§ 1.7701(l)-3 Recharacterizing financing arrangements involving fast-pay stock.

(a) Purpose and scope. This section is intended to prevent the avoidance of tax by persons participating in fast-pay arrangements (as defined in paragraph (b)(1) of this section) and should be interpreted in a manner consistent with this purpose. This section applies to all fast-pay arrangements. Paragraph (c) of this section recharacterizes certain fast-pay arrangements to ensure the participants are taxed in a manner reflecting the economic substance of the arrangements. Paragraph (f) of this section imposes reporting requirements on certain participants.

(b) Definitions -- (1) Fast-pay arrangement. A fast-pay arrangement is any arrangement in which a corporation has fast-pay stock outstanding for any part of its taxable year.

(2) Fast-pay stock -- (i) Defined. Stock is fast-pay stock if it is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if ---

(A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or

(B) It is issued for an amount that exceeds (by more than a de minimis amount, as determined under the principles of § 1.1273-1(d)) the amount at which the holder can be compelled to dispose of the stock.

(ii) Determination. The determination of whether stock is fast-pay stock is based on all the facts and circumstances, including any related agreements such as options or forward contracts. A related agreement includes any direct or indirect agreement or understanding, oral or written, between the holder of the stock and the issuing corporation, or between the holder of the stock and one or more other shareholders in the corporation. To determine if it is fast-pay stock, stock is examined when issued, and, for stock that is not fast-pay stock when issued, when there is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances. Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d) unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement.
(3) Benefited stock. With respect to any fast-pay stock, all other stock in the corporation (including other fast-pay stock having any significantly different characteristics) is benefited stock.

(c) Recharacterization of certain fast-pay arrangements -- (1) Scope. This paragraph (c) applies to any fast-pay arrangement --

(i) In which the corporation that has outstanding fast-pay stock is a regulated investment company (RIC) (as defined in section 851) or a real estate investment trust (REIT) (as defined in section 856); or

(ii) If the Commissioner determines that a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Internal Revenue Code. Application of this paragraph (c)(1)(ii) is at the Commissioner's discretion, and a determination under this paragraph (c)(1)(ii) applies to all parties to the fast-pay arrangement, including transferees.

(2) Recharacterization. A fast-pay arrangement described in paragraph (c)(1) of this section is recharacterized as an arrangement directly between the benefited shareholders and the fast-pay shareholders. The inception and resulting relationships of the recharacterized arrangement are deemed to be as follows:

(i) Relationship between benefited shareholders and fast-pay shareholders. The benefited shareholders issue financial instruments (the financing instruments) directly to the fast-pay shareholders in exchange for cash equal to the fair market value of the fast-pay stock at the time of issuance (taking into account any related agreements). The financing instruments have the same terms (other than issuer) as the fast-pay stock. Thus, for example, the timing and amount of the payments made with respect to the financing instruments always match the timing and amount of the distributions made with respect to the fast-pay stock.

(ii) Relationship between benefited shareholders and corporation. The benefited shareholders contribute to the corporation the cash they receive for issuing the financing instruments. Distributions made with respect to the fast-pay stock are distributions made by the corporation with respect to the benefited shareholders' benefited stock.

(iii) Relationship between fast-pay shareholders and corporation. For purposes of determining the relationship between the fast-pay shareholders and the corporation, the fast-pay stock is ignored. The corporation is the paying agent of the benefited shareholders with respect to the financing instruments.

(3) Other rules -- (i) Character of the financing instruments. The character of a financing instrument (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances.

(ii) Multiple types of benefited stock. If any benefited stock has any significantly different characteristics from any other benefited stock, the recharacterization rules of this paragraph (c) apply among the different types of benefited stock as appropriate to match the economic substance of the fast-pay arrangement.

(iii) Transactions affecting benefited stock -- (A) Sale of benefited stock. If one person sells benefited stock to another --

(1) In addition to any consideration actually paid and received for the benefited stock, the buyer is deemed to pay and the seller is deemed to receive the amount necessary to terminate the seller's position in the financing instruments at fair market value; and

(2) The buyer is deemed to issue financing instruments to the fast-pay shareholders in exchange for the amount necessary to terminate the seller's position in the financing instruments.

(B) Transactions other than sales. Except for transactions subject to paragraph (c)(3)(iii)(A) of this section, in the case of any transaction affecting benefited stock, the parties to the transaction must make appropriate
adjustments to properly take into account the fast-pay arrangement as characterized under paragraph (c)(2) of this section.

(iv) Adjustment to basis for amounts accrued or paid in taxable years ending before February 27, 1997. In the case of a fast-pay arrangement involving amounts accrued or paid in taxable years ending before February 27, 1997, and recharacterized under this paragraph (c), a benefited shareholder must decrease its basis in any benefited stock (as determined under paragraph (c)(2)(ii) of this section) by the amount (if any) that --

(A) Its income attributable to the benefited stock (reduced by deductions attributable to the financing instruments) for taxable years ending before February 27, 1997, computed by recharacterizing the fast-pay arrangement under this paragraph (c) and by treating the financing instruments as debt; exceeds

(B) Its income attributable to such stock for taxable years ending before February 27, 1997, computed without applying the rules of this paragraph (c).

(d) Prohibition against affirmative use of recharacterization by taxpayers. A taxpayer may not use the rules of paragraph (c) of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Internal Revenue Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the fast-pay arrangement in accordance with its form or its economic substance. For example, if a foreign person acquires fast-pay stock in a REIT and a principal purpose for acquiring such stock is to reduce United States withholding taxes by applying the rules of paragraph (c) of this section, the Commissioner may, for purposes of determining the foreign person's United States tax consequences (including withholding tax), depart from the rules of paragraph (c) of this section and treat the foreign person as holding fast-pay stock in the REIT.

(e) Examples. The following examples illustrate the rules of paragraph (c) of this section:

Example 1. Decline in dividend rate -- (i) Facts. Corporation X issues 100 shares of A Stock and 100 shares of B Stock for $1,000 per share. By its terms, a share of B Stock is reasonably expected to pay a $110 dividend in years 1 through 10 and a $30 dividend each year thereafter. If X liquidates, the holder of a share of B Stock is entitled to a preference equal to the share's issue price. Otherwise, the B Stock cannot be redeemed at either X's or the shareholder's option.

(ii) Analysis. When issued, the B Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. Since the B Stock is structured to have a declining dividend rate, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 2. Issued at a premium -- (i) Facts. The facts are the same as in Example 1 of this paragraph (e) except that a share of B Stock is reasonably expected to pay an annual $110 dividend as long as it is outstanding, and Corporation X has the right to redeem the B Stock for $400 a share at the end of year 10.

(ii) Analysis. The B Stock is structured so that the issue price of the B Stock ($1,000) exceeds (by more than a de minimis amount) the price at which the holder can be compelled to dispose of the stock ($400). Thus, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 3. Planned section 302(d) redemptions -- (i) Facts. Corporation L, a subchapter C corporation, issues 220 shares of common stock for $1,000 per share. No other stock is authorized, but L can issue warrants entitling the holder to acquire L common stock for $3,000 per share until such time as L adopts a plan of liquidation. L can adopt a plan of liquidation if approved by 90 percent of its shareholders. Half of L's stock is purchased by Corporation M, and half by Organization N, which is tax exempt. At the time of purchase, M and N agree that for a period of ten years L will annually redeem (and N will
tender) ten shares of stock in exchange for $12,100 and ten warrants. It is anticipated that, under sections 302 and 301, the annual payment to N will be a distribution of property that is a dividend.

(ii) Analysis. Considering all the facts and circumstances, including the agreement between M and N, L's redemption of N's stock is undertaken with a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. Thus, N's stock is fast-pay stock, M's stock is benefited stock, and the parties have entered into a fast-pay arrangement. Because L is neither a RIC nor a REIT, whether this fast-pay arrangement is recharacterized under paragraph (c) of this section depends on whether the Commissioner determines, under paragraph (c)(1)(ii) of this section, that a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Internal Revenue Code.

Example 4. Recharacterization illustrated -- (i) Facts. On formation, REIT Y issues 100 shares of C Stock and 100 shares of D Stock for $1,000 per share. By its terms, a share of D Stock is reasonably expected to pay a $110 dividend in years 1 through 10 and a $30 dividend each year thereafter. In years 1 through 10, persons holding a majority of the D Stock must consent before Y may take any action that would result in Y liquidating or dissolving, merging or consolidating, losing its REIT status, or selling substantially all of its assets. Thereafter, Y may take these actions without consent so long as the D Stock shareholders receive $400 in exchange for their D Stock.

(ii) Analysis. When issued, the D Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. In addition, the $1,000 issue price of a share of D Stock exceeds the price at which the shareholder can be compelled to dispose of the stock ($400). Thus, the D Stock is fast-pay stock, and the C Stock is benefited stock. Because Y is a REIT, the fast-pay arrangement is recharacterized under paragraph (c) of this section.

(iii) Recharacterization. The fast-pay arrangement is recharacterized as follows:

(A) Under paragraph (c)(2)(i) of this section, the C Stock shareholders are treated as issuing financing instruments to the D Stock shareholders in exchange for $100,000 ($1,000, the fair market value of each share of D Stock, multiplied by 100, the number of shares).

(B) Under paragraph (c)(2)(ii) of this section, the C Stock shareholders are treated as contributing $200,000 to Y (the $100,000 received for the financing instruments, plus the $100,000 actually paid for the C Stock) in exchange for the C Stock.

(C) Under paragraph (c)(2)(ii) of this section, each distribution with respect to the D Stock is treated as a distribution with respect to the C Stock.

(D) Under paragraph (c)(2)(iii) of this section, the C Stock shareholders are treated as making payments with respect to the financing instruments, and Y is treated as the paying agent of the financing instruments for the C Stock shareholders.

Example 5. Transfer of benefited stock illustrated -- (i) Facts. The facts are the same as in Example 4 of this paragraph (e). Near the end of year 5, a person holding one share of C Stock sells it for $1,300. The buyer is unrelated to REIT Y or to any of the D Stock shareholders. At the time of the sale, the amount needed to terminate the seller's position in the financing instruments at fair market value is $747.

(ii) Benefited shareholder's treatment on sale. Under paragraph (c)(3)(iii)(A) of this section, the seller's amount realized is $2,047 ($1,300, the amount actually received, plus $747, the amount necessary to terminate the seller's position in the financing instruments at fair market value). The seller's gain on the sale of the common stock is $47 ($2,047, the amount realized, minus $2,000, the seller's basis in the common stock). The
seller has no income or deduction with respect to terminating its position in the financing instruments.

(iii) Buyer's treatment on purchase. Under paragraph (c)(3)(iii)(A) of this section, the buyer's basis in the share of D Stock is $2,047 ($1,300, the amount actually paid, plus $747, the amount needed to terminate the seller's position in the financing instruments at fair market value). Under paragraph (c)(3)(iii)(B) of this section, simultaneous with the sale, the buyer is treated as issuing financing instruments to the fast-pay shareholders in exchange for $747, the amount necessary to terminate the seller's position in the financing instruments at fair market value.

Example 6. Fast-pay arrangement involving amounts accrued or paid in a taxable year ending before February 27, 1997 -- (i) Facts. Y is a calendar year taxpayer. In June 1996, Y acquires shares of REIT T benefited stock for $15,000. In December 1996, Y receives dividends of $100. Under the recharacterization rules of paragraph (c)(2) of this section, Y's 1996 income attributable to the benefited stock is $1,200, Y's 1996 deduction attributable to the financing instruments is $500, and Y's basis in the benefited stock is $25,000.

(ii) Analysis. Under paragraph (c)(3)(iv) of this section, Y's basis in the benefited stock is reduced by $600. This is the amount by which Y's 1996 income from the fast-pay arrangement as recharacterized under this section ($1,200 of income attributable to the benefited stock less $500 of deductions attributable to the financing instruments), exceeds Y's 1996 income from the fast-pay arrangement as not recharacterized under this section ($100 of income attributable to the benefited stock). Thus, in 1997 when the fast-pay arrangement is recharacterized, Y's basis in the benefited stock is $24,400.

(f) Reporting requirement -- (1) Filing requirements -- (i) In general. A corporation that has fast-pay stock outstanding at any time during the taxable year must attach the statement described in paragraph (f)(2) of this section to its federal income tax return for such taxable year. This paragraph (f)(1)(i) does not apply to a corporation described in paragraphs (f)(1)(ii), (iii), or (iv) of this section.

(ii) Controlled foreign corporation. In the case of a controlled foreign corporation (CFC), as defined in section 957, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a CFC), each controlling United States shareholder (within the meaning of §1.964-1(c)(5)) must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 5471 for the CFC's taxable year. The provisions of section 6038 and the regulations under section 6038 apply to any statement required by this paragraph (f)(1)(ii).

(iii) Foreign personal holding company. In the case of a foreign personal holding company (FPHC), as defined in section 552, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a FPHC), each United States citizen or resident who is an officer, director, or 10-percent shareholder (within the meaning of section 6035(e)(1)) of such FPHC must attach the statement described in paragraph (f)(2) of this section to his or her Form 5471 for the FPHC's taxable year. The provisions of sections 6035 and 6679 and the regulations under sections 6035 and 6679 apply to any statement required by this paragraph (f)(1)(iii).

(iv) Passive foreign investment company. In the case of a passive foreign investment company (PFIC), as defined in section 1297, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a PFIC), each shareholder that has elected (under section 1295) to treat the PFIC as a qualified electing fund and knows or has reason to know that the PFIC has outstanding fast-pay stock must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 8621 for the PFIC's taxable year. Each shareholder owning 10 percent or more of the shares of the PFIC (by vote or value) is presumed to know that the PFIC has issued fast-pay stock. The provisions of sections 1295(a)(2) and 1298(f) and the regulations under those
sections (including § 1.1295-1T(f)(2)) apply to any statement required by this paragraph (f)(1)(iv).

(2) Statement. The statement required under this paragraph (f) must say, "This fast-pay stock disclosure statement is required by § 1.7701(l)-3(f) of the income tax regulations." The statement must also identify the corporation that has outstanding fast-pay stock and must contain the date on which the fast-pay stock was issued, the terms of the fast-pay stock, and (to the extent the filing person knows or has reason to know such information) the names and taxpayer identification numbers of the shareholders of any stock that is not traded on an established securities market (as described in § 1.7704-1(b)).

(g) Effective date -- (1) In general. Except as provided in paragraph (g)(4) of this section (relating to reporting requirements), this section applies to taxable years ending after February 26, 1997. Thus, all amounts accrued or paid during the first taxable year ending after February 26, 1997, are subject to this section.

(2) Election to limit taxable income attributable to a recharacterized fast-pay arrangement for periods before April 1, 2000 -- (i) Limit. For periods before April 1, 2000, provided the shareholder recharacterizes the fast-pay arrangement consistently for all such periods, a shareholder may limit its taxable income attributable to a fast-pay arrangement recharacterized under paragraph (c) of this section to the taxable income that results if the fast-pay arrangement is recharacterized under either --

(A) Notice 97-21, 1997-1 C.B. 407, see § 601.601(d)(2) of this chapter; or

(B) Paragraph (c) of this section, computed by assuming the financing instruments are debt.

(ii) Adjustment and statement. A shareholder that limits its taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section must include as an adjustment to taxable income the excess, if any, of the amount determined under paragraph (g)(2)(i)(B) of this section, over the amount determined under paragraph (g)(2)(i)(A) of this section. This adjustment to taxable income must be made in the shareholder's first taxable year that includes April 1, 2000. A shareholder to which this paragraph (g)(2)(ii) applies must include a statement in its books and records identifying each fast-pay arrangement for which an adjustment must be made and providing the amount of the adjustment for each such fast-pay arrangement.

(iii) Examples. The following examples illustrate the rules of this paragraph (g)(2). For purposes of these examples, assume that a shareholder may limit its taxable income under this paragraph (g)(2) for periods before January 1, 2000.

Example 1. Fast-pay arrangement recharacterized under Notice 97-21; REIT holds third-party debt -- (i) Facts. (A) REIT Y is formed on January 1, 1997, at which time it issues 1,000 shares of fast-pay stock and 1,000 shares of benefited stock for $100 per share. Y and all of its shareholders are U.S. persons and have calendar taxable years. All shareholders of Y have elected to accrue market discount based on a constant interest rate, to include the market discount in income as it accrues, and to amortize bond premium.

(B) For years 1 through 5, the fast-pay stock has an annual dividend rate of $17 per share ($17,000 for all fast-pay stock); in later years, the fast-pay stock has an annual dividend rate of $1 per share ($1,000 for all fast-pay stock). At the end of year 5, and thereafter, a share of fast-pay stock can be acquired by Y in exchange for $50 ($50,000 for all fast-pay stock).

(C) On the day Y is formed, it acquires a five-year mortgage note (the note) issued by an unrelated third party for $200,000. The note provides for annual interest payments on December 31 of $18,000 (a coupon interest rate of 9.00 percent, compounded annually), and one payment of principal at the end of 5 years. The note can be prepaid, in whole or in part, at any time.
(ii) Recharacterization under Notice 97-21 -- (A) In general. One way to recharacterize the fast-pay arrangement under Notice 97-21 is to treat the fast-pay shareholders and the benefited shareholders as if they jointly purchased the note from the issuer with the understanding that over the five-year term of the note the benefited shareholders would use their share of the interest to buy (on a dollar-for-dollar basis) the fast-pay shareholders' portion of the note. The benefited shareholders' and the fast-pay shareholders' yearly taxable income under Notice 97-21 can then be calculated after determining their initial portions of the note and whether those initial portions are purchased at a discount or premium.

(B) Determining initial portions of the debt instrument. The fast-pay shareholders' and the benefited shareholders' initial portions of the note can be determined by comparing the present values of their expected cash flows. As a group, the fast-pay shareholders expect to receive cash flows of $135,000 (five annual payments of $17,000, plus a final payment of $50,000). As a group, the benefited shareholders expect to receive cash flows of $155,000 (five annual payments of $1,000, plus a final payment of $150,000). Using a discount rate equal to the yield to maturity (as determined under § 1.1272-1(b)(1)(i)) of the mortgage note (9.00 percent, compounded annually), the present value of the fast-pay shareholders' cash flows is $98,620, and the present value of the benefited shareholders' cash flows is $101,380. Thus, the fast-pay shareholders initially acquire 49 percent of the note at a $1,380 premium (that is, they paid $100,000 for $98,620 of principal in the note). The benefited shareholders initially acquire 51 percent of the note at a $1,380 discount (that is, they paid $100,000 for $98,620 of principal in the note). Under section 171, the fast-pay shareholders' premium is amortizable based on their yield in their initial portion of the note (8.574 percent, compounded annually). The benefited shareholders' discount accrues based on the yield in their initial portion of the note (9.353 percent, compounded annually).

(C) Taxable income under Notice 97-21 -- (1) Fast-pay shareholders. Under Notice 97-21, the fast-pay shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by subtracting the amortizable premium from the accrued interest on the fast-pay shareholders' portion of the note. For purposes of paragraph (g)(2)(i)(A) of this section, the fast-pay shareholders' taxable income as a group is as follows:

<table>
<thead>
<tr>
<th>Taxable period</th>
<th>Interest income</th>
<th>Amortizable premium</th>
<th>Taxable income 1/1/97-12/31/97</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/98-12/31/98</td>
<td>8,145</td>
<td>(293)</td>
<td>7,852</td>
</tr>
<tr>
<td>1/1/99-12/31/99</td>
<td>7,348</td>
<td>(281)</td>
<td>7,067</td>
</tr>
<tr>
<td>Total</td>
<td>24,369</td>
<td>(876)</td>
<td>23,493</td>
</tr>
</tbody>
</table>

(2) Benefited shareholders. Under Notice 97-21, the benefited shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by adding the accrued discount to the accrued interest on the benefited shareholders' portion of the note. For purposes of paragraph (g)(2)(i)(A) of this section, the benefited shareholders' taxable income as a group is as follows:

<table>
<thead>
<tr>
<th>Taxable period</th>
<th>Interest income</th>
<th>Accrued discount</th>
<th>Taxable income 1/1/97-12/31/97</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/98-12/31/98</td>
<td>9,855</td>
<td>251</td>
<td>10,106</td>
</tr>
<tr>
<td>1/1/99-12/31/99</td>
<td>10,652</td>
<td>274</td>
<td>10,926</td>
</tr>
<tr>
<td>Total</td>
<td>29,631</td>
<td>754</td>
<td>30,385</td>
</tr>
</tbody>
</table>
(iii) Taxable income under the recharacterization of this section -- (A) Fast-pay shareholders. Under paragraphs (c) and (g)(2)(i)(B) of this section, the fast-pay shareholders' taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, is the interest deemed paid on the financing instruments. For purposes of paragraph (g)(2)(i)(B) of this section, the fast-pay shareholders' taxable income as a group is as follows:

<table>
<thead>
<tr>
<th>Taxable period</th>
<th>Taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/97-12/31/97</td>
<td>$8,574</td>
</tr>
<tr>
<td>1/1/98-12/31/98</td>
<td>7,852</td>
</tr>
<tr>
<td>1/1/99-12/31/99</td>
<td>7,067</td>
</tr>
<tr>
<td>Total</td>
<td>23,493</td>
</tr>
</tbody>
</table>

(B) Benefited shareholders. Under paragraphs (c) and (g)(2)(i)(B) of this section, the benefited shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by subtracting the interest deemed paid on the financing instruments from the dividends actually and deemed paid on the benefited stock. For purposes of paragraph (g)(2)(i)(B) of this section, the benefited shareholders' taxable income as a group is as follows:

<table>
<thead>
<tr>
<th>Taxable period</th>
<th>Dividends paid on benefited stock</th>
<th>Interest paid on financing instruments</th>
<th>Taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/97-12/31/97</td>
<td>18,000</td>
<td>(7,852)</td>
<td>10,148</td>
</tr>
<tr>
<td>1/1/99-12/31/99</td>
<td>18,000</td>
<td>(7,067)</td>
<td>10,933</td>
</tr>
<tr>
<td>Total</td>
<td>54,000</td>
<td>(23,493)</td>
<td>30,507</td>
</tr>
</tbody>
</table>

(iv) Limit on taxable income under paragraph (g)(2)(i) of this section -- (A) Fast-pay shareholders. For periods before January 1, 2000, the fast-pay shareholders have the same taxable income under the recharacterization of Notice 97-21 and paragraph (g)(2)(i)(A) of this section ($23,493) as they have under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section ($23,493). Thus, under paragraph (g)(2)(i) of this section, the fast-pay shareholders may limit their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, to $23,493 (as a group).

(B) Benefited shareholders. For periods before January 1, 2000, the benefited shareholders have taxable income attributable to the fast-pay arrangement of $30,385 under the recharacterization of Notice 97-21 and paragraph (g)(2)(i)(A) of this section, and taxable income of $30,507 under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section. Thus, under paragraph (g)(2)(i) of this section, the benefited shareholders may limit their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, to either $30,385 (as a group) or $30,507 (as a group).

(v) Adjustment to taxable income under paragraph (g)(2)(ii) of this section. Under paragraph (g)(2)(ii) of this section, any benefited shareholder that limited its taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section must include as an adjustment to taxable income the excess, if any, of the amount determined under paragraph (g)(2)(i)(B) of this section, over the amount determined under paragraph (g)(2)(i)(A) of this section. If all benefited shareholders limited their taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section, then as a group their adjustment to income is $122 ($30,507, minus $30,385). Each shareholder must include its adjustment in income for the taxable year that includes January 1, 2000.

Example 2. REIT holds debt issued by a benefited shareholder -- (i) Facts. The facts are the same as in Example 1 of this paragraph (g)(2) except that
corporation Z holds 800 shares (80 percent) of the benefited stock, and Z, instead of a third party, issues the mortgage note acquired by Y.

(ii) Recharacterization under Notice 97-21. Because Y holds a debt instrument issued by Z, the fast-pay arrangement is recharacterized under Notice 97-21 as an arrangement in which Z issued one or more instruments directly to the fast-pay shareholders and the other benefited shareholders.

(A) Fast-pay shareholders. Consistent with this recharacterization, Z is treated as issuing a debt instrument to the fast-pay shareholders for $100,000. The debt instrument provides for five annual payments of $17,000 and an additional payment of $50,000 in year five. Thus, the debt instrument's yield to maturity is 8.574 percent per annum, compounded annually.

(B) Benefited shareholders. Z is also treated as issuing a debt instrument to the other benefited shareholders for $20,000 (200 shares multiplied by $100, or 20 percent of the $100,000 paid to Y by the benefited shareholders as a group). This debt instrument provides for five annual payments of $200 and an additional payment of $30,000 in year five. The debt instrument's yield to maturity is 9.304 percent per annum, compounded annually.

(C) Issuer's interest expense under Notice 97-21. Under Notice 97-21, Z's interest expense attributable to the fast-pay arrangement for periods before January 1, 2000, equals the interest accrued on the debt instrument held by the fast-pay shareholders, plus the interest accrued on the debt instrument held by the benefited shareholders other than Z. For purposes of paragraph (g)(2)(i)(A) of this section, Z's interest expense is as follows:

<table>
<thead>
<tr>
<th>Taxable period</th>
<th>Accrued interest</th>
<th>Accrued interest</th>
<th>Total interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>fast-pay shareholders</td>
<td>benefited shareholders</td>
<td>expense</td>
</tr>
<tr>
<td>1/1/98-12/31/97</td>
<td>(7,852)</td>
<td>(2,015)</td>
<td>(9,867)</td>
</tr>
<tr>
<td>1/1/99-12/31/99</td>
<td>(7,067)</td>
<td>(2,184)</td>
<td>(9,251)</td>
</tr>
<tr>
<td>Total</td>
<td>(23,939)</td>
<td>(6,199)</td>
<td>(29,553)</td>
</tr>
</tbody>
</table>

(iii) Recharacterization under this section. Under paragraphs (c) and (g)(2)(i)(B) of this section, Z's taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, equals Z's share of the dividends actually and deemed paid on the benefited stock (80 percent of the outstanding benefited stock), reduced by the sum of the interest accrued on the note held by Y and the interest accrued on the financing instruments deemed to have been issued by Z. For purposes of paragraph (g)(2)(i)(B) of this section, Z's taxable income is as follows:

<table>
<thead>
<tr>
<th>Taxable period</th>
<th>Dividends benefited stock</th>
<th>Accrued interest on debt held by Y</th>
<th>Accrued interest on financing instruments</th>
<th>Taxable expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/98-12/31/97</td>
<td>14,400</td>
<td>(18,000)</td>
<td>(6,281)</td>
<td>(9,881)</td>
</tr>
<tr>
<td>1/1/99-12/31/99</td>
<td>14,400</td>
<td>(18,000)</td>
<td>(5,654)</td>
<td>(9,254)</td>
</tr>
<tr>
<td>Total</td>
<td>43,200</td>
<td>(54,000)</td>
<td>(18,794)</td>
<td>(29,594)</td>
</tr>
</tbody>
</table>

(iv) Limit on taxable income under this paragraph (g)(2). For periods before January 1, 2000, Z has a taxable loss attributable to the fast-pay arrangement of $29,553 under the recharacterization of Notice 97-21 and paragraph (g)(2)(i)(A) of this section, and a taxable loss of $29,594 under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section. Thus,
under paragraph (g)(2)(i) of this section, Z may report a taxable loss attributable to the fast-pay arrangement for periods before January 1, 2000, of either $29,553 or $29,594. Under paragraph (g)(2)(ii), Z has no adjustment to its taxable income for its taxable year that includes January 1, 2000.

(3) Rule to comply with this section. To comply with this section for each taxable year in which it failed to do so, a taxpayer should file an amended return. For taxable years ending before January 10, 2000, a taxpayer that has complied with Notice 97-21, 1997-1 C.B. 407 (see §601.601(d)(2) of this chapter), for all such taxable years is considered to have complied with this section and limited its taxable income under paragraph (g)(2)(i)(A) of this section.

(4) Reporting requirements. The reporting requirements of paragraph (f) of this section apply to taxable years (of the person required to file the statement) ending after January 10, 2000.

HISTORY: [T.D. 8853, 65 FR 1310, 1313, Jan. 10, 2000, as corrected at 65 FR 16316, 16317, Mar. 28, 2000]

AUTHORITY: AUTHORITY NOTE APPLICABLE TO ENTIRE PART:


NOTES: Section 1.7701(l)-3 also issued under 26 U.S.C. 7701(l).

[EFFECTIVE DATE NOTE: 65 FR 1310, 1313, Jan. 10, 1999, added this section, effective Feb. 27, 1997.]

NOTES APPLICABLE TO ENTIRE CHAPTER:

EDITORIAL NOTE: IRS published a document at 45 FR 6088, Jan. 25, 1980, deleting statutory sections from their regulations. In Chapter I, cross references to the deleted material have been changed to the corresponding sections of the IRS Code of 1954 or to the appropriate regulations sections. When either such change produced a redundancy, the cross reference has been deleted. For further explanation, see 45 FR 20795, March 31, 1980.

[The OMB control numbers for title 26 appear in §§ 601.9000 and 602.101 of this chapter.]

NOTES APPLICABLE TO ENTIRE SUBCHAPTER:


EDITORIAL NOTE: Treasury Decision 6091, 19 FR 5167, Aug. 17, 1954, provides in part as follows:

PARAGRAPH 1. All regulations (including all Treasury decisions) prescribed by, or under authority duly delegated by, the Secretary of the Treasury, or jointly by the Secretary and the Commissioner of Internal Revenue, or by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, or jointly by the Commissioner of Internal Revenue and the Commissioner of Customs or the Commissioner of Narcotics with the approval of the Secretary of the Treasury, applicable under any provision of law in effect on the date of enactment of the Code, to the extent such provision of law is repealed by the Code, are hereby prescribed under and made applicable to the provisions of the Code corresponding to the provision of law so repealed insofar as any such regulation is not inconsistent with the Code. Such regulations shall become effective as regulations under the various provisions of the Code as of the dates the corresponding provisions of law are repealed by the Code, until superseded by regulations issued under the Code.
PAR. 2. With respect to any provision of the Code which depends for its application upon the promulgation of regulations or which is to be applied in such manner as may be prescribed by regulations, all instructions or rules in effect immediately prior to the enactment of the Code, to the extent such instructions or rules could be prescribed as regulations under authority of such provision of the Code, shall be applied as regulations under such provision insofar as such instructions or rules are not inconsistent with the Code. Such instructions or rules shall be applied as regulations under the applicable provision of the Code as of the date such provision takes effect.

PAR. 3. If any election made or other act done pursuant to any provision of the Internal Revenue Code of 1939 or prior internal revenue laws would (except for the enactment of the Code) be effective for any period subsequent to such enactment, and if corresponding provisions are contained in the Code, such election or other act shall be given the same effect under the corresponding provisions of the Code to the extent not inconsistent therewith. The term "act" includes, but is not limited to, an allocation, identification, declaration, agreement, option, waiver, relinquishment, or renunciation.

PAR. 4. The limits of the various internal revenue districts have not been changed by the enactment of the Code. Furthermore, delegations of authority made pursuant to the provisions of Reorganization Plan No. 26 of 1950 and Reorganization Plan No. 1 of 1952 (as well as redelegation thereunder), including those governing the authority of the Commissioner of Internal Revenue, the Regional Commissioners of Internal Revenue, or the District Directors of Internal Revenue, are applicable to the provisions of the Code to the extent consistent therewith.