Internal Revenue bulletin

Bulletin No. 2002–14
April 8, 2002

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.

SPECIAL ANNOUNCEMENTS

Announcement 2002–41, page 739.
The Director of Practice has extended all enrollment cards of enrolled agents until April 30, 2002.

Announcement 2002–42, page 739.
The Director of Practice has extended all existing continuing professional education sponsor agreements through August 31, 2002.

INCOME TAX

Rev. Rul. 2002–17, page 716.
Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2002.

T.D. 8985, page 707.
Final regulations under section 1221 of the Code relate to the determination of the character of gain or loss from hedging transactions.

Notice 2002–21, page 730.
This notice addresses a transaction generating tax losses based on an inflated basis in assets acquired from another party. The inflated basis is claimed as a result of a transfer of assets in which a taxpayer becomes jointly and severally liable on indebtedness of the transferor, with the indebtedness having a stated principal amount substantially in excess of the fair market value of the assets transferred. The notice states that the taxpayer's basis in the assets transferred is equal to the fair market value of such assets upon their acquisition by the taxpayer rather than the stated principal amount of the indebtedness.

Rev. Proc. 2002–20, page 732.
Guidance is provided to individuals who fail to meet the eligibility requirements of section 911(d)(1) of the Code because adverse conditions in a foreign country preclude the individual from meeting those requirements. A current list of countries and the dates those countries are subject to the section 911(d)(4) waiver is provided. Rev. Proc. 2001–27 supplemented.

EXEMPT ORGANIZATIONS

Announcement 2002–39, page 738.
Section 911(d)(4) waiver. This document contains corrections to final regulations (T.D. 8978, 2002–7 I.R.B. 500) relating to the excise taxes on excess benefit transactions.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXCISE TAX

Ct. D. 2073, page 718.
The Supreme Court has concluded, that under sections 4401(a), 1441, 3402(q), 6041, and 6050I of the Code, tribes are not exempt from paying the gambling-related taxes that Chapter 35 of the Code imposes. **Chickasaw Nation v. United States.**

Announcement 2002–39, page 738.
This document contains corrections to final regulations (T.D. 8978, 2002–7 I.R.B. 500) relating to the excise taxes on excess benefit transactions.

TAX CONVENTIONS

Page 725.
The bilateral agreement between the United States and the Republic of Ghana, providing for the reciprocal tax exemption of income from the international operation of ships and/or aircraft, is set forth.

ADMINISTRATIVE

Notice 2002–22, page 731.
Guidance priority list. Public comments are requested about items that should be included in the Guidance Priority List for 2002–2003. All comments should be submitted by April 30, 2002.

Rev. Proc. 2002–22, page 733.
Undivided fractional interests in real estate. This procedure specifies the conditions under which the Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity within the meaning of section 301.7701–3 of the regulations. Rev. Proc. 2000–46 superseded. Rev. Proc. 2002–3 modified.

Announcement 2002–38, page 738.
This document contains corrections to proposed regulations (REG–112991–01, 2002–4 I.R.B. 404) relating to the computation of the research credit.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

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

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

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

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

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

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

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

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

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

26 CFR 1.267(a)–1: Deductions disallowed.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

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

The adjusted applicable federal long-term rate is set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 511.—Imposition of Tax on Unrelated Business Income of Charitable, etc., Organizations

26 CFR 1.511–1: Imposition and rates of tax.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 512.—Unrelated Business Taxable Income

26 CFR 1.512(a)–1: Definition.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 707.—Transactions Between Partner and Partnership

26 CFR 1.707–1: Transactions between partner and partnership.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 761.—Terms Defined

26 CFR 1.761–1: Terms defined.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 856.—Definition of Real Estate Investment Trust

26 CFR 1.856–1: Definition of real estate investment trust.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 1031.—Exchange of Property Held For Productive Use or Investment

26 CFR 1.1031(a)–1: Property held for productive use in trade or business or for investment.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 1221.—Capital Asset Defined

26 CFR 1.1221–2: Hedging transactions.

T.D. 8985

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

Hedging Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the character of gain or loss from hedging transactions. The regulations reflect changes to the law made by the Ticket to Work and Work Incentives Improvement Act of 1999. The regulations affect businesses entering into hedging transactions.

DATES: *Effective Date*: These regulations are effective March 20, 2002.

Applicability Dates: For dates of applicability of these regulations, see the discussion in the Dates of Applicability paragraph in the Supplementary Information portion of the preamble.

FOR FURTHER INFORMATION CONTACT: Elizabeth Handler, (202) 622–3930 or Viva Hammer at (202) 622–0869 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1480. Some responses to these collections of information are mandatory, and others are required to obtain the benefit of the separate-entity election.

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

The estimated annual burden per respondent or recordkeeper varies from .1 to 40 hours, depending on individual circumstances, with an estimated average of 5.9 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, W:CAR: MP:FP:S, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

This document contains amendments to 26 CFR Part 1 under section 1221 of the Internal Revenue Code (Code). Prior to amendment in 1999, section 1221 generally defined a capital asset as property held by the taxpayer other than: (1) Stock in trade or other types of assets includible in inventory; (2) property used in a trade or business that is real property or property subject to depreciation; (3) certain copyrights (or similar property); (4) accounts or notes receivable acquired in the ordinary course of a trade or business; and (5) U.S. government publications.

In 1994, the IRS published in the **Federal Register** (T.D. 8555, 1994–2 C.B. 180 [59 FR 36360]) final Treasury regulations under section 1221 providing for ordinary character treatment for certain business hedges. The regulations generally apply to transactions that reduce risk with respect to ordinary property, ordinary obligations, and borrowings of the taxpayer and that meet certain identification requirements. (§ 1.1221–2). In 1996, the IRS published in the **Federal Register** (T.D. 8653, 1996–1 C.B. 67 [61 FR 517]) final regulations on the character and timing of gain or loss from hedging transactions entered into by members of a consolidated group. In this preamble, the final regulations published in 1994 and 1996 are referred to collectively as the Treasury regulations.

On December 17, 1999, section 1221 was amended by section 532 of the Ticket to Work and Work Incentives Improvement Act of 1999 (113 Stat 1860) to provide ordinary gain or loss treatment for hedging transactions and consumable supplies. Section 1221(a)(7) provides ordinary treatment for hedging transactions that are clearly identified as such before the close of the day on which they were acquired, originated, or entered into.

The statute defines a hedging transaction as a transaction entered into by the taxpayer in the normal course of business primarily to manage risk of interest rate, price changes, or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the taxpayer. Sections 1221(b)(2)(A)(i) and (ii). The statutory definition of hedging transaction also includes transactions to manage such other risks as the Secretary may prescribe in regulations. Section 1221(b)(2)(A)(iii). Further, the statute grants the Secretary the authority to provide regulations to address the treatment of nonidentified or improperly identified hedging transactions, and hedging transactions involving related parties (sections 1221(b)(2)(B) and (b)(3), respectively). The statutory hedging provisions are effective for transactions entered into on or after December 17, 1999. Congress intended that the hedging rules be the exclusive means through which the gains and losses from hedging transactions are treated as ordinary. S. Rep. No. 201, 106th Cong., 1st Sess. 25 (1999).

Section 1221(a)(8) provides that supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business are not capital assets. That provision is effective for supplies held or acquired on or after December 17, 1999.

A notice of proposed rulemaking (REG–107047–00, 2001–14 I.R.B. 1002) was published in the **Federal Register** (66 FR 4738) on January 18, 2001. On May 16, 2001, the IRS held a public hearing on the proposed regulations. Written comments responding to the notice of proposed rulemaking were also received. In response to these comments, the proposed regulations were modified and as so modified are adopted as final regulations. The principal changes to the proposed regulations are discussed below.

Explanation of Provisions

Coordination with International Provisions of the Code

The provisions of these regulations generally apply to determine the character of gain or loss from transactions that are also subject to various international provisions of the Code. Paragraph (a)(4) of the regulations, however, provides that the character of gain or loss on section 988 transactions is not determined under these regulations because gain or loss on those transactions is ordinary under section 988(a)(1). In addition, no implication is intended as to what constitutes "risk management" or "managing risk" for purposes of proposed or final regulations under section 482.

Paragraph (a)(4) of the proposed regulations provided that the definition of a hedging transaction under § 1.1221–2(b) of the proposed regulations would apply for purposes of certain other international provisions of the Code only to the extent provided in regulations issued under those provisions. Technical changes have been made in the final regulations to eliminate references to proposed regulations as well as Code sections for which the relevant regulations have not been issued in final form. Subsequent regulations will specify the extent to which the rules relating to hedging transactions that are contained in § 1.1221–2 will be applicable for purposes of those other regulations and related Code sections.

Risk Management Standard

Several commentators noted that the proposed regulations used risk reduction as the operating standard to implement the risk management definition of hedging introduced by section 1221(b)(2)(A). These commentators found that risk reduction is too narrow a standard to encompass the intent of Congress which defined hedges to include transactions that manage risk of interest rate, price changes or currency fluctuations. They urged the IRS and Treasury to adopt a broader definition of hedging to reflect Congress' intent. With one exception, the commentators did not suggest a definition of risk management.

In response to these comments, the final regulations have been restructured to implement the risk management standard. No definition of risk management is provided, but instead, the rules characterize a variety of classes of transactions as hedging transactions because they manage risk. Risk reducing transactions still qualify as one class of hedging transactions, but there are also others. In addition, specific provision is made for the recognition of additional types of qualifying risk management transactions through published guidance or private letter rulings. Under the final regulations, as under the proposed regulations, transactions entered into for speculative purposes will not qualify as hedging transactions. See S. Rep. No. 201, 106th Cong., 1st Sess. 24 (1999).

Application on the Basis of Separate Business Units

The proposed regulations provided that a taxpayer has risk of a particular type only if it is at risk when all of its operations are considered. That is, risk must exist on a "macro" basis. For this purpose, under the proposed regulations, a taxpayer has to show that hedges of particular assets or liabilities, or groups of assets or liabilities, are reasonably expected to reduce the overall risk of the taxpayer's operations.

Commentators pointed out that this entity-based approach to hedging is no longer uniform business practice. Instead, businesses often conduct risk management on a business unit by business unit basis. In response to these comments, the final regulations permit the determination of whether a transaction manages risk to be made on a business unit basis provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. An example was added to the final regulations in which for one taxpayer, the determination of whether hedging activities reduce risk is made at the business unit level. In the example, the conduct of risk management activities within separate business units is undertaken as part of a program to reduce the overall risk of the taxpayer's operations.

Fixed-to-floating Interest Rate Hedges

Paragraph (c)(1) of the proposed regulations recognized that a transaction that economically converts an interest rate or price from a fixed rate or price to a floating rate or price may manage risk. Commentators suggested that the rule in the proposed regulations provides insufficient guidance in that it states only that fixed-to-floating interest rate or price hedges may be hedging transactions. In response to these comments, the regulations have been restructured to separately address interest rate hedges and price hedges.

Commentators suggested that in the case of interest rate conversions, a taxpayer may choose to convert from a floating to a fixed rate to fix the amount payable on the obligation. However, a taxpayer could also elect to convert from a fixed to a floating rate to insure that the value of the liability remained relatively constant. In response to these comments, the final regulations provide that a transaction that converts an interest rate from a fixed rate to a floating rate or from a floating rate to a fixed rate manages risk. With respect to fixed-to-floating price hedges, the final regulations adopt the proposed rules without change.

Transactions Not Entered into Primarily to Manage Risk

Paragraph (c)(3) of the proposed regulations provided that the purchase or sale of certain assets will not qualify as a hedging transaction if the assets are not acquired primarily to manage risk. This rule was illustrated by the example of a taxpayer that has an interest rate risk from a floating rate borrowing and that acquires debt instruments bearing a comparable floating interest rate. Although the taxpayer's interest rate risk from the floating rate borrowing may be reduced by the purchase of the floating rate debt instruments, the proposed regulations provided that the acquisition of the debt instruments is not made primarily to reduce risk and, therefore, is not a hedging transaction.

The IRS and Treasury understand that some employers may invest in assets (such as shares of a mutual fund) that are used as a reference investment for purposes of computing their liability to employees under a nonqualified deferred compensation plan. A question may arise whether such an investment may constitute a hedging transaction and, if so, whether income from the investment may be deferred by the employer until payments of deferred compensation are made to employees. See § 1.446–4(b); but compare *Albertson's, Inc. v. Commissioner*, 42 F.3d 537 (9th Cir. 1994).

The rule in the proposed regulations is based on § 1.1221–2(c)(1)(vii). The rule has been restated in the final regulations to refer specifically to investments in debt instruments, equity securities, and annuity contracts so as to provide greater certainty in its application. For this purpose certain transactions in instruments that are not themselves debt instruments may include a debt investment. See, *e.g.*, § 1.446–3(g)(4). Further, the final regulations provide that the IRS may identify by future published guidance specified transactions that are determined not to be entered into primarily to manage risk. An example has been added to the final regulations to illustrate that an investment in mutual fund shares in the case described in the preceding paragraph does not qualify as a hedging transaction. A similar example is added with respect to an investment in an annuity contract.

Hedging Risks Other Than Interest Rate or Price Changes, or Currency Fluctuations

Paragraph (c)(8) of the proposed regulations provided that the Commissioner may, by published guidance, provide that hedging transactions include transactions entered into to manage risks other than interest rate or price changes, or currency fluctuations.

The notice of proposed rulemaking solicited comments regarding the expansion of the definition of hedging transactions to include transactions that manage risks other than interest rate or price changes, or currency fluctuations with respect to ordinary property, ordinary obligations or borrowings of the taxpayer. Some comments were received in response to that request. Because the comments described hedging transactions that related to the general operating results of a business (such as gross sales) rather than specific ordinary property, ordinary obligations or borrowings of the taxpayer, the implementation of rules respecting such hedges would present a number of issues not easily dealt with by the rules contained in the final regulations. Thus, the expansion of the scope of operation of the hedging rules is not being proposed at this time, so as not to delay the publication of guidance on the matters that are covered by the final regulations. However, the IRS is continuing to consider whether to expand the definition of hedging transactions to cover hedges of such other risks. The IRS and Treasury invite comments on the types of risks that should be covered, including specific examples of derivative transactions that may be incorporated into future guidance, as well as the appropriate timing of inclusion of gains and losses with respect to such transactions. Send submissions to: CC:ITA:RU (REG–107047–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

"Gap" Hedges

The status of so-called gap hedges was not separately addressed in the proposed regulations and is not covered in the final regulations. Insurance companies, for example, sometimes hedge the gap between their liabilities and the assets that fund them. Under the final regulations, a hedge of those assets would not qualify as a hedging transaction if the assets are capital assets. Whether a gap hedge qualifies as a liability hedge is a question of fact and depends on whether it is more closely associated with the liabilities than with the assets.

Identification Requirement

A rule has been added specifying additional information that must be provided for a transaction that counteracts a hedging transaction.

Dates of Applicability

The regulations generally apply to all transactions entered into on or after March 20, 2002. However, the IRS will not challenge any transaction entered into on or after December 17, 1999, and before March 20, 2002, that satisfies the provisions of either § 1.1221–2 of REG–107047–00 (2001–14 I.R.B. 1002), published in the **Federal Register** (66 FR 4738) on January 18, 2001, or the provisions of this final regulation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that very few small businesses enter into hedging transactions due to their cost and complexity. Further, those small businesses that hedge enter into very few hedging transactions because hedging transactions are costly, complex, and require constant monitoring and a sophisticated understanding of the capital markets. Therefore, a Regulatory Flexibility Analysis under the Regulatory

Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Elizabeth Handler, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.1221–2 to read as follows:

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

Section 1.1221–2 also issued under 26 U.S.C. 1221(b)(2)(A)(iii), (b)(2)(B), and (b)(3); 1502 and 6001. * * *

Par. 2. In the list below, for each location indicated in the left column, remove the language in the middle column from that section, and add the language in the right column.

Affected section	Remove	Add
1.446–4(d)(2), first sentence	1.1221–2(e)	1.1221–2(f)
1.446–4(d)(2), last sentence	1.1221–2(e)(2)	1.1221–2(f)(2)
1.446–4(d)(3), first sentence	1.1221–2(e)	1.1221–2(f)
1.446–4(d)(3), last sentence	1.1221–2(a)(4)(i)	1.1221–2(a)(4)
1.446–4(e)(7), first sentence	1.1221–2(c)(2)	1.1221–2(d)(4)
1.446–4(e)(9)(ii), first sentence	1.1221–2(d)(2)	1.1221–2(e)(2)
1.446–4(e)(9)(ii), last sentence	1.1221–2(d)(2)(ii)	1.1221–2(e)(2)(ii)
1.475(b)–1(d)(2)	1.1221–2(e)	1.1221–2(f)
1.954–2(a)(4)(ii)(A), first sentence	1.1221–2(a) through (c)	1.1221–2(a) through (d)
1.954–2(a)(4)(ii)(B), first sentence	1.1221–2(e)	1.1221–2(f)
1.954–2(g)(2)(ii)(B)(2), last sentence	1.1221–2(c)(7)	1.1221–2(c)(3)
1.954–2(g)(3)(i)(B), last sentence	1.1221–2(c)(7)	1.1221–2(c)(3)
1.1256(e)–1(b), first and last sentences	1.1221–2(e)(1)	1.1221–2(f)(1)
1.1256(e)–1(c), first sentence	1.1221–2(e)(1)	1.1221–2(f)(1)
1.1256(e)–1(c), last sentence	paragraph (f)(1)(ii) of § 1.1221–2	1.1221–2(g)(1)(ii)

Par. 3. Section 1.1221–2 is revised to read as follows:

§ 1.1221–2 Hedging transactions.

(a) *Treatment of hedging transactions*—(1) *In general*. This section governs the treatment of hedging transactions under section 1221(a)(7). Except as provided in paragraph (g)(2) of this section, the term capital asset does not include property that is part of a hedging transaction (as defined in paragraph (b) of this section).

(2) *Short sales and options*. This section also governs the character of gain or loss from a short sale or option that is part of a hedging transaction. Except as provided in paragraph (g)(2) of this section, gain or loss on a short sale or option that is part of a hedging transaction (as defined in paragraph (b) of this section) is ordinary income or loss.

(3) *Exclusivity*. If a transaction is not a hedging transaction as defined in paragraph (b) of this section, gain or loss from the transaction is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

(4) *Coordination with section 988*. This section does not apply to determine the character of gain or loss realized on a section 988 transaction as defined in section 988(c)(1) or realized with respect to any qualified fund as defined in section 988(c)(1)(E)(iii).

(b) *Hedging transaction defined*. Section 1221(b)(2)(A) provides that a hedging transaction is any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

(1) To manage risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(2) of this section) that is held or to be held by the taxpayer;

(2) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or

(3) To manage such other risks as the Secretary may prescribe in regulations (see paragraph (d)(6) of this section).

(c) *General rules*—(1) *Normal course*. Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer's trade or business, the transaction is entered into in the normal course of the taxpayer's trade or business. This rule includes managing risks relating to the expansion of an existing business or the acquisition of a new trade or business.

(2) *Ordinary property and obligations*. Property is ordinary property to a taxpayer only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss under any circumstances. Thus, for example, property used in a trade or business within the meaning of section 1231(b) (determined without regard to the holding period specified in that section) is not ordinary property. An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. For purposes of this paragraph (c)(2), the term termination has the same meaning as it does in section 1234A.

(3) *Hedging an aggregate risk*. The term hedging transaction includes a transaction that manages an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but a *de minimis* amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings.

(4) *Managing risk*—(i) *In general*. Whether a transaction manages a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction. Whether a transaction manages a taxpayer's risk may be determined on a business unit by business unit basis (for example by treating particular groups of activities, including the assets and liabilities attributable to those activities, as separate business units), provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. A taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions were entered into primarily to manage the taxpayer's risk.

(ii) *Limitation of risk management transactions to those specifically described*. Except as otherwise determined by published guidance or by private letter ruling, a transaction that is not treated as a hedging transaction under paragraph (d) does not manage risk. Moreover, a transaction undertaken for speculative purposes will not be treated as a hedging transaction.

(d) *Transactions that manage risk*—(1) *Risk reduction transactions*—(i) *In general*. A transaction that is entered into to reduce a taxpayer's risk, manages a taxpayer's risk.

(ii) *Micro and macro hedges*—(A) *In general*. A taxpayer generally has risk of a particular type only if it is at risk when all of its operations are considered. Nonetheless, a hedge of a particular asset or liability generally will be respected as reducing risk if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer's operations. If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedges are undertaken as part of a program that, as a whole, is reasonably expected to reduce the overall risk of the taxpayer's operations, the taxpayer generally does not have to demonstrate that each hedge that was entered into pursuant to the program reduces its overall risk.

(B) *Example*. The following example illustrates the rules stated in paragraph (d)(1)(ii)(A) of this section:

Example. Corporation X manages its business operations by treating particular groups of activities, including the assets and liabilities attributable to those assets, as separate business units. A separate set of books and records is maintained with respect to the activities, assets and liabilities of separate business unit *y*. As part of a risk management program that Corporation X reasonably expects to reduce the overall risks of its business operations, Corporation X enters into hedges to reduce the risks of separate business unit *y*. Corporation X may demonstrate that the hedges reduce risk by taking into account only the activities, assets and liabilities of business unit *y*.

(iii) *Written options*. A written option may reduce risk. For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer or a written put option with respect to assets to be acquired by a taxpayer may be a hedging transaction. See also paragraph (d)(3) of this section.

(iv) *Fixed-to-floating price hedges*. Under the principles of paragraph (d)(1)(ii)(A) of this section, a transaction that economically converts a price from a fixed price to a floating price may reduce risk. For example, a taxpayer with a fixed cost for its inventory may be at risk if the price at which the inventory can be sold varies with a particular factor. Thus, for such a taxpayer a transaction that converts its fixed price to a floating price may be a hedging transaction.

(2) *Interest rate conversions*. A transaction that economically converts an interest rate from a fixed rate to a floating rate or that converts an interest rate from a floating rate to a fixed rate manages risk.

(3) *Transactions that counteract hedging transactions*. If a transaction is entered into primarily to offset all or any part of the risk management effected by one or more hedging transactions, the transaction is a hedging transaction. For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, then it may be a hedging transaction.

(4) *Recycling*. A taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability as a hedge of another asset or liability (recycling).

(5) *Transactions not entered into primarily to manage risk*—(i) *Rule*. Except as otherwise determined in published guidance or private letter ruling, the purchase or sale of a debt instrument, an equity security, or an annuity contract is not a hedging transaction even if the transaction limits or reduces the taxpayer's risk with respect to ordinary property, borrowings, or ordinary obligations. In addition, the Commissioner may determine in published guidance that other transactions are not hedging transactions.

(ii) *Examples*. The following examples illustrate the rule stated in paragraph (d)(5)(i) of this section:

Example 1. Taxpayer borrows money and agrees to pay a floating rate of interest. Taxpayer purchases debt instruments that bear a comparable floating rate. Although taxpayer's interest rate risk from the floating rate borrowing may be reduced by the purchase of the debt instruments, the acquisition of the debt instruments is not a hedging transaction, because the transaction is not entered into primarily to manage the taxpayer's risk.

Example 2. Taxpayer undertakes obligations to pay compensation in the future. The amount of the future compensation payments is adjusted as if amounts were invested in a specified mutual fund and were increased or decreased by the earnings, gains and losses that would result from such an investment. Taxpayer invests funds in the shares of the mutual fund. Although the investment in shares of the mutual fund reduces the taxpayer's risk of fluctuation in the amount of its obligation to employees, the investment was not made primarily to manage the taxpayer's risk. Accordingly, the transaction is not a hedging transaction.

Example 3. Taxpayer provides a nonqualified retirement plan for employees that is structured like a defined contribution plan. Based on a schedule that takes into account an employee's monthly salary and years of service with the taxpayer, the taxpayer makes monthly credits to an account for each employee. Each employee may designate that the account will be treated as if it were used to pay premiums on a variable annuity contract issued by the M insurance company with a value that reflects a specified investment option. M offers a number of investment options for its variable annuity contracts. Taxpayer invests funds in M company variable annuity contracts that parallel the investment options selected by the employees. The investment is not made primarily to manage the taxpayer's risk and is not a hedging transaction.

(6) *Hedges of other risks*. The Commissioner may, by published guidance, determine that hedging transactions include transactions entered into to manage risks other than interest rate or price changes, or currency fluctuations.

(7) *Miscellaneous provision*—(i) *Extent of risk management*. A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to the risk.

(ii) *Number of transactions*. The fact that a taxpayer frequently enters into and terminates positions (even if done on a daily or more frequent basis) is not relevant to whether these transactions are hedging transactions. Thus, for example, a taxpayer hedging the risk associated with an asset or liability may frequently establish and terminate positions that hedge that risk, depending on the extent the taxpayer wishes to be hedged. Similarly, if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, its transactions may nonetheless qualify as hedging transactions.

(e) *Hedging by members of a consolidated group*—(1) *General rule: single-entity approach*. For purposes of this section, the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation. For example, if any member of a consolidated group hedges the risk of another member of the group by entering into a transaction with a third party, that transaction may potentially qualify as a hedging transaction. Conversely, intercompany transactions are not hedging transactions because, when considered as transactions between divisions of a single corporation, they do not manage the risk of that single corporation.

(2) *Separate-entity election*. In lieu of the single-entity approach specified in paragraph (e)(1) of this section, a consolidated group may elect separate-entity treatment of its hedging transactions. If a group makes this separate-entity election, the following rules apply:

(i) *Risk of one member not risk of other members*. Notwithstanding paragraph (e)(1) of this section, the risk of one member is not treated as the risk of other members.

(ii) *Intercompany transactions*. An intercompany transaction is a hedging transaction (an intercompany hedging transaction) with respect to a member of a consolidated group if and only if it meets the following requirements—

(A) The position of the member in the intercompany transaction would qualify as a hedging transaction with respect to the member (taking into account paragraph (e)(2)(i) of this section) if the member had entered into the transaction with an unrelated party; and

(B) The position of the other member (the marking member) in the transaction is marked to market under the marking member's method of accounting.

(iii) *Treatment of intercompany hedging transactions*. An intercompany hedging transaction (that is, a transaction that meets the requirements of paragraphs (e)(2)(ii)(A) and (B) of this section) is subject to the following rules—

(A) The character and timing rules of § 1.1502–13 do not apply to the income, deduction, gain, or loss from the intercompany hedging transaction; and

(B) Except as provided in paragraph (g)(3) of this section, the character of the marking member's gain or loss from the transaction is ordinary.

(iv) *Making and revoking the election*. Unless the Commissioner otherwise prescribes, the election described in this paragraph (e)(2) must be made in a separate statement saying "[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF SECTION 1.1221–2(e)(2) (THE SEPARATE-ENTITY APPROACH)." The statement must also indicate the date as of which the election is to be effective. The election must be signed by the common parent and filed with the group's Federal income tax return for the taxable year that includes the first date for which the election is to apply. The election applies to all transactions entered into on or after the date so indicated. The election may be revoked only with the consent of the Commissioner.

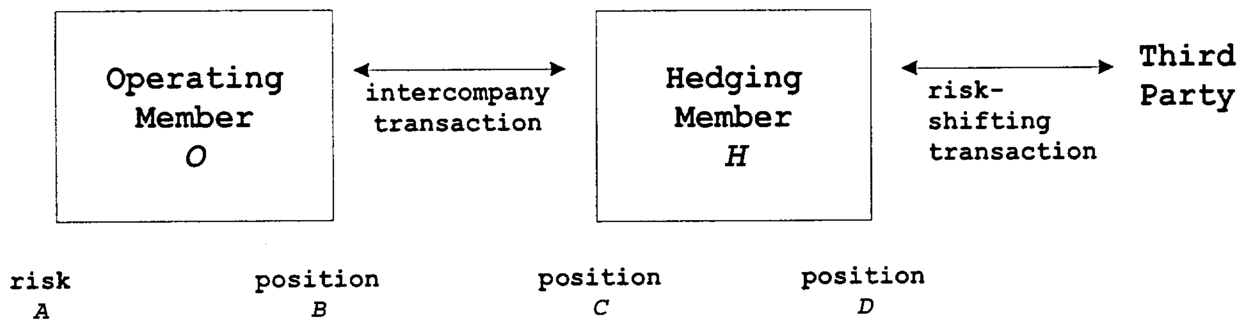
(3) *Definitions*. For definitions of consolidated group, divisions of a single corporation, group, intercompany transactions, and member, see section 1502 and the regulations thereunder.

(4) *Examples*. *General Facts*. In these examples, *O* and *H* are members of the same consolidated group. *O*'s business operations give rise to interest rate risk "*A*," which *O* wishes to hedge. *O* enters into an intercompany transaction with *H* that transfers the risk to *H*. *O*'s position in the intercompany transaction is "*B*," and *H*'s position in the transaction is "*C*." *H* enters into position "*D*" with a third party to reduce the interest rate risk it has with respect to its position *C*. *D* would be a hedging transaction with respect to risk *A* if *O*'s risk *A* were *H*'s risk. The following examples illustrate this paragraph (e):

Example 1. *Single-entity treatment*—(i) *General rule*. Under paragraph (e)(1) of this section, *O*'s risk *A* is treated as *H*'s risk, and therefore *D* is a hedging transaction with respect to risk *A*. Thus, the character of *D* is determined under the rules of this section, and the income, deduction, gain, or loss from *D* must be accounted for under a method of accounting that satisfies § 1.446–4. The intercompany transaction *B*-*C* is not a hedging transaction and is taken into account under § 1.1502–13.

(ii) *Identification*. *D* must be identified as a hedging transaction under paragraph (f)(1) of this section, and *A* must be identified as the hedged item under paragraph (f)(2) of this section. Under paragraph (f)(5) of this section, the identification of *A* as the hedged item can be accomplished by identifying the positions in the intercompany transaction as hedges or hedged items, as appropriate. Thus, substantially contemporaneous with entering into *D*, *H* may identify *C* as the hedged item and *O* may identify *B* as a hedge and *A* as the hedged item.

Example 2. *Separate-entity election; counterparty that does not mark to market*. In addition to the *General Facts* stated above, assume that the group makes a separate-entity election under paragraph (e)(2) of this section. If *H* does not mark *C* to market under its method of accounting, then *B* is not a hedging transaction, and the *B*-*C* intercompany transaction is taken into account under the rules of section 1502. *D* is not a hedging transaction with respect to *A*, but *D* may be a hedging transaction with respect to *C* if *C* is ordinary property or an ordinary obligation and if the other requirements of paragraph (b) of this section are met. If *D* is not part of a hedging transaction, then *D* may be part of a straddle for purposes of section 1092.



Example 3. Separate-entity election; counterparty that marks to market. The facts are the same as in *Example 2* above, except that *H* marks *C* to market under its method of accounting. Also assume that *B* would be a hedging transaction with respect to risk *A* if *O* had entered into that transaction with an unrelated party. Thus, for *O*, the *B-C* transaction is an intercompany hedging transaction with respect to *O*'s risk *A*, the character and timing rules of § 1.1502–13 do not apply to the *B-C* transaction, and *H*'s income, deduction, gain, or loss from *C* is ordinary. However, other attributes of the items from the *B-C* transaction are determined under § 1.1502–13. *D* is a hedging transaction with respect to *C* if it meets the requirements of paragraph (b) of this section.

(f) *Identification and recordkeeping*—(1) *Same-day identification of hedging transactions*. Under section 1221(a)(7), a taxpayer that enters into a hedging transaction (including recycling an existing hedging transaction) must clearly identify it as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction (or recycled the existing hedging transaction).

(2) *Substantially contemporaneous identification of hedged item*—(i) *Content of the identification*. A taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates. For example, if a taxpayer is hedging the price risk with respect to its June purchases of corn inventory, the transaction being hedged is the June purchase of corn and the risk is price movements in the market where the taxpayer buys its corn. For additional rules concerning the content of this identification, see paragraph (f)(3) of this section.

(ii) *Timing of the identification*. The identification required by this paragraph (f)(2) must be made substantially contemporaneously with entering into the hedging transaction. An identification is not substantially contemporaneous if it is made more than 35 days after entering into the hedging transaction.

(3) *Identification requirements for certain hedging transactions*. In the case of the hedging transactions described in this paragraph (f)(3), the identification under paragraph (f)(2) of this section must include the information specified.

(i) *Anticipatory asset hedges*. If the hedging transaction relates to the anticipated acquisition of assets by the taxpayer, the identification must include the expected date or dates of acquisition and the amounts expected to be acquired.

(ii) *Inventory hedges*. If the hedging transaction relates to the purchase or sale of inventory by the taxpayer, the identification is made by specifying the type or class of inventory to which the transaction relates. If the hedging transaction relates to specific purchases or sales, the identification must also include the expected dates of the purchases or sales and the amounts to be purchased or sold.

(iii) *Hedges of debt of the taxpayer*—(A) *Existing debt*. If the hedging transaction relates to accruals or payments under an issue of existing debt of the taxpayer, the identification must specify the issue and, if the hedge is for less than the full issue price or the full term of the debt, the amount of the issue price and the term covered by the hedge.

(B) *Debt to be issued*. If the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the expected maturity or maturities; the total expected issue price; and the expected interest provisions. If the hedge is for less than the entire expected issue price of the debt or the full expected term of the debt, the identification must also include the amount or the term being hedged. The identification may indicate a range of dates, terms, and amounts, rather than specific dates, terms, or amounts. For example, a taxpayer might identify a transaction as hedging the yield on an anticipated issuance of fixed rate debt during the second half of its fiscal year, with the anticipated amount of the debt between $75 million and $125 million, and an anticipated term of approximately 20 to 30 years.

(iv) *Hedges of aggregate risk*—(A) *Required identification*. If a transaction hedges aggregate risk as described in paragraph (c)(3) of this section, the identification under paragraph (f)(2) of this section must include a description of the risk being hedged and of the hedging program under which the hedging transaction was entered. This requirement may be met by placing in the taxpayer's records a description of the hedging program and by establishing a system under which individual transactions can be identified as being entered into pursuant to the program.

(B) *Description of hedging program*. A description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. If the program contains controls on speculation (for example, position limits), the description of the hedging program must also explain how the controls are established, communicated, and implemented.

(v) *Transactions that counteract hedging transactions*. If the hedging transaction is described in paragraph (d)(3) of this section, the description of the hedging transaction must include an identification of the risk management transaction that is being offset and the original underlying hedged item.

(4) *Manner of identification and records to be retained*—(i) *Inclusion of identification in tax records*. The identification required by this paragraph (f) must be made on, and retained as part of, the taxpayer's books and records.

(ii) *Presence of identification must be unambiguous*. The presence of an identification for purposes of this paragraph (f) must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. The taxpayer may indicate that individual hedging transactions, or a class or classes of hedging transactions, that are identified for financial accounting or regulatory purposes are also being identified as hedging transactions for purposes of this section.

(iii) *Manner of identification*. The taxpayer may separately and explicitly make each identification, or, so long as paragraph (f)(4)(ii) of this section is satisfied, the taxpayer may establish a system pursuant to which the identification is indicated by the type of transaction or by the manner in which the transaction is consummated or recorded. An identification under this system is made at the later of the time that the system is established or the time that the transaction satisfies the terms of the system by being entered, or by being consummated or recorded, in the designated fashion.

(iv) *Principles of paragraph (f)(4)(iii) of this section illustrated*. Paragraphs (f)(4)(iv)(A) through (C) of this section illustrate the principles of paragraph (f)(4)(iii) of this section and assume that the other requirements of this paragraph (f) are satisfied.

(A) A taxpayer can make an identification by designating a hedging transaction for (or placing it in) an account that has been identified as containing only hedges of a specified item (or of specified items or specified aggregate risk).

(B) A taxpayer can make an identification by including and retaining in its books and records a statement that designates all future transactions in a specified derivative product as hedges of a specified item, items, or aggregate risk.

(C) A taxpayer can make an identification by designating a certain mark, a certain form, or a certain legend as meaning that a transaction is a hedge of a specified item (or of specified items or a specified aggregate risk). Identification can be made by placing the designated mark on a record of the transaction (for example, trading ticket, purchase order, or trade confirmation) or by using the designated form or a record that contains the designated legend.

(5) *Identification of hedges involving members of the same consolidated group*—(i) *General rule: single-entity approach*. A member of a consolidated group must satisfy the requirements of this paragraph (f) as if all of the members of the group were divisions of a single corporation. Thus, the member entering into the hedging transaction with a third party must identify the hedging transaction under paragraph (f)(1) of this section. Under paragraph (f)(2) of this section, that member must also identify the item, items, or aggregate risk that is being hedged, even if the item, items, or aggregate risk relates primarily or entirely to other members of the group. If the members of a group use intercompany transactions to transfer risk within the group, the requirements of paragraph (f)(2) of this section may be met by identifying the intercompany transactions, and the risks hedged by the intercompany transactions, as hedges or hedged items, as appropriate. Because identification of the intercompany transaction as a hedge serves solely to identify the hedged item, the identification is timely if made within the period required by paragraph (f)(2) of this section. For example, if a member transfers risk in an intercompany transaction, it may identify under the rules of this paragraph (f) both its position in that transaction and the item, items, or aggregate risk being hedged. The member that hedges the risk outside the group may identify under the rules of this paragraph (f) both its position with the third party and its position in the intercompany transaction. Paragraph (e)(4) *Example 1* of this section illustrates this identification.

(ii) *Rule for consolidated groups making the separate-entity election*. If a consolidated group makes the separate-entity election under paragraph (e)(2) of this section, each member of the group must satisfy the requirements of this paragraph (f) as though it were not a member of a consolidated group.

(6) *Consistency with section 1256(e)(2)*. Any identification for purposes of section 1256(e)(2) is also an identification for purposes of paragraph (f)(1) of this section.

(g) *Effect of identification and non-identification*—(1) *Transactions identified*—(i) *In general*. If a taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (f)(1) of this section, the identification is binding with respect to gain, whether or not all of the requirements of paragraph (f) of this section are satisfied. Thus, gain from that transaction is ordinary income. If the transaction is not in fact a hedging transaction described in paragraph (b) of this section, however, paragraphs (a)(1) and (2) of this section do not apply and the character of loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself make loss from the transaction ordinary.

(ii) *Inadvertent identification*. Notwithstanding paragraph (g)(1)(i) of this section, if the taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (f) of this section, the character of the gain is determined as if the transaction had not been identified as a hedging transaction if—

(A) The transaction is not a hedging transaction (as defined in paragraph (b) of this section);

(B) The identification of the transaction as a hedging transaction was due to inadvertent error; and

(C) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(2) *Transactions not identified*—(i) *In general*. Except as provided in paragraphs (g)(2)(ii) and (iii) of this section, the absence of an identification that satisfies the requirements of paragraph (f)(1) of this section is binding and establishes that a transaction is not a hedging transaction. Thus, subject to the exceptions, the rules of paragraphs (a)(1) and (2) of this section do not apply, and the character of gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose.

(ii) *Inadvertent error*. If a taxpayer does not make an identification that satisfies the requirements of paragraph (f) of this section, the taxpayer may treat gain or loss from the transaction as ordinary income or loss under paragraph (a)(1) or (2) of this section if—

(A) The transaction is a hedging transaction (as defined in paragraph (b) of this section);

(B) The failure to identify the transaction was due to inadvertent error; and

(C) All of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as provided in paragraphs (a)(1) and (2) of this section.

(iii) *Anti-abuse rule*. If a taxpayer does not make an identification that satisfies all the requirements of paragraph (f) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (b) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(3) *Transactions by members of a consolidated group*—(i) *Single-entity approach*. If a consolidated group is under the general rule of paragraph (e)(1) of this section (the single-entity approach), the rules of this paragraph (g) apply only to transactions that are not intercompany transactions.

(ii) *Separate-entity election*. If a consolidated group has made the election under paragraph (e)(2) of this section, then, in addition to the rules of paragraphs (g)(1) and (2) of this section, the following rules apply:

(A) If an intercompany transaction is identified as a hedging transaction but does not meet the requirements of paragraphs (e)(2)(ii)(A) and (B) of this section, then, notwithstanding any contrary provision in § 1.1502–13, each party to the transaction is subject to the rules of paragraph (g)(1) of this section with respect to the transaction as though it had incorrectly identified its position in the transaction as a hedging transaction.

(B) If a transaction meets the requirements of paragraphs (e)(2)(ii)(A) and (B) of this section but the transaction is not identified as a hedging transaction, each party to the transaction is subject to the rules of paragraph (g)(2) of this section. (Because the transaction is an intercompany hedging transaction, the character and timing rules of § 1.1502–13 do not apply. See paragraph (e)(2)(iii)(A) of this section.)

(h) *Effective date*. The rules of this section apply to transactions entered into on or after March 20, 2002.

Par. 4. Section 1.1256(e)–1 is revised to read as follows:

§ 1.1256(e)–1 Identification of hedging transactions.

(a) *Identification and recordkeeping requirements*. Under section 1256(e)(2), a taxpayer that enters into a hedging transaction must identify the transaction as a hedging transaction before the close of the day on which the taxpayer enters into the transaction.

(b) *Requirements for identification*. The identification of a hedging transaction for purposes of section 1256(e)(2) must satisfy the requirements of § 1.1221–2(f)(1). Solely for purposes of section 1256(f)(1), however, an identification that does not satisfy all of the requirements of § 1.1221–2(f)(1) is nevertheless treated as an identification under section 1256(e)(2).

(c) *Consistency with § 1.1221–2*. Any identification for purposes of § 1.1221–2(f)(1) is also an identification for purposes of this section. If a taxpayer satisfies the requirements of § 1.1221–2(f)(1)(ii), the transaction is treated as if it were not identified as a hedging transaction for purposes of section 1256(e)(2).

(d) *Effective date*. The rules of this section apply to transactions entered into on or after March 20, 2002.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In § 602.101, paragraph (b) is amended by removing the entries for "1.1221–2," "1.1221–2(d)(2)(iv)," "1.1221–2(e)(5)," "1.1221–2(g)(5)(ii)," "1.1221–2(g)(6)(ii)," "1.1221–2(g)(6)(iii)," and "1.1221–2T(c)" and adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1221–2	1545–1480
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved March 14, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 15, 2002, 8:54 a.m., and published in the issue of the Federal Register for March 20, 2002, 67 F.R. 12863)

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

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

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2002.

Rev. Rul. 2002–17

This revenue ruling provides various prescribed rates for federal income tax purposes for April 2002 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2002–17 TABLE 1

Applicable Federal Rates (AFR) for April 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	2.88%	2.86%	2.85%	2.84%
110% AFR	3.17%	3.15%	3.14%	3.13%
120% AFR	3.46%	3.43%	3.42%	3.41%
130% AFR	3.75%	3.72%	3.70%	3.69%
Mid-Term				
AFR	4.65%	4.60%	4.57%	4.56%
110% AFR	5.12%	5.06%	5.03%	5.01%
120% AFR	5.60%	5.52%	5.48%	5.46%
130% AFR	6.07%	5.98%	5.94%	5.91%
150% AFR	7.02%	6.90%	6.84%	6.80%
175% AFR	8.21%	8.05%	7.97%	7.92%
Long-Term				
AFR	5.62%	5.54%	5.50%	5.48%
110% AFR	6.18%	6.09%	6.04%	6.01%
120% AFR	6.76%	6.65%	6.60%	6.56%
130% AFR	7.33%	7.20%	7.14%	7.09%

REV. RUL. 2002–17 TABLE 2

Adjusted AFR for April 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	2.08%	2.07%	2.06%	2.06%
Mid-term adjusted AFR	3.52%	3.49%	3.47%	3.46%
Long-term adjusted AFR	4.87%	4.81%	4.78%	4.76%

REV. RUL. 2002–17 TABLE 3

Rates Under Section 382 for April 2002

Adjusted federal long-term rate for the current month	4.87%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.01%

REV. RUL. 2002–17 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for April 2002

Appropriate percentage for the 70% present value low-income housing credit	8.20%
Appropriate percentage for the 30% present value low-income housing credit	3.51%

REV. RUL. 2002–17 TABLE 5

Rate Under Section 7520 for April 2002

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.6%

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 1361.—S Corporation Defined

26 CFR 1.1361–1: S Corporation defined.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 4401.—Imposition of Tax

Ct. D. 2073

SUPREME COURT OF THE UNITED STATES

No. 00–507

CHICKASAW NATION *v.* UNITED STATES

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

November 27, 2001*

Syllabus

The Indian Gaming Regulatory Act (Gaming Act) provides, as relevant here, that Internal Revenue Code (Code) provisions "(including [Secs.] 1441, 3402(q), 6041, and 6050I, and chapter 35 . . .) concerning the reporting and withholding of taxes" with respect to gambling operations shall apply to Indian tribes in the same way as they apply to States. 25 U.S.C. Sec. 2719(d)(i). Chapter 35 *imposes* taxes from which it exempts certain state-controlled gambling activities, but says nothing about tax *reporting or withholding*. Petitioners, the Choctaw and Chickasaw Nations, claim that the Gaming Act subsection's explicit parenthetical reference exempts them from paying those chapter 35 taxes from which the States are exempt. Rejecting that claim, the Tenth Circuit held that the subsection applies only to Code provisions concerning tax withholding and reporting.

Held: Section 2719(d)(i) does not exempt tribes from paying the gambling-related taxes that chapter 35 imposes. Pp. 3–11.

(a) The subsection's language outside the parenthetical says that the subsection applies to Code provisions concerning reporting and withholding, and the other four parenthetical references arguably concern reporting and withholding. The Tribes nonetheless claim that the subsection's explicit parenthetical reference to chapter 35 expands the Gaming Act's scope beyond reporting and withholding provisions — to the tax-imposing provisions that chapter 35 contains — and at the very least gives the subsection an ambiguity that can be resolved by applying the canon that statutes are to be construed liberally in favor of Indians with ambiguous provisions interpreted to their benefit. Rejecting their argument reduces the chapter 35 phrase to surplusage, but there is no other reasonable reading of the statute. Pp. 3–4.

(b) The statute's language is too strong to give the chapter 35 reference independent operative effect. The unambiguous language outside the parenthetical says without qualification that the subsection applies to "provisions . . . concerning the reporting and withholding of taxes"; and the language inside the parenthetical, prefaced with the word "including," literally says the same, since to "include" means to "contain." The use of parentheses emphasizes the fact that that which is within is meant simply to be illustrative. To give the chapter 35 reference independent operative effect would require seriously rewriting the rest of the statute. One would have to read "including" to mean what it does not mean, namely, "including. . . and." To read the language outside the parenthetical as if it referred to (1) Code provisions concerning tax reporting and withholding and (2) those "concerning . . . wagering operations" would be far too convoluted to believe Congress intended it. There is no reason to think Congress intended to sweep within the subsection's scope every Code provision concerning wagering. The subject matter at issue — tax exemption — also counsels against accepting the Tribes' interpretation. This Court can find no comparable instance in which Congress

*Together with *Choctaw Nation of Oklahoma v. United States* (see this Court's Rule 12.4), also on certiorari to the same court.

legislated an exemption through a parenthetical numerical cross-reference. Since the more plausible role for the parenthetical to play in this subsection is that of providing an illustrative list of examples, common sense suggests that "chapter 35" is simply a bad example that Congress included inadvertently, a drafting mistake. Pp. 4–6.

(c) The Gaming Act's legislative history on balance supports this Court's conclusion. And the canons of interpretation to which the Tribes point — that every clause and word of a statute should be given effect and that statutes are to be construed liberally in favor of the Indians with ambiguous provisions interpreted to their benefit — do not determine how to read this statute. First, the canons are guides that need not be conclusive. *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 115. To accept these canons as conclusive here would produce an interpretation that the Court firmly believes would conflict with congressional intent. Second, specific canons are often countered by some maxim pointing in a different direction. *Ibid*. The canon requiring a court to give effect to each word "if possible" is sometimes offset by the canon permitting a court to reject words as mere surplusage if inadvertently inserted or if repugnant to the rest of the statute. Moreover, the pro-Indian canon is offset by the canon warning against interpreting federal statutes as providing tax exemptions unless the exemptions are clearly expressed. Given the individualized nature of this Court's previous cases, one cannot say that the pro-Indian canon is inevitably stronger, particularly where the interpretation of a congressional statute rather than an Indian treaty is at issue. Pp. 6–11.

208 F.3d 871 (first judgment); 210 F.3d 389 (second judgment), affirmed.

BREYER, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and STEVENS, KENNEDY, and GINSBURG, JJ., joined, and in all but Part II-B of which SCALIA and THOMAS, JJ., joined. O'CONNOR, J., filed a dissenting opinion, in which SOUTER, J., joined.

SUPREME COURT OF THE UNITED STATES

No. 00–507

CHICKASAW NATION, PETITIONER *v.* UNITED STATES

CHOCTAW NATION OF OKLAHOMA, PETITIONER *v.* UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

November 27, 2001

JUSTICE BREYER delivered the opinion of the Court.*

In these cases, we must decide whether a particular subsection in the Indian Gaming Regulatory Act, 102 Stat. 2467–2486, 25 U.S.C. Secs. 2701–2721 (1994 ed.), exempts tribes from paying the gambling-related taxes that chapter 35 of the Internal Revenue Code imposes — taxes that States need not pay. We hold that it does not create such an exemption.

I

The relevant Indian Gaming Regulatory Act (Gaming Act) subsection, as codified in 25 U.S.C. Sec. 2719(d)(i), reads as follows:

> "The provisions of [the Internal Revenue Code of 1986] (including sections 1441, 3402(q), 6041, and 6050I, and chapter 35 of such Code) concerning the reporting and withholding of taxes with respect to the winnings from gaming or wagering operations shall apply to Indian gaming operations conducted pursuant to this chapter, or under a Tribal-State compact entered into under section 2710(d)(3) of this title that is in effect, in the same manner as such provisions apply to State gaming and wagering operations."

The subsection says that Internal Revenue Code provisions that "concer[n] the reporting and withholding of taxes" with respect to gambling operations shall apply to Indian tribes in the same way as they apply to States. The subsection also says in its parenthetical that those provisions "includ[e]" Internal Revenue Code "chapter 35." Chapter 35, however, says nothing about the *reporting* or the *withholding* of taxes. Rather, that chapter simply *imposes* taxes — excise taxes and occupational taxes related to gambling — from which it exempts certain state-controlled gambling activities. See, *e.g.*, 26 U.S.C. Sec. 4401(a) (1994 ed.) (imposing 0.25% excise tax on each wager); Sec. 4411 (imposing $50 occupational tax on each individual engaged in wagering business); Sec. 4402(3) (exempting state-operated gambling operations, such as lotteries).

In this lawsuit two Native American Indian Tribes, the Choctaw and Chickasaw Nations, claim that the Gaming Act subsection exempts them from paying those chapter 35 taxes from which States are exempt. Brief for Petitioners 34–36. They rest their claim upon the subsection's explicit parenthetical reference to chapter 35. The Tenth Circuit rejected their claim on the ground that the subsection, despite its parenthetical reference, applies only to Code provisions that concern the "reporting and withholding of taxes." 208 F.3d 871, 883–884 (2000); see also 210 F.3d 389 (2000). The Court of Appeals for the Federal Circuit, however, reached the opposite conclusion. *Little Six, Inc. v. United States,* 210 F.3d 1361, 1366 (2000). We granted certiorari in order to resolve the conflict. We agree with the Tenth Circuit.

II

The Tribes' basic argument rests upon the subsection's explicit reference to "chapter 35" — contained in a parenthetical that refers to four other Internal Revenue Code provisions as well. The subsection's language outside the parenthetical says that the subsection applies to those Internal Revenue Code provisions that concern "reporting and withholding." The other four parenthetical references are to provisions that concern, or at least arguably concern, reporting and withholding. See 26 U.S.C. Sec. 1441 (withholding of taxes for nonresident alien); Sec. 3402(q) (withholding of

*JUSTICE SCALIA and JUSTICE THOMAS join all but Part II-B of this opinion.

taxes from certain gambling winnings); 26 U.S.C. Sec. 6041 (reporting by businesses of payments, including payments of gambling winnings, to others); Sec. 6050I (reporting by businesses of large cash receipts, arguably applicable to certain gambling winnings or receipts).

But what about chapter 35? The Tribes correctly point out that chapter 35 has nothing to do with "reporting and withholding." Brief for Petitioners 28–29. They add that the reference must serve some purpose, and the only purpose that the Tribes can find is that of expanding the scope of the Gaming Act's subsection beyond reporting and withholding provisions — to the tax-imposing provisions that chapter 35 does contain. The Gaming Act therefore must exempt them (like States) from those tax payment requirements. The Tribes add that at least the reference to chapter 35 makes the subsection ambiguous. And they ask us to resolve the ambiguity by applying a special Indian-related interpretative canon, namely, "'statutes are to be construed liberally in favor of the Indians' with ambiguous provisions interpreted to their benefit." Brief for Petitioners 13 (quoting *Montana v. Blackfeet Tribe*, 471 U.S. 759, 766 (1985)).

We cannot accept the Tribes' claim. We agree with the Tribes that rejecting their argument reduces the phrase "(including . . . chapter 35) . . ." to surplusage. Nonetheless we can find no other reasonable reading of the statute.

A

The language of the statute is too strong to bend as the Tribes would wish — *i.e.*, so that it gives the chapter 35 reference independent operative effect. For one thing, the language outside the parenthetical is unambiguous. It says without qualification that the subsection applies to "provisions . . . concerning the reporting and withholding of taxes." And the language inside the parenthetical, prefaced with the word "including," literally says the same. To "include" is to "contain" or "comprise as part of a whole." Webster's Ninth New Collegiate Dictionary 609 (1985). In this instance, that which "contains" the parenthetical references — the "whole" of which the references are "parts" — is the phrase "provisions . . . concerning the reporting and withholding of taxes. . . ." The use of parentheses emphasizes the fact that that which is within is meant simply to be illustrative, hence redundant — a circumstance underscored by the lack of any suggestion that Congress intended the illustrative list to be complete. Cf. 26 U.S.C. Sec. 3406 (backup withholding provision not mentioned in parenthetical).

Nor can one give the chapter 35 reference independent operative effect without seriously rewriting the language of the rest of the statute. One would have to read the word "including" to mean what it does not mean, namely, "including . . . and." One would have to read the statute as if, for example, it placed "chapter 35" outside the parenthetical and said "provisions of the . . . Code *including chapter 35 and also provisions* . . . concerning the reporting and withholding of taxes. . . ." Or, one would have to read the language as if it said "provisions of the . . . Code . . . concerning *the taxation and* the reporting and withholding of taxes. . . ." We mention this latter possibility because the congressional bill that became the law before us once did read that way. But when the bill left committee, it contained not the emphasized words ("the taxation and") but the cross-reference to chapter 35.

We recognize the Tribes' claim (made here for the first time) that one could avoid rewriting the statute by reading the language outside the parenthetical as if it referred to two kinds of "provisions of the . . . Code": first those "concerning the reporting and withholding of taxes with respect to the winnings from gaming," and, second, those "concerning . . . wagering operations." See Reply Brief for Petitioners 8–10. The subsection's grammar literally permits this reading. But that reading, even if ultimately comprehensible, is far too convoluted to believe Congress intended it. Nor is there any reason to think Congress intended to sweep within the subsection's scope every Internal Revenue Code provision concerning wagering — a result that this unnatural reading would accomplish.

The subject matter at issue also counsels against accepting the Tribes' interpretation. That subject matter is tax exemption. When Congress enacts a tax exemption, it ordinarily does so explicitly. We can find no comparable instance in which Congress legislated an exemption through an inexplicit numerical cross-reference — especially a cross-reference that might easily escape notice.

As we have said, the more plausible role for the parenthetical to play in this subsection is that of providing an illustrative list of examples. So considered, "chapter 35" is simply a bad example — an example that Congress included inadvertently. The presence of a bad example in a statute does not warrant rewriting the remainder of the statute's language. Nor does it necessarily mean that the statute is ambiguous, *i.e.*, "capable of being understood in two or more possible senses or ways." Webster's Ninth New Collegiate Dictionary 77 (1985). Indeed, in ordinary life, we would understand an analogous instruction — say, "Test drive some cars, including Plymouth, Nissan, Chevrolet, Ford, and Kitchenaid" — not as creating ambiguity, but as reflecting a mistake. Here too, in context, common sense suggests that the cross-reference is simply a drafting mistake, a failure to delete an inappropriate cross-reference in the bill that Congress later enacted into law. Cf. *Little Six, Inc. v. United States*, 229 F.3d 1383, 1385 (CA Fed. 2000) (Dyk, J., dissenting from denial of rehearing en banc) ("The language of the provision has all the earmarks of a simple mistake in legislative drafting").

B

The Gaming Act's legislative history on balance supports our conclusion. The subsection as it appeared in the original Senate bill applied both to taxation and to reporting and withholding. It read as follows:

> "Provisions of the Internal Revenue Code . . . concerning *the taxation and* the reporting and withholding of taxes with respect to gambling or wagering operations shall apply to Indian gaming operations . . . the same as they apply to State operations," S. 555, 100th Cong., 1st Sess., 37 (1987).

With the "taxation" language present, it would have made sense to include chapter 35, which concerns taxation, in a parenthetical that included other provisions that concern reporting and withholding. But the Senate committee deleted the taxation language. Why did it permit the cross-reference to chapter 35 to remain? Committee documents do not say.

The Tribes argue that the committee intentionally left it in the statute in order to serve as a *substitute* for the word "taxation." An *amicus* tries to support this view by pointing to a tribal representative's testimony that certain Tribes were "opposed to any indication where Internal Revenue would be collecting taxes from the tribal bingo operations." Hearings on S. 555 and S. 1303 before the Senate Select Committee on Indian Affairs, 100th Cong., 1st Sess., 109 (1987) (statement of Lionel John, Executive Director of United South and Eastern Tribes). Other Tribes thought the "taxation" language too "vague," preferring a clear statement "that the Internal Revenue Service is not being granted authority to tax tribes." *Id.*, at 433, 435 (statement of Charles W. Blackwell, Representative of the American Indian Tribal Government and Policy Consultants, Inc.).

Substitution of "chapter 35" for the word "taxation," however, could not have served the tribal witnesses purposes, for doing so took from the bill the very words that made clear the tribes would *not* be taxed and substituted language that made it more likely they would be taxed. Nor can we believe that anyone seeking to grant a tax exemption would intentionally substitute a confusion-generating numerical cross-reference, see Part A, *supra*, for pre-existing language that unambiguously carried out that objective. It is far easier to believe that the drafters, having included the entire parenthetical while the word "taxation" was still part of the bill, unintentionally failed to remove what had become a superfluous numerical cross-reference—particularly since the tax-knowledgeable Senate Finance Committee never received the opportunity to examine the bill. Cf. S. Doc. No. 100–1, Senate Manual, 30 (1987) (proposed legislation concerning revenue measures shall be referred to the Committee on Finance).

Finally, the Tribes point to a letter written by one of the Gaming Act's authors, stating that "by including reference to Chapter 35," Congress intended "that the tax treatment of wagers conducted by tribal governments be the same as that for wagers conducted by state governments under Chapter 35." App. to Pet. for Cert. 113a. This letter, however, was written after the event. It expresses the views of only one member of the committee. And it makes no effort to explain the critical legislative circumstance, namely, the elimination of the word "taxation" from the bill. The letter may express the Senator's interpretive preference, but that preference cannot overcome the language of the statute and the related considerations we have discussed. See *Heintz v. Jenkins*, 514 U.S. 291, 298 (1995) (A "statement [made] not during the legislative process, but *after* the statute became law . . . is not a statement upon which other legislators might have relied in voting for or against the Act, but it simply represents the views of one informed person on an issue about which others may (or may not) have thought differently"). Cf. *New York Telephone Co. v. New York State Dept. of Labor*, 440 U.S. 519, 564, n. 18 (1979) (Powell, J., dissenting) ("The comments . . . of a single Congressman, delivered long after the original passage of the [act at issue], are of no aid in determining congressional intent . . .").

In sum, to adopt the Tribes' interpretation would read back into the Act the very word "taxation" that the Senate committee deleted. We ordinarily will not assume that Congress intended "'to enact statutory language that it has earlier discarded in favor of other language.'" *INS v. Cardoza-Fonseca*, 480 U.S. 421, 443 (1987) (quoting *Nachman Corp. v. Pension Benefit Guaranty Corporation*, 446 U.S. 359, 392–393 (1980)); *Gulf Oil Corp. v. Copp Paving Co.*, 419 U.S. 186, 200 (1974) (same); *Mescalero Apache Tribe v. Jones*, 411 U.S. 145, 157 (1973) (same). There is no special reason for doing so here.

C

The Tribes point to canons of interpretation that favor their position. The Court has often said that "'every clause and word of a statute'" should, "'if possible,'" be given "'effect.'" *United States v. Menasche*, 348 U.S. 528, 538–539 (1955) (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883)). The Tribes point out that our interpretation deprives the words "chapter 35" of any effect. The Court has also said that "statutes are to be construed liberally in favor of the Indians with ambiguous provisions interpreted to their benefit." *Montana v. Blackfeet Tribe*, 471 U.S. at 766; *South Carolina v. Catawba Tribe, Inc.*, 476 U.S. 498, 520 (1986) (Blackmun, J., dissenting). The Tribes point out that our interpretation is not to the Indians' benefit.

Nonetheless, these canons do not determine how to read this statute. For one thing, canons are not mandatory rules. They are guides that "need not be conclusive." *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 115 (2001). They are designed to help judges determine the Legislature's intent as embodied in particular statutory language. And other circumstances evidencing congressional intent can overcome their force. In this instance, to accept as conclusive the canons on which the Tribes rely would produce an interpretation that we conclude would conflict with the intent embodied in the statute Congress wrote. Cf. *Choteau v. Burnet*, 283 U.S. 691 (1931) (upholding taxation where congressional intent reasonably clear); *Superintendent of Five Civilized Tribes v. Commissioner*, 295 U.S. 418 (1935) (same); *Mescalero Apache Tribe v. Jones, supra* (same). In light of the considerations discussed earlier, we cannot say that the statute is "fairly capable" of two interpretations, cf. *Montana v. Blackfeet Tribe, supra*, at 766, nor that the Tribes' interpretation is fairly "possible."

Specific canons "are often countered . . . by some maxim pointing in a different direction." *Circuit City Stores, Inc. v. Adams, supra*, at 115. The canon requiring a court to give effect to each word "*if possible*" is sometimes offset by the canon that permits a court to reject words "as surplusage" if "inadvertently inserted or if repugnant to the rest of the statute . . . ." K. Llewellyn, The Common Law Tradition 525 (1960). And the latter canon has particular force here where the surplus words consist simply of a numerical cross-reference in a parenthetical. Cf. *Cabell Huntington Hospital, Inc. v. Shalala*, 101 F.3d 984, 990 (CA4 1996) ("A parenthetical is, after all, a parenthetical, and it cannot be used to overcome the operative terms of the statute").

Moreover, the canon that assumes Congress intends its statutes to benefit the tribes is offset by the canon that warns us against interpreting federal statutes as providing tax exemptions unless those exemptions are clearly expressed. See *United States v. Wells Fargo Bank*, 485 U.S. 351, 354 (1988) ("[E]xemptions from taxation . . . must be unambiguously proved"); *Squire v. Capoeman*, 351 U.S. 1, 6 (1956) ("[T]o be valid, exemptions to tax laws should be clearly expressed"); *United States Trust Co. v. Helvering*, 307 U.S. 57, 60 (1939) ("Exemptions from taxation do not rest upon implication"). Nor can one say that the pro-Indian canon is inevitably stronger — particularly where the interpretation of a congressional statute, rather than an Indian treaty, is at issue. Cf. *post*, at 7. This Court's earlier cases are too individualized, involving too many different kinds of legal circumstances, to warrant any such assessment about the two canons' relative strength. Compare, *e.g.*, *Choate v. Trapp*, 224 U.S. 665, 675–676 (1912) (interpreting statement in treaty-related Indian land patents that land is "nontaxable" as creating property right invalidating later congressional effort to tax); *Squire, supra*, at 3 (Indian canon offsetting tax canon when related statutory provision and history make clear that language freeing Indian land "'of all charge or incumbrance whatsoever'" includes tax); *McClanahan v. Arizona Tax Comm'n*, 411 U.S. 164, 174 (1973) (state tax violates principle of Indian sovereignty embodied in treaty), with *Mescalero, supra* (relying on tax canon to find Indians taxable); *Choteau, supra* language makes clear no exemption); *Five Tribes*, *supra* (same).

Consequently, the canons here cannot make the difference for which the Tribes argue. We conclude that the judgments of the Tenth Circuit must be affirmed.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 00–507

CHICKASAW NATION, PETITIONER *v*. UNITED STATES

CHOCTAW NATION OF OKLAHOMA, PETITIONER *v*. UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

November 27, 2001

JUSTICE O'CONNOR, with whom JUSTICE SOUTER joins, dissenting.

The Court today holds that 25 U.S.C. Sec. 2719(d) (1994 ed.) clearly and unambiguously fails to give Indian Nations (Nations) the exemption from federal wagering excise and related occupational taxes enjoyed by the States. Because I believe Sec. 2719(d) is subject to more than one interpretation, and because "statutes are to be construed liberally in favor of the Indians, with ambiguous provisions interpreted to their benefit," *Montana v. Blackfeet Tribe*, 471 U.S. 759, 766 (1985), I respectfully dissent.

I

I agree with the Court that Sec. 2719(d) incorporates an error in drafting. I disagree, however, that the section's reference to chapter 35 is necessarily that error.

As originally proposed in the Senate, the bill that became the Indian Gaming Regulatory Act (IGRA) would have applied all gambling and wagering-related sections of the Internal Revenue Code to the Nations in the same manner as the States:

> "Provisions of the Internal Revenue Code of 1986, concerning the taxation and the reporting and withholding of taxes with respect to gambling or wagering operations shall apply to Indian gaming operations conducted pursuant to this Act the same as they apply to State operations." S. 555, 100th Cong., 1st Sess., 37 (1987).

The Senate Indian Affairs Committee altered the language of this bill in two contradictory ways. It restricted the applicable Code sections to those relating to the "reporting and withholding of taxes with respect to the winnings" from gaming operations. 25 U.S.C. Sec. 2719(d). It also added a parenthetical listing specific Code sections to be applied to the Nations in the same manner as the States, including chapter 35, a Code provision that relates to gambling operations generally, but not to the reporting and withholding of gambling winnings. *Ibid*.

One of these two changes must have been made in error. There is no reason to assume, however, that it must have been the latter. It is equally likely that Congress intended Sec. 2719(d) to apply chapter 35 to the Nations, but adopted too restrictive a general characterization of the applicable sections.

The Court can do no more than speculate that the bill's drafters included the parenthetical while the original restriction was in place and failed to remove it when that restriction was altered. See *ante*, at 7. Both the inclusion of the parenthetical and the alteration of the restriction occurred in the Senate committee, S. Rep. No. 100–446 (1988), and there is no way to determine the order in which they were adopted. If the parenthetical was added after the restriction, one could just as easily characterize the *restriction* as an unintentional holdover from a previous version of the bill.

True, reading the statute to grant the Nations the exemption requires the section's reference to the "reporting and withholding of taxes with respect to the winnings" from gaming operations to sustain a meaning the words themselves cannot bear. But the Court's reading of the statute fares no better: It requires excising from Sec. 2719(d) Congress' explicit reference to chapter 35. This goes beyond treating statutory language as mere surplusage. See *Potter v. United States*, 155 U.S. 438, 446 (1894) (the presence of statutory language "cannot be regarded as mere surplusage; it means something"); cf. *ante*, at 3. Surplusage is redundant statutory language, *Babbitt v. Sweet Home Chapter, Communities for Great Ore.*, 515 U.S. 687, 697–698 (1995); W. Popkin, Materials on Legislation: Political Language and the Political Process 214 (3d ed. 2001) — the Court's reading negates language that undeniably bears separate meaning. This is not a step to be undertaken lightly.

Both approaches, therefore, require rewriting the statute, see *ante*, at 4. Neither of these rewritings is necessarily more "serious" than the other: At most, each involves doing no more than reversing a change made in committee. Cf. *ante*, at 4–5.

The Court argues that because the reference to chapter 35 occurs in a parenthetical, negating this language does less damage to the statute than concluding that the restrictive language outside the parenthetical is too narrowly drawn. I am aware of no generally accepted canon of statutory construction favoring language outside of parentheses to language within them, see, *e.g.*, W. Eskridge, P. Frickey, & E. Garrett, Legislation and Statutory Interpretation, App. C (2000) (listing canons), nor do I think it wise for the Court to adopt one today. The importance of statutory language depends not on its punctuation, but on its meaning. See *United States Nat. Bank of Ore. v. Independent Ins. Agents of America, Inc.*, 508 U.S. 439, 454 (1993) ("[A] purported plain-meaning analysis based only on punctuation is necessarily incomplete and runs the risk of distorting a statute's true meaning").

The fact that the parenthetical is illustrative does not change the analysis: If Congress' illustration does not match its general description, there is as much reason to question the description as the illustration. Where another general description is possible — and was in fact part of the bill at an earlier stage — Congress' choice of an example that matches the earlier description is at least ambiguous. Moreover, as Sec. 2719(d)'s parenthetical specifically lists statutory sections to be applied to the Nations, one might in fact conclude that the doctrine that the specific governs the general, *Crawford Fitting Co. v. J. T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987), makes this specific parenthetical even more significant than the general restriction that follows.

Nor is negating Congress' clear reference to chapter 35 required by the policy behind the statute. If anything, congressional policy weighs in favor of the Nations. Congress' central purpose in enacting IGRA was "to provide a statutory basis for the operation of gaming by Indian tribes as a means of promoting tribal economic development, self-sufficiency, and strong tribal governments." Sec. 2702(1). Exempting Nations from federal gaming taxation in the same manner as States preserves the Nations' sovereignty and avoids giving state gaming a competitive advantage that would interfere with the Nations' ability to raise revenue in this manner.

II

Because nothing in the text, legislative history, or underlying policies of Sec. 2719(d) clearly resolves the contradiction inherent in the section, it is appropriate to turn to canons of statutory construction. The Nations urge the Court to rely upon the Indian canon, that "statutes are to be construed liberally in favor of the Indians, with ambiguous provisions interpreted to their benefit," *Montana v. Blackfeet Tribe*, 471 U.S., at 766, as a basis for deciding that the error in Sec. 2719(d) lies in the restriction of the subclass, not in the specific listing of chapter 35. "[R]ooted in the unique trust relationship between the United States and the Indians," *County of Oneida v. Oneida Indian Nation of N.Y.*, 470 U.S. 226, 247 (1985), the Indian canon presumes congressional intent to assist its wards to overcome the disadvantages our country has placed upon them. Consistent with this purpose, the Indian canon applies to statutes as well as treaties: The form of the enactment does not change the presumption that Congress generally intends to benefit the Nations. *Montana v. Blackfeet Tribe, supra; County of Yakima v. Confederated Tribes and Bands of Yakima Nation*, 502 U.S. 251 (1992). In this case, because Congress has chosen gaming as a means of enabling the Nations to achieve self-sufficiency, the Indian canon rightly dictates that Congress should be presumed to have intended the Nations to receive more, rather than less, revenue from this enterprise.

Of course, the Indian canon is not the only canon with potential applicability in this case. Also relevant is the taxation principle, that exemptions from taxation must be clearly expressed. *United States Trust Co. v. Helvering*, 307 U.S. 57, 60 (1939); see also *ante*, at 10. These canons pull in opposite directions, the former favoring the Nations' preferred reading, and the latter favoring the Government's.

This Court has repeatedly held that, when these two canons conflict, the Indian canon predominates. In *Choate v. Trapp*, 224 U.S. 665 (1912), a State attempted to rely on the taxation principle to argue that a treaty provision making land granted to Indians nontaxable was merely a bounty, capable of being withdrawn at any time. The Court acknowledged the taxation principle, responding:

> "But in the Government's dealings with the Indians, the rule is exactly the contrary. The construction, instead of being strict, is liberal; doubtful expressions, instead of being resolved in favor of the United States, are to be resolved in favor of [Indian nations.] *Id.*, at 674–675.

In *Squire v. Capoeman*, 351 U.S. 1, 3 (1956), the Federal Government had conveyed land to the Nations "'free of all charge or encumbrance whatsoever.'" Although this phrase did not expressly mention nontaxability, the Court held that the language "might well be sufficient to include taxation," *id.*, at 7. Invoking the Indian canon, *id.*, at 6–7, we found the Nations exempt.

Likewise, in *McClanahan v. Arizona Tax Comm'n*, 411 U.S. 164 (1973), this Court inferred an exemption from state taxation of property inside reservations from a treaty reserving lands for the exclusive use and occupancy of the Nations. In doing so, the Court noted that: "It is true, of course, that exemptions from tax laws should, as a general rule, be clearly expressed. But we have in the past construed language far more ambiguous than this as providing a tax exemption for Indians." *Id.*, at 176 (citing *Squire*, *supra*, at 6).

As the purpose behind the Indian canon is the same regardless of the form of enactment, *supra*, at 5, there is no reason to alter the Indian canon's relative strength where a statute rather than a treaty is involved. Cf. *ante*, at 10. The primacy of the Indian canon over the taxation principle should not be surprising, as this Court has also held that the general presumption supporting the legality of executive action must yield to the Indian canon, a "counterpresumption specific" to Indians. *Minnesota v. Mille Lacs Band of Chippewa Indians*, 526 U.S. 172, 194, n. 5 (1999).

This Court has failed to apply the Indian canon to extend tax exemptions to the Nations only when nothing in the language of the underlying statute or treaty suggests the Nations should be exempted. *The Cherokee Tobacco*, 11 Wall. 616, 618–620 (1871) (finding no exemption for the Nations from language imposing taxes on certain "'articles produced anywhere within the exterior boundaries of the United States'"); *Choteau v. Burnet*, 283 U.S. 691, 693–694 (1931) (finding no exemption in provisions "subject[ing] the income of 'every individual' to tax," including "income 'from any source whatever'"); *Superintendent of Five Civilized Tribes v. Commissioner*, 295 U.S. 418 (1935) (same); *Mescalero Apache Tribe v. Jones*, 411 U.S. 145, 155 (1973) (refusing to exempt the Nations from taxes on land use income based on language that "[o]n its face . . . exempts land and rights in land, not income derived from its use"). *Mescalero* also went further, suggesting that because of the taxation principle, the Court would refuse to find such an exemption absent "clear statutory guidance." *Id.*, at 156. *Mescalero's* formulation is admittedly in tension with the Court's precedents giving the Indian canon primacy over the taxation principle where statutory language is ambiguous. As *Mescalero* was decided on the same day as one of those very precedents, the unanimous decision in *McClanahan v. Arizona Tax Comm'n*, *supra*, however, it cannot have intended to alter the Court's established practice.

Section 2719(d) provides an even more persuasive case for application of the Indian canon than any of our precedents. Here, the Court is not being asked to create out of vague language a tax exemption not specifically provided for in the statute. Instead, the Nations simply ask the Court to use the Indian canon as a tiebreaker between two equally plausible (or, in this case, equally implausible) constructions of a troubled statute, one which specifically makes chapter 35's tax exemption applicable to the Nations, and one which specifically does not. Breaking interpretive ties is one of the least controversial uses of any canon of statutory construction. See Eskridge, Frickey, & Garrett, Legislation and Statutory Interpretation, at 341 ("The weakest kind of substantive canon operates merely as a *tiebreaker* at the end of the interpretive analysis").

Faced with the unhappy choice of determining which part of a flawed statutory section is in error, I would thus rely upon the long-established Indian canon of construction and adopt the reading most favorable to the Nations.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page716.

Part II. Treaties and Tax Legislation
Subpart A.—Tax Conventions and Other Related Items

EMBASSY OF THE
UNITED STATES OF AMERICA

No. 2001-055

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Republic of Ghana, and has the honor to propose that the two governments conclude an agreement to exempt from income tax, on a reciprocal basis, certain income derived from the international operation of a ship or ships and aircraft as follows:

The Government of the United States of America, in accordance with Sections 872(b) and 883(a) of the U.S. Internal Revenue Code of 1986, agrees to exempt from U.S. federal income tax gross income derived from the international operation of a ship or ships or aircraft by individuals who are residents of Ghana (other than U.S. citizens or residents) and corporations that are organized in Ghana, in each case, that are engaged in the international operation of a ship or ships or aircraft. This exemption shall be granted on the basis of equivalent exemptions granted by Ghana to individual residents of the United States and to corporations organized in the United States.

In the case of a Ghanaian corporation, the exemption shall apply only if the corporation meets the ownership or public trading requirements of U.S. law. For purposes of such ownership requirements, the Government of Ghana shall be treated as an individual resident of Ghana.

Gross income derived from the international operation of a ship or ships or aircraft includes:

(i) Income from the rental on a full (time or voyage) basis of a ship or ships or aircraft used in international transport;

(ii) Income from the rental on a bareboat basis of a ship or ships or aircraft used in international transport;

(iii) Income from the rental of containers and related equipment used in international transport that is incidental to income from the international operation of a ship or ships or aircraft;

(iv) Gains from the sale or other alienation of a ship or ships or aircraft used in international transport; and

(v) Income derived by an individual or corporation otherwise engaged in the international operation of a ship or ships or aircraft from active participation in a pool, an alliance, joint venture, international operating agency, or other venture, that is itself engaged in the international operation of a ship or ships or aircraft.

The Embassy, on behalf of the Government of the United States of America, proposes that if the foregoing is acceptable to the Government of Ghana, this note and the Ministry's reply note shall constitute an agreement between the two Governments, which shall enter into force on the date of the Ministry's reply note and shall have effect with respect to taxable years beginning on or after January 1, 2001 It shall remain in force until terminated by either Government giving written notice to the other Government through diplomatic channels.

The Embassy of the United States of America avails itself of this opportunity to renew to the Ministry of Foreign Affairs of the Government of Ghana the assurances of its highest consideration.

Enclosure:
1. Draft reply note

Embassy of the United States of America

Accra, April 24, 2001

EMBASSY OF THE UNITED STATES OF AMERICA
ACCRA

SCR.TI/TA/USA

REPUBLIC OF GHANA

MINISTRY OF FOREIGN AFFAIRS

The Ministry of Foreign Affairs of the Republic of Ghana presents its compliments to the Embassy of the United States of America and has the honour to acknowledge with thanks the receipt of Note No. 2001-005 of April 24, 2001 proposing an agreement to exempt from Ghanaian tax gross income derived from the international operation of a ship or ships or aircraft by individual residents of the United States and by corporations organized in the United States, in each case, that are engaged in the international operation of a ship or ships or aircraft. This exemption shall be granted on the basis of equivalent exemptions granted by the United States to individuals who are residents of Ghana (other than U.S. citizens or residents) and to corporations that are organized in Ghana.

The terms of the agreement are as follows:

The Government of Ghana agrees to exempt from Ghanaian tax gross income derived from the international operations of a ship or ships or aircraft by individuals who are residents of the United States and corporations that are organized in the United States, in each case, that are engaged in the international operation of a ship or ships or aircraft. This exemption is granted on the basis of equivalent exemptions granted by the United States under the terms of the Embassy's note of April 24, 2001.

Gross income derived from the international operation of a ship or ships or aircraft includes:

- Income from the rental on a full (time or voyage) basis of a ship or ships or aircraft used in international transport;

- Income from the rental on a bareboat basis of a ship or ships or aircraft used in international transport;

- Income from the rental of containers and related equipment used in international transport that is incidental to income from the international operation of a ship or ships or aircraft;

- Gains from the sale or other alienation of a ship or ships or aircraft used in international transport; and

- Income derived by an individual or corporation otherwise engaged in the international operation of a ship or ships or aircraft from active participation in a pool, an alliance, joint venture, international operating agency, or other venture, that is itself engaged in the international operation of a ship or ships or aircraft.

The Ministry of Foreign Affairs of the Republic of Ghana confirms that the Government of Ghana accepts the proposal contained in the Embassy's Note No. 2001-055 and that the Embassy's note and this note in reply constitute an agreement between the two Governments, which shall enter into force on the date of this note and shall have effect with respect to taxable years beginning on or after January 1, 2001. It shall remain in force until terminated by either Government giving written notice to the other Government through diplomatic channels.

The Ministry of Foreign Affairs of the Government of Ghana avails itself of this opportunity to renew to the Embassy of the United States the assurances of its highest consideration.

Accra, 12th November, 2001

THE EMBASSY OF THE
UNITED STATES OF AMERICA,
ACCRA.

Part III. Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Inflated Basis

Notice 2002–21

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is used by taxpayers to generate tax losses. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

In general, the transaction involves the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. This inflated basis is claimed as a result of a transfer of assets in which a U.S. taxpayer (Taxpayer) becomes jointly and severally liable on indebtedness of the transferor of the assets (Transferor), with the indebtedness having a stated principal amount substantially in excess of the fair market value of the assets transferred. Transferor may not be subject to U.S. tax or otherwise may be indifferent to the federal income tax consequences of the transaction.

In one variation of the transaction, Transferor borrows money from a lender (Lender) on a long term basis such as 30 years (the "Loan"). The amount borrowed may be in a foreign currency. Interest is payable at regular intervals, and principal is due at maturity. The Loan may permit prepayment. The Loan is made with full recourse to Transferor.

Transferor uses the proceeds to purchase assets (the "Assets"), such as short-term deposits, government bonds, or high-grade corporate debt, which may be denominated in a foreign currency. The Assets serve as collateral for the Loan pursuant to a loan agreement. As each interest payment becomes due, the collateral is used to satisfy such payments. Upon maturity or earlier payment, the Loan is satisfied, by its terms, first from the collateral, and only then against Transferor (or Transferor and any party that has assumed the liability as a joint and several obligor) to satisfy any shortfall.

Pursuant to a separate agreement between Transferor and Taxpayer, Transferor transfers a portion of the Assets to Taxpayer in consideration for Taxpayer's agreement to pay a portion of the Loan and become jointly and severally liable to Lender as a co-obligor on the Loan. The fair market value of the Assets transferred to Taxpayer (the "Conveyed Assets") equals the present value of the Loan's principal payment at maturity, determined by using a market rate of interest. Thus, the fair market value of the Conveyed Assets is substantially less than the Loan's stated principal amount. Taxpayer provides substitute collateral for the Loan, equal in value to the Conveyed Assets. The remainder of the Assets owned by Transferor continue to serve as collateral for the Loan.

Also pursuant to the agreement between Transferor and Taxpayer, Transferor agrees to make all interest payments on the Loan, and Taxpayer agrees to pay the principal due at maturity. The co-obligors and Lender anticipate that the collateral will be substantially (if not entirely) sufficient to repay the Loan.

Taxpayer subsequently disposes of the Conveyed Assets for their fair market value. Taxpayer claims that, as a result of its assumption of joint and several liability on the Loan, the entire principal amount of the Loan is included in Taxpayer's basis in the Conveyed Assets. As a result, Taxpayer claims a loss for federal income tax purposes in an amount equal to the excess of the stated principal amount of the Loan over the fair market value of the Conveyed Assets. If the Conveyed Assets are nonfunctional currency, Taxpayer claims an ordinary loss.

ANALYSIS

Section 1012 of the Internal Revenue Code provides that the basis of property is equal to the cost of the property. Section 1.1012–1(a) of the Income Tax Regulations defines "cost" to mean the "amount paid" for the property in cash or other property. Under general tax law principles, the amount paid for property generally includes the amount of the seller's liabilities assumed by the buyer. *Commissioner v. Oxford Paper Co.*, 194 F.2d 190 (2d. Cir. 1952). The inclusion of liabilities in basis by a buyer, however, is predicated on the assumption that the liabilities will be paid in full by the buyer. *See Commissioner v. Tufts*, 461 U.S. 300, 308 (1983), 1983–1 C.B. 120, 123.

In appropriate cases, the courts have rejected attempts to assign an inflated basis to property and have limited the basis of property to its fair market value. For example, the basis of property acquired with the issuance or assumption of recourse indebtedness has been limited to the acquired property's fair market value where "a transaction is not conducted at arm's-length by two economically self-interested parties or where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value." *Lemmen v. Commissioner*, 77 T.C. 1326, 1348 (1981) (citing *Bixby v. Commissioner*, 58 T.C. 757, 776 (1972)); *Webber v. Commissioner*, T.C. Memo. 1983–633, *aff'd*, 790 F.2d 1463 (9th Cir. 1986). *See also Majestic Securities Corp. v. Commissioner*, 42 B.T.A. 698, 701 (1940), *aff'd*, 120 F.2d 12 (8th Cir. 1941) ("The general rule that the price paid is the basis for determining gain or loss on future disposition presupposes a normal business transaction.")

Other cases have limited the portion of an assumed indebtedness that may be taken into account for federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities will be paid. *See Maher v. United States*, No. 16253–1 (W.D. Mo. 1969) (property was not in substance "subject to" liability where lender was not actually relying on property as collateral); *Maher v. Commissioner*, 469 F.2d 225 (8th Cir. 1972) (corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised); *Snowa v. Commissioner*, T.C. Memo 1995–336, *rev'd on other grounds*, 123 F.3d 190 (4th Cir. 1997) (co-obligor's cost of a new residence included only her ratable share of the liability due to state law's right of contribution).

Under the facts and circumstances of the transaction described in this Notice, as a matter of economic reality, the parties will bear responsibility for repayment of the Loan in accordance with their relative ownership of the Assets immediately after the transfer from Transferor to Taxpayer. Accordingly, the Service and the Treasury believe that Taxpayer's basis in the Conveyed Assets is equal to the fair market value of such assets upon their acquisition by Taxpayer. The losses purportedly resulting from the transaction described in this Notice (or substantially similar to the transaction described in this Notice) are not allowable to the extent Taxpayer derives a tax benefit that is attributable to a basis in excess of the fair market value of the Conveyed Assets. The purported tax benefits from these transactions also may be subject to challenge under other provisions of the Code and regulations, including but not limited to § 988 and, in the case of individuals, §§ 165(c)(2) and 465.

In addition, the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice 2002–21 are identified as "listed transactions" for the purposes of §§ 1.6011–4T(b)(2) of the Temporary Income Tax Regulations and 301.6111–2T(b)(2) of the Temporary Procedure and Administrative Regulations. See also § 301.6112–1T, A–4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111–2T and 301.6112–1T, A–4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111–1T and 301.6112–1T, A–3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a), and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this Notice. These taxpayers are advised to take prompt action to file amended returns.

The principal author of this Notice is Christina A. Morrison of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this Notice, contact Ms. Morrison at (202) 622–3950 (not a toll-free call).

Request for Comments on Items for 2002–2003 Published Guidance Priority List

Notice 2002–22

The Department of Treasury and Internal Revenue Service request public comment about items that should be included in the Guidance Priority List for 2002–2003.

IRS and Treasury's Office of Tax Policy use the Guidance Priority List ("Priority List") each year to identify and prioritize the tax issues that should be addressed through regulations, rulings, and other published administrative guidance. The Priority List will set forth guidance Treasury and the IRS intend to issue from July 1, 2002, through June 30, 2003. Public input is invited as part of the process of formulating the Priority List to ensure that the agencies' resources focus on the guidance items that are most important to taxpayers and tax administration.

As Treasury and the IRS draft guidance and consider suggestions for guidance, we will focus on providing needed guidance on a timely basis and consider the following questions:

1. Whether the guidance is consistent with the letter and the intent of the statutory language.
2. Whether the guidance is easily understood and applied by taxpayers.
3. Whether the guidance is enforceable on a uniform basis by the IRS.
4. Whether the guidance provides bright-line rules and resolves issues rather than raises issues.
5. Whether the guidance reduces controversy and lessens the burden on taxpayer and IRS resources.

No particular format is required for comments submitted in response to this Notice. However, it will be helpful for comments both to briefly describe the item that is recommended for inclusion on the Priority List and to explain why there is a need for guidance. In addition, comments may present an analysis of how the issue should be resolved.

Please submit all comments by April 30, 2002. Written comments should be sent to:

Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–22)
Room 5226
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered between the hours of 8 a.m. and 5 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–22)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, comments may be submitted electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2002–22" in the subject line. All comments will be available for public inspection and copying in their entirety.

For further information regarding this notice, contact Brenda Wilson of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4800 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, § 911, 1.911–1)

Rev. Proc. 2002–20

SECTION 1. PURPOSE

01. This revenue procedure provides information to any individual who failed to meet the eligibility requirements of § 911(d)(1) of the Internal Revenue Code because adverse conditions in a foreign country precluded the individual from meeting those requirements for taxable year 2001.

02. The Internal Revenue Service has previously listed countries for which the eligibility requirements of § 911(d)(1) of the Code are waived under § 911(d)(4) because of adverse conditions in those countries on and after the date stated. See Rev. Proc. 2001–27 (2001–19 I.R.B. 1155), Rev. Proc. 2000–14 (2000–1 C.B. 960), and Rev. Proc. 99–20 (1999–1 C.B. 872) . This revenue procedure lists the country added to the list in 2001, for which the eligibility requirements of § 911(d)(1) are waived. Rev. Proc. 2001–27, Rev. Proc. 2000–14, and Rev. Proc. 99–20 remain in full force and effect.

SECTION 2. BACKGROUND

01. Section 911(a) of the Code allows a "qualified individual," as defined in § 911(d)(1), to exclude foreign earned income and housing cost amounts from gross income. Section 911(c)(3) of the Code allows a qualified individual to deduct housing cost amounts from gross income.

02. Section 911(d)(1) of the Code defines the term "qualified individual" as an individual whose tax home is in a foreign country and who is (A) a citizen of the United States and establishes to the satisfaction of the Secretary of the Treasury that the individual has been a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (B) a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.

03. Section 911(d)(4) of the Code provides an exception to the eligibility requirements of § 911(d)(1). An individual will be treated as a qualified individual with respect to a period in which the individual was a *bona fide* resident of, or was present in, a foreign country if the individual left the country during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business. An individual must establish that but for those conditions the individual could reasonably have been expected to meet the eligibility requirements.

04. For 2001, the Secretary of the Treasury in consultation with the Secretary of State, has determined that war, civil unrest, or similar adverse conditions that precluded the normal conduct of business existed in the following country beginning on the specified date:

	Date of Departure
Country	*On or After*
Macedonia	July 27, 2001

05. Accordingly, for purposes of § 911 of the Code, an individual who left Macedonia on or after July 27, 2001, shall be treated for 2001 as a qualified individual with respect to the period during which that individual was present in, or was a *bona fide* resident of Macedonia, if the individual establishes a reasonable expectation of meeting the requirements of § 911(d) but for those conditions.

06. To qualify for relief under § 911(d)(4) of the Code, an individual must have established residency on or prior to July 27, 2001, or have been physically present in Macedonia on July 27, 2001, the date that the Secretary of the Treasury determined that individuals were required to leave the foreign country. Individuals who establish residency or are first physically present in Macedonia after July 27, 2001, shall not be treated as qualified individuals under § 911(d)(4) of the Code for taxable year 2001.

07. In order to assist those individuals who are filing prior year or amended tax returns, the Internal Revenue Service is republishing the countries listed for tax years 1998, 1999, and 2000, for which the eligibility requirements of § 911(d)(1) of the Code are waived under § 911(d)(4):

Tax Year 1998 —

	Date of Departure
Country	*On or After*
Albania	August 14, 1998
Democratic Republic of the Congo	August 5, 1998
Eritrea	June 5, 1998
Guinea-Bissau	June 10, 1998
Indonesia	May 15, 1998
Pakistan	August 16, 1998
Sierra Leone	December 23, 1998
Serbia-Montenegro	October 11, 1998

Tax Year 1999 —

	Date of Departure
Country	*On or After*
Eritrea	February 12, 1999
Ethiopia	February 12, 1999
Serbia-Montenegro	March 20, 1999

Tax Year 2000 —

	Date of Departure
Country	*On or After*
Eritrea	May 19, 2000

SECTION 3. INQUIRIES

A taxpayer who needs assistance on how to claim this exclusion, or on how to file an amended return, should contact a local IRS Office or, for a taxpayer residing or traveling outside the United States, the nearest overseas IRS office.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2001–27 (2001–19 I.R.B. 1155) is supplemented.

DRAFTING INFORMATION

The principal author of this revenue procedure is Kate Y. Hwa of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure contact Ms. Hwa at (202) 622–3840 (not a toll-free call).

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26 CFR 601.201: Rulings and determination letters. (Also Part I, §§ 267, 511, 512, 707, 761, 856, 1031, 1361; 1.761–1, 1.761–2; 301.7701–1, 301.7701–2, 301.7701–3, 301.7701–4.)

Rev. Proc. 2002–22

SECTION 1. PURPOSE

This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity, within the meaning of § 301.7701–2(a) of the Procedure and Administration Regulations.

This revenue procedure supersedes Rev. Proc. 2000–46 (2000–2 C.B. 438), which provides that the Service will not issue advance rulings or determination letters on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under § 1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under § 7701. This revenue procedure also modifies Rev. Proc. 2002–3 (2002–1 I.R.B. 117) by removing these issues from the list of subjects on which the Service will not rule. Requests for advance rulings described in Rev. Proc. 2000–46 that are not covered by this revenue procedure, such as rulings concerning mineral property, will be considered under procedures set forth in Rev. Proc. 2002–1 (2002–1 I.R.B. 1) (or its successor).

SECTION 2. BACKGROUND

Section 301.7701–1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701–1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.

Section 301.7701–2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701–3) that is not properly classified as a trust under § 301.7701–4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761–1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§ 301.7701–1, 301.7701–2, and 301.7701–3.

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property §§ 50.01–50.07 (Michael Allan Wolf ed., 2000).

Rev. Rul. 75–374 (1975–2 C.B. 261) concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. See also Rev. Rul. 79–77 (1979–1 C.B. 448), which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among the co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in *Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993), seventy-eight investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). *Bergford*, 12 F.3d at 169–170. *Accord Bussing v. Commissioner*, 88 T.C. 449 (1987), *aff'd on reh'g*, 89 T.C. 1050 (1987); *Alhouse v. Commissioner*, T.C. Memo. 1991–652.

Under § 1.761–1(a) and §§ 301. 7701–1 through 301.7701–3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. However, as the above authorities demonstrate, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. *Bergford*, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. *Bussing*, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. *Bergford*, 12 F.3d at 169.

SECTION 3. SCOPE

This revenue procedure applies to co-ownership of rental real property (other than mineral interests) (the Property) in an arrangement classified under local law as a tenancy-in-common.

This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.

SECTION 4. GUIDELINES FOR SUBMITTING RULING REQUESTS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the information described in section 5 of this revenue procedure is included in the ruling request and the conditions described in section 6 of this revenue procedure are satisfied. Even if sections 5 and 6 of this revenue procedure are satisfied, however, the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "Property." In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. The Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

For purposes of this revenue procedure, the following definitions apply. The term "co-owner" means any person that owns an interest in the Property as a tenant in common. The term "sponsor" means any person who divides a single interest in the Property into multiple co-ownership interests for the purpose of offering those interests for sale. The term "related person" means a person bearing a relationship described in § 267(b) or 707(b)(1), except that in applying § 267(b) or 707(b)(1), the co-ownership will be treated as a partnership and each co-owner will be treated as a partner. The term "disregarded entity" means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified REIT subsidiaries (within the meaning of § 856(i)(2)), qualified subchapter S subsidiaries (within the meaning of § 1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations. The term "blanket lien" means any mortgage or trust deed that is recorded against the Property as a whole.

SECTION 5. INFORMATION TO BE SUBMITTED

.01 Section 8 of Rev. Proc. 2002–1 outlines general requirements concerning the information to be submitted as part of a ruling request, including advance rulings under this revenue procedure. For example, any ruling request must contain a complete statement of all facts relating to the co-ownership, including those relating to promoting, financing, and managing the Property. Among the information to be included are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information and conditions specified below and in section 6 of this revenue procedure, or at least account for all of the items. For example, if a co-ownership arrangement has no brokerage agreement permitted in section 6.12 of this revenue procedure, the ruling request should so state. Furthermore, merely submitting documents and supplementary materials required by section 5.02 of this revenue procedure does not satisfy all of the information requirements contained in section 5.02 of this revenue procedure or in section 8 of Rev. Proc. 2002–1; all material facts in the documents submitted must be explained in the ruling request and may not be merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments. The ruling request must identify and explain any information or documents required in section 5 of this revenue procedure that are not included and any conditions in section 6 of this revenue procedure that are or are not satisfied.

.02 *Required General Information and Copies of Documents and Supplementary Materials*. Generally the following information and copies of documents and materials must be submitted with the ruling request:

(1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;

(2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;

(3) A full description of the Property;

(4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;

(5) All promotional documents relating to the sale of fractional interests in the Property;

(6) All lending agreements relating to the Property;

(7) All agreements among the co-owners relating to the Property;

(8) Any lease agreement relating to the Property;

(9) Any purchase and sale agreement relating to the Property;

(10) Any property management or brokerage agreement relating to the Property; and

(11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

SECTION 6. CONDITIONS FOR OBTAINING RULINGS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate.

.01 *Tenancy in Common Ownership*. Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02 *Number of Co-Owners*. The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in § 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

.03 *No Treatment of Co-Ownership as an Entity*. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

.04 *Co-Ownership Agreement*. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

.05 *Voting*. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

.06 *Restrictions on Alienation*. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

.07 *Sharing Proceeds and Liabilities upon Sale of Property*. If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

.08 *Proportionate Sharing of Profits and Losses*. Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

.09 *Proportionate Sharing of Debt*. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

.10 *Options*. A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

.11 *No Business Activities*. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75–374 (1975–2 C.B. 261). Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

.12 *Management and Brokerage Agreements*. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

.13 *Leasing Agreements*. All leasing arrangements must be *bona fide* leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

.14 *Loan Agreements*. The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

.15 *Payments to Sponsor*. Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000–46 is superseded. Rev. Proc. 2002–3 is modified by removing sections 5.03 and 5.06.

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Jeanne Sullivan and Deane Burke of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Sullivan or Mr. Burke at (202) 622–3070 (not a toll-free call).

Part IV. Items of General Interest

Credit for Increasing Research Activities; Correction

Announcement 2002–38

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains corrections to a notice of proposed rulemaking (REG–112991–01, 2002–4 I.R.B. 404) and notice of public hearing relating to the computation of the research credit.

This document was published in the **Federal Register** on December 26, 2001 (66 FR 66362).

FOR FURTHER INFORMATION CONTACT: Lisa J. Shuman (202) 622–3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The proposed regulations that are the subject of these corrections are under sections 41(c) and and 41(d) of the Internal Revenue Code.

Need for Correction

As published, the proposed regulations REG–112991–01, contains errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the proposed regulations REG–112991–01, which is the subject of FR. Doc. 01–31007, is corrected as follows:

§ 1.41–3 [Corrected]

1. On page 66368, column 1, § 1.41–3, paragraph (e), line 3, the language "ending on or after the date December 21" is corrected to read "ending on or after December 26".

§ 1.41–4 [Corrected]

2. On page 66369, column 1, § 1.41–4, paragraph (a)(8), paragraph (i) of *Example 2.*, line 3 from the bottom of paragraph, the language "tests the nozzles to ensure that to ensure that" is corrected to read "tests the nozzles to ensure that".

3. On page 66369, column 1, § 1.41–4, paragraph (a)(8), paragraph (ii) of *Example 2.*, line 2 the language "painting process is a separate business" is corrected to read "painting process relate to a separate business".

4. On page 66369, column 3, § 1.41–4, paragraph (a)(8), paragraph (i) of *Example 6.*, lines 5 through 8 from the bottom of the paragraph, the language "X conducts extensive and complex scientific or laboratory testing to determine if the current model vehicle meets X's requirements." is removed.

5. On page 66370, column 3, § 1.41–4, paragraph (c)(6), line 2 of the paragraph heading, the language "years beginning on or after the" is corrected to read "years beginning on or after".

6. On page 66371, column 2, § 1.41–4, paragraph (c)(6)(iv)(C), line 1 of the column, the language "leased, licensed or otherwise marketed" is corrected to read "leased, licensed, or otherwise marketed".

7. On page 66371, column 2, § 1.41–4, paragraph (c)(6)(vi)(C), line 2 from the bottom of the paragraph, the language "paragraphs (c)(6)(v)(A) and (B) of this" is corrected to read "paragraphs (c)(6)(vi)(A) and (B) of this".

8. On page 66371, column 3, § 1.41–4, paragraph (c)(6)(viii), paragraph (i) of *Example 2.*, line 3, the language "order to create an improved reserve valuation" is corrected to read "order to create the improved reserve valuation".

9. On page 66372, column 3, § 1.41–4, paragraph (c)(6), paragraph (ii) of *Example 7.*, line 1, the language "(ii) *Conclusion*. X's software is software" is corrected to read "(ii) *Conclusion*. X's software is".

10. On page 66375, column 1, § 1.41–4, paragraph (c)(10), paragraph (i) of *Example 6.*, line 1, the language "*Example 6*. (i) *Facts*. X manufacturer and" is corrected to read "*Example 6*. (i) *Facts*. X manufacturers and".

11. On page 66375, column 2, § 1.41–4, paragraph (c)(10), paragraph (1) of *Example 7*. is correctly designated § 1.41–4, paragraph (c)(10), paragraph (i) of *Example 7*.

12. On page 66375, column 2, § 1.41–4, paragraph (c)(10), paragraph (i) of *Example 7.*, line 9, the language "purchases the existing robotic equipment for" is corrected to read "purchases existing robotic equipment for".

13. On page 66375, column 3, § 1.41–4, paragraph (e), line 4, the language "December 26, 2002." is corrected to read "December 26, 2001.".

§ 1.41–8 [Corrected]

14. On page 66375, column 3, § 1.41–8, paragraph (b)(4), line 4, the language "December 26, 2002." is corrected to read "December 26, 2001.".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Associate Chief Counsel
(Income Tax and Accounting).

(Filed by the Office of the Federal Register on March 18, 2002, 8:45 a.m., and published in the issue of the Federal Register for March 19, 2002, 67 F.R. 12494)

Excise Taxes on Excess Benefit Transactions; Correction

Announcement 2002–39

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains corrections to final regulations (T.D. 8978, 2002–7 I.R.B. 500) that were published in the **Federal Register** on Wednesday, January 23, 2002 (67 FR 3076) relating to the excise taxes on excess benefit transactions.

DATES: This correction is effective January 23, 2002.

FOR FURTHER INFORMATION CONTACT: Phyllis D. Haney, (202) 622–4290 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these corrections are under section 4958 of the Internal Revenue Code.

Need for Correction

As published, the final regulations contain errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the final regulations (T.D. 8978), that were the subject of FR Doc. 02–985, is corrected as follows:

1. On page 3078, column 1, in the preamble under the paragraph heading "*Definition of Applicable Tax-Exempt Organization*", line 6 from the top of the column, the language "to the efficient administration of the" is corrected to read "for the efficient administration of the".

2. On page 3082, column 3, in the preamble under the paragraph heading "*Final Regulatory Flexibility Analysis*", first paragraph, line 13, the language "REP. 104–506 at 56–7, March 28, 1996)" is corrected to read "REP. 506, 104th Congress, 2d SESS. (1996), 53, 56–7)".

3. On page 3083, column 1, in the preamble under the paragraph heading "*Final Regulatory Flexibility Analysis*", first full paragraph, line 1, the language "The objective for the rebuttable" is corrected to read "The objective of the rebuttable".

§ 53.4958–4 [Corrected]

4. On page 3091, column 3, § 53.4958–4(a)(3)(vii), *Example 1*, line 12, the language "T (see § 53.4958–3(a)). Under the initial" is corrected to read "T (see § 53.4958–3(c)(3)). Under the initial".

5. On page 3095, column 2, § 53.4958–4(c)(4), *Example 2*, line 10, the language "D fails to report the bonus on his individual" is corrected to read "D fails to report the bonus on D's individual".

§ 301.7611–1 [Corrected]

6. On page 3099, column 2, in A–19, line 1, the language "A–19: See § 53.4958–7(b) of this" is corrected to read "A–19: See § 53.4958–8(b) of this".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Associate Chief Counsel
(Income Tax and Accounting).

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Renewal of Enrolled Agent Status

Announcement 2002–41

Enrolled agent cards will expire on March 31, 2002. However, all cards for the upcoming three year cycle will not be mailed out by that date. Therefore, the Director of Practice has extended all current enrollment cards until April 30, 2002. Anyone not receiving their enrollment card by that date should call (313) 234–1280 or e-mail the Enrolled Practitioner Unit at *epp@irs.gov*. Enrolled agents may continue to use their existing enrollment card until April 30, 2002.

Renewal of Sponsor Agreements for Enrolled Agent Continuing Professional Education

Announcement 2002–42

Sponsor agreements for sponsors of qualifying continuing professional education expire on March 31, 2002. The Director of Practice will not mail out their approval or disapproval of sponsor agreements for the upcoming three year cycle by that date. Therefore, the Director of Practice has extended all existing sponsor agreements through August 31, 2002. Sponsors will be notified by August 31, 2002, of their renewal status. Sponsors seeking renewal will continue to be approved until that date.

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions 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.—Intemal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

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2002–6, 2002–3 I.R.B. *326*
2002–7, 2002–6 I.R.B. *489*
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2002–10, 2002–6 I.R.B. *490*
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2002–12, 2002–7 I.R.B. *526*
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2002–15, 2002–8 I.R.B. *548*
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2002–13, 2002–8 I.R.B. *549*
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2002–15, 2002–6 I.R.B. *490*
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8975, 2002–4 I.R.B. *379*
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8977, 2002–6 I.R.B. *463*
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8979, 2002–6 I.R.B. *466*
8980, 2002–6 I.R.B. *477*
8981, 2002–7 I.R.B. *496*
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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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REG–107100–00
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REG–119436–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–120135–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–125450–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–125626–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–126485–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–137519–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–142299–01
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Ann. 2002–15, 2002–7 I.R.B. *540*
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84–57
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87–50
Modified by
Rev. Proc. 2002–10, 2002–4 I.R.B. *400*

96–13
Modified by
Rev. Proc. 2002–1, 2002–1 I.R.B. *1*

97–27
Modified and amplified by
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Superseded by
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Superseded by
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2001–5
Superseded by
Rev. Proc. 2002–5, 2002–1 I.R.B. *173*

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Superseded by
Rev. Proc. 2002–6, 2002–1 I.R.B. *203*

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2001–16
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Ann. 2002–26, 2002–11 I.R.B. *629*

2001–36
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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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Modified and amplified by
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64–328
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66–110
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Notice 2002–8, 2002–4 I.R.B. *398*

89–29
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T.D. 8976, 2002–5 I.R.B. *421*

92–19
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Rev. Rul. 2002–12, 2002–11 I.R.B. *624*

2002–7
Corrected by
Ann. 2002–13, 2002–7 I.R.B. *540*

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8972
Corrected by
Ann. 2002–23, 2002–8 I.R.B. *563*

8973
Corrected by
Ann. 2002–14, 2002–7 I.R.B. *540*

8975
Corrected by
Ann. 2002–21, 2002–8 I.R.B. *562*

8976
Corrected by
Ann. 2002–21, 2002–8 I.R.B. *562*