the residual grouping:	\$86,625
(v) Amount apportioned to the statutory grouping:	\$3,375

(B) The total research and experimental expense apportioned to the statutory grouping (\$3,375) under the gross income method is 30 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use option two of the gross income method (paragraph (d)(3) of this section) and apportion to the statutory grouping fifty percent (50%) of the \$11,250 apportioned to that grouping under the sales method. Thus, X apportions \$5,625 of research and experimental expense to the statutory grouping. X's use of the optional gross income methods will constitute a binding election to use the optional gross income methods for 1996 and four taxable years thereafter.

**Example 3—(i) Facts.** Assume the same facts as in *Example 1* except that in 1997 X continues its sales of the new engines, with sales of \$600,000 in the United States and \$400,000 abroad by subsidiary Y. X also acquires a 60 percent (by value) ownership interest in foreign corporation Z and a 100 percent ownership interest in foreign corporation C. X transfers its engine technology to Z for a royalty equal to 5 percent of sales, and X enters into an arm's length cost-sharing arrangement with C to share the funding of all of X's research activity. In 1997, corporation Z has sales in country Z equal to \$1,000,000. X incurs expense of \$80,000 on research and experimentation in 1997, and in addition, X performs \$15,000 of research on gasoline engines which was funded by the cost-sharing arrangement with C. All of Z's sales are from the product category, Engines and Turbines (SIC Industry Group 351). X performs all of its research in the United States and \$20,000 of its expenditure of \$80,000 is made solely to meet pollution standards mandated by law. X establishes, to the satisfaction of the Commissioner, that the expenditure in response to

pollution standards is not expected to generate gross income (beyond *de minimis* amounts) outside the United States.

(ii) **Allocation.** The \$20,000 of research expense which X incurred in connection with pollution standards is definitely related and thus allocable to the residual grouping, gross income from sources within the United States. The remaining \$60,000 in research and experimental expenditure incurred by X is definitely related to all gasoline engines and is therefore allocable to the class of gross income to which the engines give rise, gross income from sales of gasoline engines in the United States, royalties from country Y, and royalties from country Z. No part of the \$60,000 research expense is allocable to dividends from country C, because corporation C has already paid, through its cost-sharing arrangement, for research activity performed by X which may benefit C.

(iii) **Apportionment.** For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources without the United States, and the residual grouping is gross income from sources within the United States. X's deduction of \$60,000 for its research and experimental expenditure must be apportioned between these groupings. Because more than 50 percent of the research and experimentation was performed in the United States, 50 percent of the \$60,000 deduction can be apportioned exclusively to the residual grouping. The remaining 50 percent of the deduction can then be apportioned between the residual and the statutory grouping on the basis of sales of gasoline engines by X, Y, and Z. (If X utilized the optional gross income methods in 1996, then its use of such methods constituted a binding election to use the optional gross income methods in 1996 and for four taxable years thereafter. If X utilized the sales method in 1996, then its use of such method constituted a binding election to use the sales method in 1996 and for four taxable years thereafter.) The optional gross income methods are not illustrated in this *Example 3* (see instead *Examples 1* and 2). Since X has only a 60 percent ownership interest in corporation Z, only 60 percent of Z's sales (60% of \$1,000,000, or \$600,000) are included for purposes of apportionment. The allocation and apportionment for 1997 is as follows:

(A) X's total research expense:	\$80,000
(B) Less: Legally mandated research directly allocated to the residual grouping of gross income:	\$20,000
(C) Tentative apportionment on the basis of sales:	
(1) Research and experimental expense to be apportioned between residual and statutory groupings of gross income:	\$60,000
(2) Less: Exclusive apportionment of research and experimental expense to the residual grouping of gross income ( $\$60,000 \times 50$ percent):	\$30,000
(3) Research and experimental expense to be apportioned between the residual and the statutory groupings on the basis of sales:	\$30,000
(4) Apportionment of research and experimental expense to gross income from sources within the United States (residual grouping) ( $\$30,000 \times \$600,000 / (\$600,000 + \$400,000 + \$600,000)$ ):	\$11,250

(5) Apportionment of research and experimental expense to general limitation gross income from countries Y and Z (statutory grouping) ( $\$30,000 \times \$400,000 + \$600,000 / (\$600,000 + \$400,000 + \$600,000)$ ):	\$18,750
(6) Total apportioned deduction for research and experimentation ( $\$30,000 + \$30,000$ ):	\$60,000
(7) Amount apportioned to the residual grouping ( $\$30,000 + \$11,250$ ):	\$41,250
(8) Amount apportioned to the statutory grouping of gross income from sources within countries Y and Z:	\$18,750

**Example 4—Research and Experimentation—**

(i) **Facts.** X, a domestic corporation, manufactures and sells forklift trucks and other types of materials handling equipment in the United States. The manufacture and sale of forklift trucks and other materials handling equipment belongs to the product category, Construction, Mining, and Materials Handling Machinery and Equipment (SIC Industry Group 353). X also sells its forklift trucks to a wholesaling subsidiary located in foreign country Y (but title passes in the United States), and X manufactures forklift trucks in foreign country Z. The wholesaling of forklift trucks to country Y also belongs to X's product category Transportation equipment and, therefore, may not belong to the product category, Wholesale trade (SIC Major Group 50 and 51). In 1997, X sold \$7,000,000 of forklift trucks to purchasers in the United States, \$3,000,000 of forklift trucks to the wholesaling subsidiary in Y, and transferred forklift truck components with an FOB export value of \$2,000,000 to its branch in Z. The branch's sales of finished forklift trucks were \$5,000,000. In response to legally mandated emission control requirements, X's United States research department has been engaged in a research project to improve the performance and quality of engine exhaust systems used on its products in the United States. It incurs expenses of \$100,000 for this purpose in 1997. In the past, X has customarily adapted the product improvements developed originally for the domestic market to its forklift trucks manufactured abroad. During the taxable year 1997, development of an improved engine exhaust system is completed and X begins installing the new system during the latter part of the taxable year in products manufactured and sold in the United States. X continues to manufacture and sell forklift trucks in foreign countries without the improved engine exhaust systems.

(ii) **Allocation.** X's deduction for its research expense is definitely related to the income to which it gives rise, namely income from the manufacture and sale of forklift trucks within the United States and in country Z. Although the research is undertaken in response to a legal mandate, it can reasonably be expected to generate gross income from the manufacture and sale of trucks by the branch in Z. Therefore, the deduction is not allocable solely to income from X's domestic sales of forklift trucks. It is allocable to income from such sales and income from the sales of X's branch in Z.

(iii) **Apportionment.** For the method of apportionment on the basis of either sales or gross income, see *Example 3*. However, in determining the amount of research apportioned to income from foreign and domestic sources, the net sales of the branch in Z are \$3,000,000 (\$5,000,000 less \$2,000,000) and the sales within the United

States are \$12,000,000 (\$7,000,000 plus \$3,000,000 plus \$2,000,000). See §1.861-17(c)-(3)(iii).

*Example 5*—(i) *Facts.* X, a domestic corporation, is a drug company that manufactures a wide variety of pharmaceutical products for sale in the United States. Pharmaceutical products belong to the product category, Drugs (SIC Industry Group 283). X exports its pharmaceutical products through a foreign sales corporation (FSC). X's wholly owned foreign subsidiary Y also manufactures pharmaceutical products. In 1997, X has domestic sales of pharmaceutical products of \$10,000,000, the FSC has sales of pharmaceutical products of \$3,000,000, and Y has sales of pharmaceutical products of \$5,000,000. In that same year, 1997, X incurs expense of \$200,000 on research to test a product in response to requirements imposed by the United States Food and Drug Administration (FDA). X is able to show that, even though country Y imposes certain testing requirements on pharmaceutical products, the research performed in the United States is not accepted by country Y for purposes of its own licensing requirements, and the research has minimal use abroad. X is further able to show that FSC sells goods to countries that do not accept or do not require research performed in the United States for purposes of their own licensing standards.

(ii) *Allocation.* Since X's research expense of \$200,000 is undertaken to meet the requirements of the United States Food and Drug Administration, and since it is reasonable to expect that the expenditure will not generate gross income (beyond *de minimis* amounts) outside the United States, the deduction is definitely related and thus allocable to the residual grouping.

(iii) *Apportionment.* No apportionment is necessary since the entire expense is allocated to the residual grouping, gross income from sales within the United States.

*Example 6*—(i) *Facts.* X, a domestic corporation, is engaged in continuous research and experimentation to improve the quality of the products that it manufactures and sells, which are floodlights, flashlights, fuse boxes, and solderless connectors. X incurs and deducts \$100,000 of expenditure for research and experimentation in 1997 that was performed exclusively in the United States. As a result of this research activity, X acquires patents that it uses in its own manufacturing activity. X licenses its floodlight patent to Y and Z, uncontrolled foreign corporations, for use in their own territories, countries Y and Z, respectively. Corporation Y pays X an arm's length royalty of \$3,000 plus \$0.20 for each floodlight sold. Sales of floodlights by Y for the taxable year are \$135,000 (at \$4.50 per unit) or 30,000 units, and the royalty is \$9,000 (\$3,000 + \$0.20 × 30,000). Y has sales of other products of \$500,000. Z pays X an arm's length royalty of \$3,000 plus \$0.30 for each unit sold. Z manufactures 30,000 floodlights in the taxable year, and the royalty is \$12,000 (\$3,000 + \$0.30 × 30,000). The dollar value of Z's floodlight sales is not known and cannot be reasonably estimated because, in this case, the floodlights are not sold separately by Z but are instead used as a component in Z's manufacture of lighting equipment for theaters. The sales of all Z's products, including the lighting equipment for theaters, are \$1,000,000. Y and Z each sell the floodlights exclusively within their respective countries. X's sales of floodlights for the taxable

year are \$500,000 and its sales of its other products, flashlights, fuse boxes, and solderless connectors, are \$400,000. X has gross income of \$500,000, consisting of gross income from domestic sources from sales of floodlights, flashlights, fuse boxes, and solderless connectors of \$479,000, and royalty income of \$9,000 and \$12,000 from foreign corporations Y and Z respectively. X utilized the optional gross income methods of apportionment for its return filed for its first taxable year to which this section applies.

(ii) *Allocation.* X's research and experimental expenses are definitely related to all of the products that it produces, which are floodlights, flashlights, fuse boxes, and solderless connectors. All of these products are in the same three digit SIC Code category, Electric Lighting and Wiring Equipment (SIC Industry Group 364). Thus, X's research and experimental expenses are allocable to all items of income attributable to this product category, domestic sales income and royalty income from the foreign countries in which corporations Y and Z operate.

(iii) *Apportionment.* (A) The statutory grouping of gross income is general limitation income from sources without the United States. The residual grouping is gross income from sources within the United States. X's deduction of \$100,000 for its research expenditures must be apportioned between the groupings. For apportionment on the basis of sales in accordance with paragraph (c) of this section, X is entitled to an exclusive apportionment of 50 percent of its research and experimental expense to the residual grouping, gross income from sources within the United States, since more than 50 percent of the research activity was performed in the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales. Since Y and Z are unrelated licensees of X, only their sales of the licensed product, floodlights, are included for purposes of apportionment. Floodlight sales of Z are unknown, but are estimated at ten times royalties from Z, or \$120,000. All of X's sales from the entire product category are included for purposes of apportionment on the basis of sales. Alternatively, X may apportion its deduction on the basis of gross income, in accordance with paragraph (d) of this section. The apportionment is as follows:

(1) *Tentative Apportionment on the basis of sales.*

(i) Research and experimental expense to be apportioned between statutory and residual groupings of gross income: \$100,000

(ii) Less: Exclusive apportionment of research and experimental expense to the residual groupings of gross income (\$100,000 × 50 percent): \$50,000

(iii) Research and experimental expense to be apportioned between the statutory and residual groupings of gross income on the basis of sales: \$50,000

(iv) Apportionment of research and experimental expense to the residual groupings of gross income (\$50,000 × \$900,000/(\$900,000 + \$135,000 + \$120,000)): \$38,961

(v) Apportionment of research and experimental expense to the statutory

grouping, royalty income from countries Y and Z (\$50,000 × \$135,000 + \$120,000/(\$900,000 + \$135,000 + \$120,000)): \$11,039

(vi) Total apportioned deduction for research and experimentation: \$100,000

(vii) Amount apportioned to the residual grouping (\$50,000 + \$38,961): \$88,961

(viii) Amount apportioned to the statutory grouping of sources within countries Y and Z: \$11,039

(2) *Tentative apportionment on gross income basis.*

(i) Exclusive apportionment of research and experimental expense to the residual grouping of gross income (\$100,000 × 25 percent): \$25,000

(ii) Apportionment of research and experimental expense to the residual grouping of gross income (\$75,000 × \$479,000/\$500,000): \$71,850

(iii) Apportionment of research and experimental expense to the statutory grouping of gross income (\$75,000 × \$9,000 + \$12,000/\$500,000): \$3,150

(iv) Amount apportioned to the residual grouping: \$96,850

(v) Amount apportioned to the statutory grouping of general limitation income from sources without the United States: \$3,150

(B) Since X has elected to use the optional gross income methods of apportionment and its apportionment on the basis of gross income to the statutory grouping, \$3,150, is less than 50 percent of its apportionment on the basis of sales to the statutory grouping, \$11,039, it must use Option two of paragraph (d)(3) of this section and apportion \$5,520 (50 percent of \$11,039) to the statutory grouping.

Margaret Milner Richardson,  
Commissioner of  
Internal Revenue.

Approved December 13, 1995.

Leslie Samuels,  
Assistant Secretary of  
the Treasury.

(Filed by the Office of the Federal Register on December 21, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 22, 1995, 60 F.R. 66502)

## Section 3406.—Backup Withholding

26 CFR 31.3406(h)-3: Certificates.

When does a substitute Form W-9 that contains a single signature line both for the certifications under section 3406 of the Internal Revenue Code and for unrelated account opening provisions satisfy the requirement that the certifications be clearly set forth? See Rev. Proc. 96-26, page 22.

# Part III. Administrative, Procedural, and Miscellaneous

## Weighted Average Interest Rate Update

### Notice 96-11

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of

the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for January 1996 is 6.05 percent.

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

Month	Year	Weighted Average	90% to 108% Permissible Range	90% to 110% Permissible Range
February	1996	7.01	6.31 to 7.57	6.31 to 7.71

### Drafting Information

The principal author of this notice is Donna Prestia of the Employee Plans Division. For further information regarding this notice, call (202) 622-6076 between 2:30 and 4:00 p.m. Eastern time (not a toll-free number). Ms. Prestia's number is (202) 622-7377 (also not a toll-free number).

*26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, § 280F; 1.280F-7, 1.280F-5T.)*

### Rev. Proc. 96-25

#### SECTION 1. PURPOSE

This revenue procedure provides limitations on depreciation deductions for owners of passenger automobiles first placed in service during calendar year 1996, and the amounts to be included in income by lessees of passenger automobiles first leased during calendar year 1996. The tables detailing these amounts reflect the automobile price inflation adjustments required by § 280F(d)(7) of the Internal Revenue Code.

#### SECTION 2. BACKGROUND

For owners of automobiles, § 280F(a) imposes dollar limitations on the depreciation deduction for both the year that the automobile is placed in

service and each succeeding year. Section 280F(d)(7) requires the amounts allowable as depreciation deductions to be increased by a price inflation adjustment amount for passenger automobiles placed in service after calendar year 1988.

For leased automobiles, § 280F(c) requires a reduction in the deduction allowed to the lessee of the automobile. The reduction must be substantially equivalent to the limitations on the depreciation deductions imposed on owners of automobiles. Under § 1.280F-7(a) of the Income Tax Regulations, this reduction requires the lessees to include in gross income an inclusion amount determined by applying a formula to the amount obtained from a table. The table shows inclusion amounts for a range of fair market values for each tax year after the automobile is first leased.

#### SECTION 3. SCOPE AND OBJECTIVE

01. The limitations on depreciation deductions in section 4.02 of this revenue procedure apply to automobiles (other than leased automobiles) that are placed in service in calendar year 1996 and continue to apply for each tax year that the automobile remains in service.

02. The table in section 4.03 of this revenue procedure applies to leased automobiles for which the lease term begins in calendar year 1996. Lessees of such automobiles must use this table to determine the inclusion amount for each tax year during which the auto-

mobile is leased. See §§ 1.280F-5T(d) and 1.280F-5T(e) of the temporary Income Tax Regulations, § 1.280F-7(a), Rev. Proc. 89-64, 1989-2 C.B. 783, Rev. Proc. 90-22, 1990-1 C.B. 504, Rev. Proc. 91-30, 1991-1 C.B. 563, Rev. Proc. 92-43, 1992-1 C.B. 873, Rev. Proc. 93-35, 1993-2 C.B. 472, Rev. Proc. 94-53, 1994-2 C.B. 712, and Rev. Proc. 95-9, 1995-1 C.B. 498, to determine inclusion amounts for automobiles first leased before January 1, 1996.

#### SECTION 4. APPLICATION

01. A taxpayer placing an automobile in service for the first time during calendar year 1996 is limited to the depreciation deduction shown in Table 1 of section 4.02(2). A taxpayer first leasing an automobile in calendar year 1996 must use Table 2 in section 4.03 to determine the inclusion amount that is added to gross income. Otherwise, the procedures of § 1.280F-7(a) must be followed.

02. *Limitations on Depreciation Deductions for Certain Automobiles.*

(1) *Amount of the Inflation Adjustment.* Under § 280F(d)(7)(B)(i), the automobile price inflation adjustment for any calendar year is the percentage (if any) by which the CPI automobile component for October of the preceding calendar year exceeds the CPI automobile component for October 1987. The term "CPI automobile component" is defined in § 280F(d)(7)(B)(ii) as the "automobile component" of the Consumer Price Index for all Urban

Consumers published by the Department of Labor (the CPI). The new car component of the CPI was 115.2 for October 1987 and 138.6 for October 1995. The October 1995 index exceeded the October 1987 index by 23.4. The Internal Revenue Service has, therefore, determined that the auto-

mobile price inflation adjustment for 1996 is 20.31 percent ( $23.4/115.2 \times 100\%$ ). This adjustment is applicable to all automobiles that are first placed in service in calendar year 1996. The dollar limitations in § 280F(a) must therefore be multiplied by a factor of 0.2031, and the resulting increases,

after rounding to the nearest \$100, are added to the 1988 limitations to give the depreciation limitations for 1996.

(2) *Amount of the Limitation.* For automobiles placed in service in calendar year 1996, Table 1 contains the dollar amount of the depreciation limitations for each tax year.

REV. PROC. 96-25 TABLE 1	
DEPRECIATION LIMITATIONS FOR AUTOMOBILES FIRST PLACED IN SERVICE IN CALENDAR YEAR 1996	
<i>Tax Year</i>	<i>Amount</i>
1st Tax Year	\$3,060
2nd Tax Year	\$4,900
3rd Tax Year	\$2,950
Each Succeeding Year	\$1,775

03. *Inclusions in Income of Lessees of Automobiles.*

The inclusion amounts for automobiles first leased in calendar year 1996 are calculated under the procedures described in § 1.280F-7(a). Table 2 of this revenue procedure is the applicable table to be used in applying those procedures.

REV. PROC. 96-25 TABLE 2						
DOLLAR AMOUNTS FOR AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1996						
Fair Market Value of Automobile		Tax Year During Lease				
		1st	2nd	3rd	4th	5th and Later
Over	Not Over					
\$15,500	\$15,800	3	6	8	10	10
15,800	16,100	5	11	16	19	21
16,100	16,400	7	16	24	27	32
16,400	16,700	10	21	31	37	42
16,700	17,000	12	26	39	46	53
17,000	17,500	15	33	49	58	67
17,500	18,000	19	42	61	73	84
18,000	18,500	23	50	74	88	102
18,500	19,000	27	59	86	104	119
19,000	19,500	31	67	99	119	136
19,500	20,000	35	75	112	134	154
20,000	20,500	38	84	125	149	171
20,500	21,000	42	93	137	164	189
21,000	21,500	46	101	150	179	207
21,500	22,000	50	110	162	194	225
22,000	23,000	56	122	182	217	250
23,000	24,000	64	139	207	247	286
24,000	25,000	71	157	232	277	320
25,000	26,000	79	174	257	308	355
26,000	27,000	87	191	282	338	390
27,000	28,000	95	207	308	369	425
28,000	29,000	103	224	333	399	460

## REV. PROC. 96-25 TABLE 2

DOLLAR AMOUNTS FOR AUTOMOBILES  
WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1996

Fair Market Value of Automobile		Tax Year During Lease				
		1st	2nd	3rd	4th	5th and Later
Over	Not Over					
29,000	30,000	110	242	358	429	495
30,000	31,000	118	259	383	459	531
31,000	32,000	126	276	408	490	565
32,000	33,000	134	293	433	520	600
33,000	34,000	141	310	459	550	635
34,000	35,000	149	327	484	581	670
35,000	36,000	157	344	509	611	705
36,000	37,000	165	361	535	641	740
37,000	38,000	172	378	560	672	775
38,000	39,000	180	395	585	702	810
39,000	40,000	188	412	611	732	844
40,000	41,000	196	429	636	762	880
41,000	42,000	203	446	661	793	915
42,000	43,000	211	463	687	822	950
43,000	44,000	219	480	712	853	985
44,000	45,000	227	497	737	883	1,020
45,000	46,000	235	514	762	914	1,054
46,000	47,000	242	531	788	944	1,089
47,000	48,000	250	548	813	974	1,125
48,000	49,000	258	565	838	1,005	1,159
49,000	50,000	266	582	863	1,035	1,195
50,000	51,000	273	599	889	1,065	1,230
51,000	52,000	281	616	914	1,096	1,264
52,000	53,000	289	633	939	1,126	1,299
53,000	54,000	297	650	964	1,157	1,334
54,000	55,000	304	668	989	1,186	1,370
55,000	56,000	312	684	1,015	1,217	1,404
56,000	57,000	320	701	1,040	1,247	1,440
57,000	58,000	328	718	1,066	1,277	1,474
58,000	59,000	336	735	1,091	1,307	1,509
59,000	60,000	343	753	1,115	1,338	1,544
60,000	62,000	355	778	1,154	1,383	1,597
62,000	64,000	370	812	1,205	1,443	1,667
64,000	66,000	386	846	1,255	1,504	1,737
66,000	68,000	402	880	1,305	1,565	1,807
68,000	70,000	417	914	1,356	1,626	1,876
70,000	72,000	433	948	1,406	1,686	1,947
72,000	74,000	448	982	1,457	1,747	2,016
74,000	76,000	464	1,016	1,508	1,807	2,086
76,000	78,000	479	1,050	1,558	1,868	2,156
78,000	80,000	495	1,084	1,609	1,928	2,226
80,000	85,000	522	1,144	1,697	2,034	2,349
85,000	90,000	561	1,229	1,823	2,186	2,523
90,000	95,000	600	1,314	1,950	2,337	2,698
95,000	100,000	638	1,400	2,075	2,489	2,873
100,000	110,000	697	1,527	2,265	2,716	3,135
110,000	120,000	774	1,697	2,518	3,019	3,485
120,000	130,000	852	1,868	2,770	3,322	3,834
130,000	140,000	930	2,038	3,023	3,624	4,185
140,000	150,000	1,007	2,208	3,276	3,927	4,534
150,000	160,000	1,085	2,378	3,529	4,230	4,884

REV. PROC. 96-25 TABLE 2

DOLLAR AMOUNTS FOR AUTOMOBILES  
WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1996

Fair Market Value of Automobile		Tax Year During Lease				
		1st	2nd	3rd	4th	5th and Later
Over	Not Over					
160,000	170,000	1,163	2,548	3,781	4,533	5,234
170,000	180,000	1,240	2,719	4,033	4,837	5,583
180,000	190,000	1,318	2,889	4,286	5,139	5,933
190,000	200,000	1,396	3,059	4,539	5,442	6,282
200,000	210,000	1,473	3,230	4,791	5,745	6,632
210,000	220,000	1,551	3,400	5,044	6,047	6,982
220,000	230,000	1,629	3,570	5,296	6,351	7,332
230,000	240,000	1,706	3,740	5,550	6,653	7,681
240,000	250,000	1,784	3,911	5,801	6,956	8,032

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for automobiles (other than leased automobiles) that are first placed in service during calendar year 1996 and to leased automobiles that are first leased during calendar year 1996.

DRAFTING INFORMATION

The principal author of this revenue procedure is Bernard P. Harvey of the Office of Assistant Chief Counsel Passthroughs and Special Industries). For further information regarding this revenue procedure contact Mr. Harvey on (202) 622-3110 (not a toll-free call).

26 CFR 601.602: Forms and instructions.  
(Also Part I, Section 3406; 31.3406(h)-3)

Rev. Proc. 96-26

SECTION 1. PURPOSE

This revenue procedure clarifies the certification requirements for a substitute Form W-9, Request for Taxpayer Identification Number and Certification, and amplifies Rev. Proc. 83-89, 1983-2 C.B. 613, which provides guidelines for payors of interest, dividends, and patronage dividends and brokers that want to design and provide their own substitute Forms W-9.

SECTION 2. BACKGROUND

.01 Under §§ 6109(a)(2) and 3406(a)(1)(A) of the Internal Revenue

Code, a payee of a reportable payment must provide its Taxpayer Identification Number (TIN) to a person who is required to file an information return with respect to the payment. In addition, under § 3406(a)(1)(A) the payee of a reportable interest or dividend payment generally must certify that its TIN is correct and that it is not subject to backup withholding under § 3406(a)-(1)(C) for failure to include interest and dividend income on its tax return (required certifications). Section 3406(a)(1)(A) and (D) requires the imposition of backup withholding on a reportable interest or dividend payment to a payee if the payee does not provide its TIN or make the required certifications.

.02 The Internal Revenue Service provides an official Form W-9 for a payee to provide the required certifications to the payor. A payor may use a substitute Form W-9 to obtain the TIN and the required certifications provided the certification requirements in the substitute Form W-9 comply with section 4 of Rev. Proc. 83-89. A payor may incorporate the required certifications into other business forms customarily used, such as account signature cards, provided the required certifications are clearly set forth. See section 5.01 of Rev. Proc. 83-89.

SECTION 3. SCOPE

This revenue procedure applies to payors that choose to obtain the required certifications by using a substitute Form W-9 incorporated into business forms the payor customarily

uses, as set forth in section 2.02 of this revenue procedure.

SECTION 4. FORMAT FOR MAKING THE REQUIRED CERTIFICATIONS

.01 *Required certifications clearly set forth.* For a payor to be treated as having provided a taxpayer with a valid substitute Form W-9, the required certifications must be clearly set forth. The Service will treat the required certifications as being clearly set forth only if they meet the provisions of section 4.02 or 4.03 of this revenue procedure.

.02 *Separate signature for required certifications.* A substitute Form W-9 is valid if a separate signature line is provided just for the required certifications.

.03 *Single signature for required certifications and other provisions.* A substitute Form W-9 is valid if:

(1) a single signature line is provided for the required certifications as well as other provisions unrelated to the required certifications;

(2) the language of the required certifications is highlighted, boxed, printed in bold-face type, or presented in some other manner that distinguishes and causes the language to stand out from all other information contained on the substitute Form W-9; and

(3) the following statement is provided in the same manner prescribed in section 4.03(2) and appears immediately above the single signature line on the substitute Form W-9: "The

Internal Revenue Service does not require your consent to any provision of this document other than the certifications required to avoid backup withholding.”

#### SECTION 5. IMPERMISSIBLE USE OF THE CERTIFICATIONS

.01 A payor may not (1) require a payee to agree to provisions included on a substitute Form W-9 other than the required certifications in order to avoid backup withholding, or (2) threaten backup withholding in order to secure a payee’s acceptance of provisions included on a substitute Form W-9 that are unrelated to the required certifications.

.02 If a payor contravenes the provisions of section 5.01 of this revenue procedure, the payor may be subject to civil or criminal penalties under 31 U.S.C. § 333. That section generally prohibits the use of any words, titles, abbreviations, etc. in connection with a business solicitation or activity in a manner that could reasonably be interpreted to convey a false impression that such activity is approved, endorsed, sponsored, or authorized by the Service.

#### SECTION 6. EFFECT ON OTHER DOCUMENTS

This revenue procedure amplifies Rev. Proc. 83-89.

#### SECTION 7. EFFECTIVE DATE

Except for section 5, the provisions of this revenue procedure apply to substitute Forms W-9 completed by payees after December 31, 1996. The provisions of section 5.02 of this revenue procedure apply to violations occurring after March 31, 1995, the effective date of 31 U.S.C. § 333.

#### DRAFTING INFORMATION

The principal author of this revenue procedure is Renay France of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Renay France on (202) 622-4910 (not a toll-free call).

## Part IV. Items of General Interest

### Notice of Proposed Rulemaking

#### Treatment of Gain From the Disposition of Interest in Certain Natural Resource Recapture Property by S Corporations and Their Shareholders

PS-7-89

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 1254 of the Internal Revenue Code relating to the tax treatment by S corporations and their shareholders of gain from the disposition by an S corporation (and a former S corporation) of certain natural resource recapture property (section 1254 property after enactment of the Tax Reform Act of 1986 and oil, gas, or geothermal property before enactment of the Tax Reform Act of 1986), and also rules relating to the disposition of stock in an S corporation that holds certain natural resource recapture property. Changes to the applicable tax law were made by the Tax Reform Act of 1986, and the Subchapter S Revision Act of 1982. The regulations provide the public with guidance in complying with the changed tax laws.

DATES: Written comments and requests for a public hearing must be received by February 20, 1996.

ADDRESSES: Send comments and requests for a public hearing to: CC:DOM:CORP:R (PS-7-89), Room 5228, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand-delivered to CC:DOM:CORP:R (PS-7-89), Room 5228, Internal Revenue Service Building, 1111 Constitution Avenue, NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: James A. Quinn, 202-622-3060 (not a toll-free number).

### SUPPLEMENTARY INFORMATION:

#### *Paperwork Reduction Act*

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

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 IT:FP, Washington, DC 20224. Comments on the collection of information should be received by January 22, 1996.

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

The collection of information is contained in §1.1254-4(c) of the proposed regulations. This information is required by the Internal Revenue Service to verify that taxpayers have reported the appropriate amount of gain as ordinary income under section 1254 when a shareholder sells stock in an S corporation that holds natural resource recapture property. The likely respondents are individuals and businesses and other for-profit institutions.

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

Estimated total annual reporting burden: **1,000 hours**.

The estimated annual burden per respondent varies from **.5 hours** to **1.5 hours**, depending on individual circumstances, with an estimated average of **1 hour**.

Estimated number of respondents: **1,000**.

Estimated annual frequency of responses: **On occasion**.

### *Background*

On June 11, 1980, proposed amendments to the Income Tax Regulations, 26 CFR part 1, under sections 170, 301, 312, 341, 453, 751, 1254, and 1502 of the Internal Revenue Code of 1954 (Code) were published in the Federal Register (45 FR 39512). These amendments were proposed to conform the regulations to section 205(a), (b), (c)(1) and (2) of the Tax Reform Act of 1976, Public Law 94-455, 90 Stat. 1533, and section 402(c) of the Energy Tax Act of 1978, Public Law 95-618, 92 Stat. 3202, and to make certain other technical amendments to the regulations to conform them to section 1(c) of the Act of September 12, 1966, Public Law 89-570, 80 Stat. 762, section 211(b)(6) of the Tax Reform Act of 1969, Public Law 91-172, 83 Stat. 570, and sections 1042(c)(2), 1101(d)(2), 1901(a)(93), and 2110(a) of the Tax Reform Act of 1976, 90 Stat. 1637, 1658, 1780, 1905. Section 1.1254-3 of the proposed regulations provided rules relating to the sale or exchange of stock in an electing small business corporation (hereinafter referred to as an S corporation). Because of the substantial changes in the tax treatment of S corporations since the proposed regulations were issued, the proposed regulations contained in §1.1254-3 needed to be completely revised.

This document revises and re-proposes §1.1254-3 of the above-referenced notice of proposed rulemaking as amendments to the Income Tax Regulations, 26 CFR part 1, under section 1254 of the Code, relating to S corporations (redesignated as §1.1254-4). These amendments are proposed to conform the regulations to section 5(a)(37) of the Subchapter S Revision Act of 1982, Public Law 97-354, 96 Stat. 1669, and sections 411 and 413 of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2225, 2227. The amendments are to be issued under the authority contained in sections 1254(b) and 7805 of the Code.

### *Explanation of Provisions*

These proposed regulations contain rules for applying the provisions of section 1254 to the disposition of



natural resource recapture property by an S corporation (and a former S corporation) and the disposition of S corporation stock.

The proposed regulations provide that the recognition of ordinary income under section 1254 upon the disposition of natural resource recapture property by an S corporation is generally computed at the shareholder level. Determining the amount of ordinary income to be recognized under section 1254 at the shareholder level is appropriate because the determination of section 1254 costs can be affected by shareholder elections and characteristics. See, for example, sections 59(e) and 1363(c)(2)(A). Similarly, in the case of oil and gas properties, gain on the disposition of the property and depletion with respect to the property are computed at the shareholder level. See section 613A(c)(11).

The proposed regulations also contain rules relating to the recognition of ordinary income under section 1254 upon a sale or exchange of S corporation stock. Under section 1254(b)(2), rules similar to the rules of section 751 are to be applied to that portion of the excess of the amount realized over the adjusted basis of the stock that is attributable to section 1254 costs. Pursuant to section 1254(b)(2), the proposed regulations provide that, as a general rule, a shareholder must treat any gain recognized on a sale or exchange of S corporation stock as ordinary income to the extent of the shareholder's section 1254 costs with respect to the shares sold or exchanged.

The proposed regulations provide two exceptions to the general rule for determining the amount treated as ordinary income under section 1254 upon a sale or exchange of stock. The first exception is that the general rule does not apply to the extent that the shareholder establishes that the gain is not attributable to the section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the shareholder of

ordinary income under section 1254. To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

The second exception to the general rule for sales or exchanges of stock is that, in the case of a contribution of property to the S corporation prior to a stock sale or exchange pursuant to a plan a principal purpose of which is to avoid the recognition of ordinary income under section 1254, the selling or exchanging shareholder must recognize as ordinary income under section 1254 the amount of ordinary income the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold all of its natural resource recapture property the disposition of which would result in ordinary income under section 1254. Section 1.1254-4(c)(3) *Example 3* of the proposed regulations illustrates this exception.

The proposed regulations also provide rules for determining an S corporation shareholder's section 1254 costs. Generally, an S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the shareholder's section 1254 costs with respect to the property while in the hands of the S corporation. In the case of a person (acquiring shareholder) who acquires stock from another shareholder, the proposed regulations provide that the acquiring shareholder's section 1254 costs are zero if the acquiring shareholder's basis for the stock transferred is determined by reference to its cost (within the meaning of section 1012) or by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date). However, an acquiring shareholder's section 1254 costs include any section 1254 costs paid or incurred before the decedent's death, to the extent that the basis of the stock is reduced under section 1014(b)(9) (relating to adjustments to

basis if the property is acquired from a decedent prior to death). For stock that is acquired in a transfer that is a gift, in a transfer that is part sale or exchange and part gift, or a transfer described in section 1041, the acquiring shareholder generally acquires the section 1254 costs of the transferor but reduces the section 1254 costs by the amount of any gain treated as ordinary income under section 1254 by the transferor on the transfer.

The proposed regulations provide rules for applying section 1254 to the shareholders of an S corporation that incurred section 1254 costs while it was a C corporation (former C corporation). In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a *pro rata* share of the section 1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.

The proposed regulations also provide rules for applying section 1254 to a corporation that holds natural resource recapture property after the termination of its S corporation election (former S corporation). In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year for which the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders' section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A).

Because certain transactions will change the allocation to the shareholders of gain or amount realized from the natural resource recapture property if the S corporation disposes of it subsequent to these transactions, the proposed regulations require that section 1254 costs be reallocated to reflect the effects of these transactions. Transactions requiring reallocation of the section 1254 costs are transactions involving the issuance of stock by an S

corporation in a reorganization or otherwise, and transfers of natural resource recapture property to the S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction or in a reorganization).

The rules for former S corporations and the rules for allocating section 1254 costs upon certain transfers require the S corporation to determine the aggregate of its shareholders' section 1254 costs. The proposed regulations provide rules for the S corporation to apply in determining a shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation. In general, the S corporation may determine a shareholder's section 1254 costs by using written data provided by the shareholder or by applying certain assumptions.

These regulations are proposed to apply to dispositions of natural resource recapture property by an S corporation (and a former S corporation) and dispositions of S corporation stock occurring after publication of these regulations as final regulations in the Federal Register.

#### *Comments and Requests for a Public Hearing*

Before the adoption of these proposed regulations, consideration will be given to any written comments that are timely submitted (preferably an original and eight copies) to the IRS. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

#### *Special Analyses*

It has been determined that this proposed regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to

section 7805(f) of the Internal Revenue Code, 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.

#### *Drafting Information*

The principal author of these regulations is James A. Quinn of the Office of Assistant Chief Counsel (Pass-throughs 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 continues to read in part as follows:

Authority: 26 U.S.C. 7805. \* \* \*  
Section 1.1254-4 also issued under 26 U.S.C. 1254(b). \* \* \*

Par. 2. Section 1.1254-0 is amended by revising the entry for §1.1254-4 to read as follows:

*§1.1254-0 Table of contents for section 1254 recapture rules.* \* \* \*

\* \* \* \* \*

*§1.1254-4 Special rules for S corporations and their shareholders.*

- (a) In general.
- (b) Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation.
  - (1) General rule.
  - (2) Examples.
- (c) Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock.
  - (1) General rule.
  - (2) Exceptions.
  - (3) Examples.
- (d) Section 1254 costs of a shareholder.

- (e) Section 1254 costs of an acquiring shareholder after certain acquisitions.
  - (1) Basis determined under section 1012.
  - (2) Basis determined by reason of the application of section 1014(a).
  - (3) Basis determined by reason of the application of section 1014(b)(9).
  - (4) Gifts and section 1041 transfers.
- (f) Special rules for former S corporations and former C corporations.
  - (1) Section 1254 costs of an S corporation that was formerly a C corporation.
  - (2) Examples.
  - (3) Section 1254 costs of a C corporation that was formerly an S corporation.
- (g) Determination of a shareholder's section 1254 costs upon certain stock transactions
  - (1) Issuance of stock.
  - (2) Natural resource recapture property acquired in exchange for stock.
  - (3) Treatment of nonvested stock.
  - (4) Exception.
  - (5) Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation
  - (6) Examples.
- (h) Effective date.

\* \* \* \* \*

Par. 3. Section 1.1254-4 is amended by adding text to read as follows:

*§1.1254-4 Special rules for S corporations and their shareholders.*

(a) *In general.* This section provides rules for applying the provisions of section 1254 to S corporations and their shareholders upon the disposition by an S corporation (or a former S corporation) of natural resource recapture property and upon the disposition by a shareholder of stock of an S corporation that holds natural resource recapture property.

(b) *Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation—(1) General rule.* Upon a disposi-

tion of natural resource recapture property by an S corporation, the amount of gain treated as ordinary income under section 1254 is determined at the shareholder level. Each shareholder must recognize as ordinary income under section 1254 the lesser of—

(i) The shareholder's section 1254 costs with respect to the property disposed of; or

(ii) The shareholder's share of the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition (including a distribution), exceeds the adjusted basis of the property.

(2) *Examples.* The following examples illustrate the provisions of paragraph (b)(1) of this section:

*Example 1. Disposition of natural resource recapture property other than oil and gas property.* A and B are equal shareholders in X, an S corporation. On January 1, 1995, X acquires for \$90,000 an undeveloped mineral property, its sole property. During 1995, X expends and deducts \$100,000 in developing the property. On January 15, 1996, X sells the property for \$250,000 when X's basis in the property is \$90,000. Thus, X recognizes gain of \$160,000 on the sale. A and B's share of the \$160,000 gain recognized is \$80,000 each. Each shareholder has \$50,000 of section 1254 costs with respect to the property. Under these circumstances, A and B each are required to recognize \$50,000 of the \$80,000 of gain on the sale of the property as ordinary income under section 1254.

*Example 2. Disposition of oil and gas property the adjusted basis of which is allocated to the shareholders under section 613A(c)(11).* C and D are equal shareholders in Y, an S corporation. On January 1, 1995, Y acquires for \$150,000 an undeveloped oil and gas property, its sole property. During 1995, Y expends in developing the property \$40,000 in intangible drilling costs which it elects to expense under section 263(c). On January 15, 1996, Y sells the property for \$200,000. C and D's share of the \$200,000 amount realized on the sale is \$100,000 each. C and D each have a basis of \$75,000 in the property and \$20,000 of section 1254 costs with respect to the property. Under these circumstances, C and D each are required to recognize \$20,000 of the \$25,000 gain on the sale of the property as ordinary income under section 1254.

(c) *Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock—(1) General rule.* Except as provided in paragraph (c)(2) of this section, if an S corporation shareholder recognizes gain upon a sale or exchange of stock in the S corporation (determined without regard to section 1254), the gain is treated as ordinary income under section 1254 to the extent of the shareholder's section

1254 costs (with respect to the shares sold or exchanged).

(2) *Exceptions—(i) Gain not attributable to section 1254 costs—(A) General rule.* Paragraph (c)(1) of this section does not apply to any portion of the gain recognized on the sale or exchange of the stock that the taxpayer establishes is not attributable to section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the shareholder of ordinary income under section 1254.

(B) *Substantiation.* To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs so as to qualify for the exception contained in paragraph (c)-(2)(i)(A) of this section, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

(ii) *Transactions entered into as part of a plan to avoid recognition of ordinary income under section 1254.* In the case of a contribution of property prior to a sale or exchange of stock pursuant to a plan a principal purpose of which is to avoid recognition of ordinary income under section 1254, paragraph (c)(1) of this section does not apply. Instead, the amount recognized as ordinary income under section 1254 is the amount of ordinary income the selling or exchanging shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold its natural resource recapture property the disposition of which would have resulted in the recognition of ordinary income under section 1254. The amount recognized as ordinary income under the preceding sentence reduces the amount realized on the sale or exchange of the stock. This reduced amount realized is used in determining

any gain or loss on the sale or exchange.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (c):

*Example 1. Application of general rule upon a sale of S corporation stock.* C and D are equal shareholders in Y, an S corporation. As of January 1, 1995, Y holds two mining properties: Blackacre, with an adjusted basis of \$5,000 and a fair market value of \$35,000, and Whiteacre, with an adjusted basis of \$20,000 and a fair market value of \$15,000. Y also holds securities with a basis of \$5,000 and a fair market value of \$10,000. On January 1, 1995, D sells 50 percent of D's Y stock to E for \$15,000. As of the date of the sale, D's adjusted basis in the Y stock sold is \$7,500, and D has \$18,000 of section 1254 costs with respect to Blackacre and \$12,000 of section 1254 costs with respect to Whiteacre. Under this paragraph (c), the gain recognized by D upon the sale of Y stock is treated as ordinary income to the extent of D's section 1254 costs with respect to the stock sold, unless D establishes that a portion of such excess is not attributable to D's section 1254 costs. However, because D would recognize \$7,500 in ordinary income under section 1254 with respect to the stock sold if Y sold Blackacre (the only asset the disposition of which would result in ordinary income to D under section 1254), the \$7,500 of gain recognized by D upon the sale of D's Y stock is attributable to D's section 1254 costs. Therefore, upon the sale of stock to E, D recognizes \$7,500 of ordinary income under this paragraph (c).

*Example 2. Sale of S corporation stock where gain is not entirely attributable to section 1254 costs.* Assume the same facts as in *Example 1*, except that Blackacre has a fair market value of \$25,000, and the securities have a fair market value of \$20,000. Immediately prior to the sale of stock to E, if Y had sold Blackacre (its only asset the disposition of which would result in the recognition of ordinary income to D under section 1254), D would recognize \$5,000 in ordinary income with respect to the stock sold under section 1254. D attaches a statement to D's tax return for 1995 detailing D's share of the fair market values and bases, and D's section 1254 costs with respect to Blackacre and Whiteacre. Therefore, upon the sale of stock to E, of the \$7,500 gain recognized by D, \$5,000 is ordinary income under this paragraph (c).

*Example 3. Contribution of property prior to sale of S corporation stock as part of a plan to avoid recognition of ordinary income under section 1254.* H owns all of the stock of Z, an S corporation. As of January 1, 1995, H has \$3,000 of section 1254 costs with respect to property P, which is natural resource recapture property and Z's only asset. Property P has an adjusted basis of \$5,000 and a fair market value of \$8,000. H has a basis of \$5,000 in Z stock, which has a fair market value of \$8,000. On January 1, 1995, H contributes securities to Z which have a basis of \$7,000 and a fair market value of \$4,000. On April 15, 1995, H sells all of the Z stock to J for \$12,000. On that date, H's adjusted basis in the Z stock is also \$12,000. Based on all the facts and circumstances, the sale of stock is part of a plan (along with the contribution by H of the securities to Z) that has a principal purpose to avoid recognition of ordinary income under section 1254. Consequently, under paragraph

(c)(2)(ii) of this section, H must recognize \$3,000 as ordinary income under section 1254, the amount of ordinary income that H would recognize as ordinary income under section 1254 if property P were sold at fair market value. In addition, H reduces the amount realized on the sale of the stock (\$12,000) by \$3,000. As a result, H also recognizes a \$3,000 capital loss on the sale of the stock (\$9,000 amount realized less \$12,000 adjusted basis).

(d) *Section 1254 costs of a shareholder.* An S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the shareholder's section 1254 costs with respect to the property in the hands of the S corporation. See §1.1254-1(b)(1) for the definition of section 1254 costs.

(e) *Section 1254 costs of an acquiring shareholder after certain acquisitions—(1) Basis determined under section 1012.* If stock in an S corporation that holds natural resource recapture property is acquired and the acquiring shareholder's basis for the stock is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(2) *Basis determined by reason of the application of section 1014(a).* If stock in an S corporation that holds natural resource recapture property is acquired from a decedent and the acquiring shareholder's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(3) *Basis determined by reason of the application of section 1014(b)(9).* If stock in an S corporation that holds natural resource recapture property is acquired before the death of the decedent, the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands includes the amount, if any, of the section 1254 costs deducted by the acquiring shareholder before the decedent's death, to the extent that the basis of the stock (determined under section 1014(a)) is required to be

reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(4) *Gifts and section 1041 transfers.* If stock is acquired in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, or in a transfer that is described in section 1041(a), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands immediately after the transfer is an amount equal to—

(i) The amount of section 1254 costs with respect to the property held by the corporation in the hands of the transferor immediately before the transfer; minus

(ii) The amount of any gain recognized as ordinary income under section 1254 by the transferor upon the transfer.

(f) *Special rules for former S corporations and former C corporations—(1) Section 1254 costs of an S corporation that was formerly a C corporation.* In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a *pro rata* share of the section 1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.

(2) *Examples.* The following examples illustrate the application of the provisions of paragraph (f)(1) of this section:

*Example 1. Sale of natural resource recapture property held by an S corporation that was formerly a C corporation—*(i) Y is a C corporation that elects to be an S corporation effective January 1, 1996. On that date, Y owns Oil Well, which is natural resource recapture property and a capital asset. Y has section 1254 costs of \$20,000 as of the close of the last taxable year that it was a C corporation. On January 1, 1996, Oil Well has a value of \$200,000 and a basis of \$100,000. Thus, under section 1374, Y's net unrealized built-in gain is \$100,000. Also on that date, Y's basis in Oil Well is allocated to A, Y's sole shareholder, under section 613A(c)(11) and the section 1254 costs are allocated to A under §1.1254-4(f)(1). In addition, A has a basis in A's Y stock of \$100,000.

(ii) On November 1, 1996, Y sells Oil Well for \$250,000. During 1996, Y has taxable income greater than \$100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of \$100,000. Assuming a tax rate of 35 percent on capital gain, Y has a

tax of \$35,000 under section 1374. The tax of \$35,000 is treated as a capital loss under section 1366(f)(2). A has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000) of which \$20,000 is recognized as ordinary income under section 1254, and \$130,000 is recognized as capital gain. Consequently, A recognizes ordinary income of \$20,000 and net capital gain of \$95,000 (\$130,000 minus \$35,000) on the sale.

*Example 2. Sale of stock followed by sale of natural resource recapture property held by an S corporation that was formerly a C corporation—*(i) Assume the same facts as in *Example 1*(i). On November 1, 1996, A sells all of A's Y stock to P for \$250,000. A has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000) of which \$20,000 is recognized as ordinary income under section 1254, and \$130,000 is recognized as capital gain.

(ii) On November 2, 1996, Y sells Oil Well for \$250,000. During 1996, Y has taxable income greater than \$100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of \$100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of \$35,000 under section 1374. The tax of \$35,000 is treated as a capital loss under section 1366(f)(2). P has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000), which is recognized as capital gain. Consequently, P recognizes net capital gain of \$115,000 (\$150,000 minus \$35,000) on the sale.

(3) *Section 1254 costs of a C corporation that was formerly an S corporation.* In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year that the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders' section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A). See paragraph (g)(5) of this section for rules on determining the aggregate amount of the shareholders' section 1254 costs.

(g) *Determination of a shareholder's section 1254 costs upon certain stock transactions—(1) Issuance of stock.* Upon an issuance of stock (whether such stock is newly-issued or had been held as treasury stock) by an S corporation in a reorganization or otherwise—

(i) Each recipient of shares must be allocated a *pro rata* share (determined solely with respect to the shares issued in the transaction) of the aggregate of

the S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance (as determined pursuant to paragraph (g)(5) of this section); and

(ii) Each pre-existing shareholder must reduce his or her section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance by an amount equal to the pre-existing shareholder's section 1254 costs immediately before the issuance multiplied by the percentage of stock of the corporation issued in the transaction.

(2) *Natural resource recapture property acquired in exchange for stock.* If natural resource recapture property is transferred to an S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction, or in a reorganization described in section 368), the S corporation must allocate to its shareholders a *pro rata* share of the S corporation's section 1254 costs with respect to the property immediately after the transaction (as determined under §1.1254-3(b)(1)).

(3) *Treatment of nonvested stock.* Stock issued in connection with the performance of services that is substantially nonvested (within the meaning of §1.83-3(b)) is treated as issued for purposes of this section at the first time it is treated as outstanding stock of the S corporation for purposes of section 1361.

(4) *Exception.* Paragraph (g)(1) of this section does not apply to stock issued in exchange for stock of the same S corporation (as for example, in a recapitalization described in section 368(a)(1)(E)).

(5) *Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation—(i) In general.* The aggregate of S corporation shareholders' section 1254 costs is equal to the sum of each shareholder's section 1254 costs. The S corporation must determine each shareholder's section 1254 costs under either paragraph (g)(5)(i)(A) (written data) or paragraph (g)(5)(i)(B) (assumptions) of this section. The S corporation may determine the section 1254 costs of some shareholders under paragraph (g)(5)(i)(A) of this section and of others under paragraph (g)(5)(i)(B) of this section.

(A) *Written data.* An S corporation may determine a shareholder's section

1254 costs by using written data provided by a shareholder showing the shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation unless the S corporation knows or has reason to know that the written data is inaccurate. If an S corporation does not receive written data upon which it may rely, the S corporation must use the assumptions provided in paragraph (g)(5)(i)(B) of this section in determining a shareholder's section 1254 costs.

(B) *Assumptions.* An S corporation that does not use written data pursuant to paragraph (g)(5)(i)(A) of this section to determine a shareholder's section 1254 costs must use the following assumptions to determine the shareholder's section 1254 costs.

(1) The shareholder deducted his or her share of the amount of deductions under sections 263(c), 616, and 617 in the first year in which the shareholder could claim a deduction for such amounts, unless in the case of expenditures under sections 263(c) or 616 the S corporation elected to capitalize such amounts;

(2) The shareholder was not subject to the following limitations with respect to the shareholder's depletion allowance under section 611, except to the extent a limitation applied at the corporate level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of sections 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

(6) *Examples.* The following examples illustrate the provisions of this paragraph (g):

*Example 1. Transfer of natural resource recapture property to an S corporation in a section 351 transaction.* As of January 1, 1996, A owns all the stock (20 shares) in X, an S corporation. X holds property that is not natural resource recapture property that has a fair market value of \$2,000 and an adjusted basis of \$2,000. On January 1, 1996, B transfers natural resource recapture property, Property P, to X in exchange for 80 shares of X stock in a transaction that qualifies under section 351. Property P has a fair market value of \$8,000 and an adjusted basis of \$5,000. Pursuant to section 351, B does not recognize gain on the transaction. Immediately prior to the transaction, B's section 1254 costs with respect to Property P equaled \$6,000. Under §1.1254-2(c)(1), B does not recognize any gain under section 1254 on the section 351 transaction and, under §1.1254-3(b)(1), X's section 1254 costs with respect to Property P immediately after the contribution equal \$6,000. Under paragraph (g)(2) of this section, each shareholder is allocated a *pro rata* share of X's section 1254

costs. The *pro rata* share of X's section 1254 costs that is allocated to A equals \$1,200 (20 percent interest in X multiplied by X's \$6,000 of section 1254 costs). The *pro rata* share of X's section 1254 costs that is allocated to B equals \$4,800 (80 percent interest in X multiplied by X's \$6,000 of section 1254 costs).

*Example 2. Contribution of money in exchange for stock of an S corporation holding natural resource recapture property.* As of January 1, 1996, A and B each own 50 percent of the stock (50 shares each) in X, an S corporation. X holds natural resource recapture property, Property P, which has a fair market value of \$20,000 and an adjusted basis of \$14,000. A's and B's section 1254 costs with respect to Property P are \$4,000 and \$1,500, respectively. On January 1, 1996, C contributes \$20,000 to X in exchange for 100 shares of X's stock. Under paragraph (g)(1)(i) of this section, X must allocate to C a *pro rata* share of its shareholders' section 1254 costs. Using the assumptions set forth in paragraph (g)(5)(i)(B) of this section, X determines that A's section 1254 costs with respect to natural resource recapture property held by X equal \$4,500. Using written data provided by B, X determines that B's section 1254 costs with respect to Property P equal \$1,500. Thus, the aggregate of X's shareholders' section 1254 costs equals \$6,000. C's *pro rata* share of the \$6,000 of section 1254 costs equals \$3,000 (C's 50 percent interest in X multiplied by \$6,000). Under paragraph (g)(1)(ii) of this section, A's section 1254 costs are reduced by \$2,000 (A's actual section 1254 costs (\$4,000) multiplied by 50 percent). B's section 1254 costs are reduced by \$750 (B's actual section 1254 costs (\$1,500) multiplied by 50 percent).

*Example 3. Merger involving an S corporation that holds natural resource recapture property.* X, an S corporation with one shareholder, A, holds as its sole asset natural resource recapture property that has a fair market value of \$120,000 and an adjusted basis of \$40,000. A has section 1254 costs with respect to the property of \$60,000. For valid business reasons, X merges into Y, an S corporation with one shareholder, B, in a reorganization described in section 368(a)(1)(A). Y holds property that is not natural resource recapture property that has a fair market value of \$120,000 and basis of \$120,000. Under paragraph (c) of this section, A does not recognize ordinary income under section 1254 upon the exchange of stock in the merger because A did not otherwise recognize gain on the merger. Under paragraph (g)(2) of this section, Y must allocate to A and B a *pro rata* share of its \$60,000 of section 1254 costs. Thus, A and B are each allocated \$30,000 of section 1254 costs (50 percent interest in X, each, multiplied by \$60,000).

(h) *Effective date.* This section applies to dispositions of natural resource recapture property by an S corporation (and a former S corporation) and dispositions of S corporation stock occurring after [publication of these regulations as final regulations in the Federal Register].

Margaret Milner Richardson,  
Commissioner of  
Internal Revenue.

## Changes to Excise Tax Rates

### Announcement 96-9

The changes listed below are effective

after December 31, 1995, and will be reflected on Form 720 for the first quarter of 1996, as well as on the next revisions of Forms 4136 and 8849. If these rates are modified by legislation, the IRS will issue another announcement and will revise all forms accordingly.

## I. FUEL TAXES

These changes to the fuel taxes reflect the expiration of the Leaking Underground Storage Tank Trust Fund Tax (LUST) and a reduction in certain aviation-related fuel taxes.

The rates listed below are effective January 1, 1996.

IRS No.	Type of fuel	Tax rate per gallon (in cents)
60	Diesel fuel	24.3
71	Dyed diesel fuel for use in trains	5.55
78	Dyed diesel fuel for use in buses	7.3
61	Special motor fuel (including LPG)	18.3
62	Gasoline	18.3
58	Gasoline sold for gasohol production, 10% alcohol	14.333
73	Gasoline sold for gasohol production, 7.7% alcohol	15.321
74	Gasoline sold for gasohol production, 5.7% alcohol	16.142
59	Gasohol, 10% alcohol	12.9
75	Gasohol, 7.7% alcohol	14.142
76	Gasohol, 5.7% alcohol	15.222
69	Aviation fuel (other than gasoline)	4.3
14	Gasoline used in noncommercial aviation (expired)	0.0
77	Aviation fuel (other than gasoline) for use in commercial aviation	4.3
64	Inland waterways fuel use tax	24.3
101	Compressed natural gas taxed at 48.54 cents per thousand cubic feet remains unchanged	

The rates of tax for the "other alcohol fuels" have decreased and will be listed in the Instructions for Form 720.

## II. LUXURY TAX

The base amount not subject to the luxury tax for passenger vehicles has increased from \$32,000 to \$34,000 effective for sales or uses occurring after December 31, 1995. Get Form 8807, Certain Manufacturers and Retailers Excise Taxes, from the IRS to compute the luxury tax.

## III. TRANSPORTATION TAXES

The excise tax on transportation of persons and property by air and use of international air travel facilities (IRS Nos. 26, 28, and 27) expired December 31, 1995. Travelers that paid for tickets in 1995 for travel in 1996 may be entitled to refunds of the tax. Some airlines are refunding the tax to the traveler. Therefore, contact the airline to discuss its refund policy or get Form 8849, Claim for Refund of Excise

Taxes, from the IRS to obtain a refund. All refund claims submitted to IRS require an original passenger receipt.

## IV. SUPERFUND TAX

The excise tax on domestic and imported petroleum, chemicals, and imported chemical substances (IRS Nos. 53, 16, 54, and 17) expired December 31, 1995.

## V. HOW TO GET FORMS

Forms can be obtained by calling 1-800-829-3676 or downloaded off the IRS home page on Internet at <http://www.irs.ustreas.gov>.

### Deletions from Cumulative List of Organizations Contributions to Which Are Deductible Under Section 170 of the Code

#### Announcement 96-10

The name of an organization that no

longer qualifies as an organization described in section 170(c)(2) of the Internal Revenue Code of 1986 is listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section

170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on (DATE) 1996, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is \$1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Christian Job Center of Colorado, Inc.  
Denver, CO  
Foundation for Airborne Relief  
Long Beach, CA

Southern Legal Defense Foundation  
Raleigh, NC

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**Section 7428(c) Validation of Certain Contributions Made During Pendency of Declaratory Judgment Proceedings**

This announcement serves notice to potential donors that the organization listed below has recently filed a timely declaratory judgment suit under section 7428 of the Code, challenging revocation of its status as an eligible donee under section 170(c)(2).

Protection under section 7428(c) of the Code begins on the date that the notice of revocation is published in the Internal Revenue Bulletin and ends on the date on which a court first determines that an organization is not described in section 170(c)(2), as more particularly set forth in section

7428(c)(1). In the case of individual contributors, the maximum amount of contributions protected during this period is limited to \$1,000.00, with a husband and wife being treated as one contributor. This protection is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for the revocation. This protection also applies (but without limitation as to amount) to organizations described in section 170(c)(2) which are exempt from tax under section 501(a). If the organization ultimately prevails in its declaratory judgment suit, deductibility of contributions would be subject to the normal limitations set forth under section 170.

Southern Legal Defense Foundation  
Raleigh, NC

# Announcement of the Disbarment, Suspension, or Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents and enrolled actuaries are prohibited in any Internal

Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attor-

ney, certified public accountant, enrolled agent or enrolled actuary and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Isdamer, Thomas M.	Crofton, MD	CPA	October 31, 1995 to October 30, 1996
Cacciola, Marlene	Pittsburg, CA	Enrolled Agent	November 9, 1995 to May 8, 1996
Goldman, William D.	Hot Springs, AR	Attorney	November 9, 1995 to November 8, 1996
Armstrong, David L.	Norman, OK	CPA	Indefinite from November 10, 1995
Heckathorn, Ben	Red Oak, TX	CPA/ Attorney	Indefinite from November 28, 1995
Tisdell, Linda	Seattle, WA	Enrolled Agent	November 28, 1995 to May 27, 1997
Webb, Herbert M.	Gainesville, FL	Attorney	December 21, 1995 to June 20, 1997
Hipp, Robert J.	Evanston, IL	CPA	December 28, 1995 to April 27, 1996
Ruff, James M.	Willmar, MN	CPA	January 1, 1996 to March 31, 1996
Mulkerin, John J.	Wheaton, IL	CPA	January 5, 1996 to April 4, 1996
Redwitz, Robert	Irvine, CA	CPA	February 15, 1996 to May 14, 1996
Lind, Stanley L.	Milwaukee, WI	Attorney	March 1, 1996 to February 28, 1997
Dais, Robert E.	Plano, TX	CPA	March 1, 1996 to February 28, 1997

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly

or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled

agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been disbarred from further practice before the Internal Revenue Service:



Name	Address	Designation	Effective Date
Muraskin, David	New York, NY	Attorney	November 6, 1995
Kelsey, Patrick	Poolesville, MD	CPA	November 13, 1995

## Announcement of the Expedited Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under title 31 of the Code of Federal Regulations, section 10.76, the Director of Practice is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years, from the date the expedited proceeding is instituted, (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause; or (2) has been convicted of any crime under title 26 of the United States Code or, of a felony under title 18 of the United States Code involving dishonesty or breach of trust.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal

Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled

agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions of the applicable regulations:

Name	Address	Designation	Date of Suspension
Trebatch, Henry T.	Great Neck, NY	CPA	Indefinite from November 6, 1995
Roomberg, Alan	Minersville, PA	CPA	Indefinite from November 10, 1995
Elfenbein, Emanuel B.	Miami, FL	Enrolled Agent	Indefinite from November 27, 1995
Cerullo, Louis, J.	Boca Raton, FL	CPA	Indefinite from November 27, 1995
Fogel, Harold	St. Paul, MN	CPA	Indefinite from December 13, 1995
Glover, Paul L.	Downers Grove, IL	Attorney	Indefinite from December 13, 1995
Miller, John R.	Akron, OH	Attorney	Indefinite from December 13, 1995
Pofahl, Charles	Dallas, TX	Attorney	Indefinite from December 18, 1995
Walburg, Douglas	Mahtomedi, MN	CPA	Indefinite from December 18, 1995
Hibler, Thomas M.	Plymouth, MI	CPA/ Attorney	Indefinite from December 18, 1995
Oringer, Ronald	Flanders, NJ	CPA	Indefinite from December 29, 1995
Butcher, Frederick	Stillwater, NJ	CPA	Indefinite from December 29, 1995
Tokars, Frederic	Atlanta, GA	Attorney	Indefinite from December 29, 1995
Atkins, Sanford I.	Moreland Hills, OH	Attorney	Indefinite from December 29, 1995

## Definition of Terms

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

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

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

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

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior

ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If

If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

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

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

## Abbreviations

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

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C.—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.

E.O.—Executive Order.  
ER—Employer.  
ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contribution Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
F.R.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign Corporation.  
G.C.M.—Chief Counsel's Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.

PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.  
PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statements of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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<sup>1</sup>A cumulative list of all Revenue Rulings, Revenue Procedures, Treasury Decisions, etc., published in Internal Revenue Bulletins 1995-27 through 1995-52 will be found in Internal Revenue Bulletin 1996-1, dated January 2, 1996.

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\*Denotes entry since last publication

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<sup>1</sup>A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1995-27 through 1995-52 will be found in Internal Revenue Bulletin 1996-1, dated January 2, 1996.

## NOTES

## NOTES

## NOTES