Bulletin No. 1996–52
December 23, 1996

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 96–61, page 24.
Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning January 1, 1997, will be 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 is 6.5 percent.

T.D. 8687, page 4.
Final regulations under section 863 of the Code governs the source of income from sales of natural resources or other inventory produced in and sold outside the United States.

Notice 96–68, page 30.
Definitions relating to application of exclusion under section 127. This notice provides guidance regarding the definitions of the terms "graduate level course" and "courses beginning."

EXEMPT ORGANIZATIONS

Announcement 96–131, page 32.
A list is given of organizations now classified as private foundations.

ESTATE TAX

T.D. 8686, page 14.
Final regulations provide guidance relating to the additional requirements necessary to ensure the collection of estate taxes imposed under section 2056A of the Code with respect to taxable events involving qualified domestic trusts (QDOTs).

EXCISE TAX

Announcement 96–130, page 32.
Effective after December 31, 1996, the tax rates for aviation gasoline and aviation fuel taxes have changed. The rate and base amount imposed on luxury passenger vehicles have also changed. Ozone-depleting chemical rates for 1997 are included in this announcement. Also, excise taxes on transportation expire December 31, 1996.

ADMINISTRATIVE

Notice 96–65, page 28.
This notice provides guidance for certain provisions of the Small Business Job Protection Act of 1996 (the "Act") dealing with the status of a trust as domestic or foreign under sections 7701(a)(30) and 7701(a)(31) of the Code. This notice grants taxpayers additional time to comply with the new domestic trust criteria contained in the Act and announces the time and manner for making an election to apply the new trust criteria retroactively. Also, guidance regarding the application of sections 1491 through 1494 of the Code is provided if the status of a trust changes from domestic to foreign.

Announcement 96–132, page 33.
Orthopaedic Development Foundation, Hilton Head, SC, no longer qualifies as an organization to which contributions are deductible under section 170 of the Code.

Finding Lists begin on page 36.
Announcement of Disbarments and Suspensions begins on page 34.

Mission of the Service

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

Statement of Principles of Internal Revenue Tax Administration

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

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

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

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

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

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

Section 863.—Special Rules for Determining Source

26 CFR 1.863–3: Allocation and apportionment of income from certain sales of inventory.

T.D. 8687

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

Source of Income From Sales of Inventory and Natural Resources Produced in One Jurisdiction and Sold in Another Jurisdiction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations governing the source of income from sales of natural resources or other inventory produced in the United States and sold outside the United States or produced outside the United States and sold in the United States. This document affects persons who produce natural resources or other inventory in the United States and sell outside the United States, or produce natural resources or other inventory outside the United States and sell in the United States.

EFFECTIVE DATE: December 30, 1996.

Applicability: Taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and on or before December 30, 1996.

FOR FURTHER INFORMATION CONTACT: Anne Shelburne, (202) 622–3880 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1476. Responses to this collection of information are mandatory.

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

The estimated average annual burden per respondent is approximately 2.6 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, T:FP, Washington, DC 20224, and the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC, 20503.

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

Background

This document contains final regulations to be added to the Income Tax Regulations (26 CFR part 1) under section 863 of the Internal Revenue Code (Code). The final regulations provide rules for allocating and apportioning income between U.S. and foreign sources from natural resources and other inventory produced in the United States and sold outside the United States, or produced outside the United States and sold in the United States.

On December 11, 1995, proposed regulations [INTL–0003–95 (1996–1 C.B. 831)] were published in the **Federal Register** (60 FR 63478). The IRS received written comments on the proposed regulations and held a public hearing on April 10, 1996. Having considered the comments and the statements made at the hearing, the IRS and the Treasury Department adopt the proposed regulations as modified by this Treasury decision. The comments and revisions are discussed below.

Explanation of Provisions

I. Allocation of gross income from sales of natural resources under section 863(a)

Section 1.863–1(b) of the proposed regulations relate to the rules governing natural resources. The proposed regulations provide three methods for determining the amount of United States or foreign source income from sales of natural resources. One method (derived from the existing regulations) sources income in its entirety to the location of the natural resources, and applies where the taxpayer does not engage in substantial additional production beyond production of the natural resources. The second method, the export terminal rule, splits sales income at the export terminal, sourcing gross receipts equal to the fair market value at the export terminal to the location of the natural resources, and gross receipts in excess of that amount either to the place of sale or according to the rules in § 1.863–3, depending on the circumstances. The third method requires taxpayers performing additional production in the country where the natural resources are located, to split gross receipts at the point of the additional production, sourcing gross receipts equal to the fair market value prior to that point to the location of the natural resources and gross receipts in excess of that amount according to the rules in § 1.863–3.

1. Implications of the Tenth Circuit's Order in *Phillips*

Section 1.863–1(b)(1)(i) of the proposed regulations sources certain income from natural resources in its entirety to the location of the resources. The preamble to the proposed regulations states that Treasury and the IRS would consider the Tenth Circuit's unpublished opinion in its Order and Judgment in *Phillips Petroleum v. Comm'r*, 97 T.C. 30 (1991), 101 T.C. 78 (1993), *aff'd. without published opinion*, 70 F.3d 1282 (10th Cir., 1995), in finalizing the regulations. In *Phillips*, the Tax Court ruled § 1.863–1(b)'s natural resource regulation, generally sourcing income from U.S. natural resources in its entirety to the United States, invalid to the extent it conflicted with the Court's interpretation of section 863(b)(2). That section provides that gains, profits and income from the sale of inventory property produced within and sold without the United States (or vice versa) shall be treated as derived partly from sources within and partly from sources without the United States. The Tenth Circuit affirmed the Tax Court.

In view of *Phillips*, the final regulations modify the proposed regulations to eliminate the 100 percent allocation rule, making the determination of the source of income subject instead to the export terminal rule. Thus, gross receipts equal to the fair market value of the product at the export terminal are allocated to the location of the farm, mine, well, deposit or uncut timber, with the source of gross receipts from such sales in excess of the product's fair market value at the export terminal allocated to the country of sale.

Several commentators requested that any change to the natural resource rules made in light of *Phillips* be done in proposed form, providing opportunity to comment on the regulations. However, because the final regulations merely eliminate the rule which required a single source of income for sales of natural resources, and because Treasury and the IRS believe that there has been adequate opportunity to comment on the proposed regulations' export terminal rule, the natural resources rules are issued in final form.

2. Availability of the 50/50 method for natural resources

Several commentators wrote that there is no basis for treating natural resources differently than other inventory. Therefore, producers of natural resources should be permitted to determine the source of their income under the 50/50 method described in § 1.863–3(b)(1). They point to legislation enacted in the Tax Reform Act of 1986, arguing that Congress, in enacting section 865 to govern personal property sales, drew no distinction between sales of natural resources and sales of other inventory. Commentators have also pointed to section 865(b), enacted in 1993, providing that income from sales of U.S. softwood must be U.S. source in its entirety. They conclude that Congress was aware of the Tax Court's decision in *Phillips*, overruling *Phillips* only for softwood, but intending that all other natural resources be sourced under the 50/50 method.

Treasury and the IRS do not believe that Congress in the 1986 Act evidenced an intent to source all income from sales of natural resources under the 50/50 method. Rather, Congress merely referred to the 50/50 method to generally describe the methods for sourcing income from certain types of inventory sales. In addition, the legislative history to the 1993 Act, requiring income from softwood sales to be allocated in its entirety to the United States, does not suggest that Congress intended to overturn the longstanding regime governing sales of other natural resources. Moreover, the Small Business Job Protection Act of 1996, Public Law 104–188 (August 20, 1996) (the 1996 Act), further clarifies that the Service is not required to apply the 50/50 method. Prior to the 1996 Act, section 865(b) provided that income from inventory sales was to be sourced under sections 861(a)(6), 862(a)(6), and 863(b). The 1996 Act, in section 1704(f)(4)(A), amended Code section 865(b)(2) by striking 863(b) and inserting 863. The Act makes this amendment effective as if included in amendments made by section 1211 of the Tax Reform Act of 1986 (Public Law 99–514). This technical correction to the 1986 Act clarifies that Treasury has broad authority to provide rules sourcing income from sales of inventory under section 863, and is not restricted to any particular method.

Treasury and the IRS also believe longstanding distinctions have been made in the tax treatment of natural resources and other property, both in our tax laws and in our tax treaties. Most treaties, for example, grant primary or exclusive taxing jurisdiction to the country where natural resources are located. Thus, income from sales of natural resources is treated differently than income derived from sales of other inventory, which is normally subject to the business profits article of a treaty. See, e.g., Article 6 of the United States Model Income Tax Convention (September 20, 1996), which provides that income from real property, ''including income from agriculture and forestry'' may be taxed by the country where the resources are located.

The legislative history to section 863's predecessor, section 217(e) of the Revenue Act of 1921, also reflects an intention that natural resources be treated differently from other property. The House version of section 217 (H.R. 8245, 67th Cong., 1st Sess. (Aug.20, 1921)) included a provision sourcing income from natural resources in its entirety to the location of the resources. However, based on testimony raising the possibility of a case where such a single source rule should not apply, the Senate struck the provision that allocated all of the income from natural resources to a single country. (H.R. 8245 (67th Cong., 1st Sess. (November 4, 1921)); Hearings Before The Committee on Finance, United States Senate, H.R. 8245, 67th Cong., 1st Sess. (September 1 to October 1, 1921), at 309–310. A provision similar to that considered by the House, but with flexibility available for unusual cases, was then added to the regulations promulgated in 1922.

Thus, Treasury and the IRS believe that income from natural resources should be sourced differently than income from other sales of inventory.

3. Clarification of language in § 1.863–2

In response to a comment, the final regulations are modified to clarify that the source of income from sales of natural resources must be determined solely under the rules set forth in § 1.863–1(b) of the final regulations. Treasury and the IRS clarified this point in corrections to the proposed regulations, published on August 27, 1996, in the **Federal Register** (61 FR 44023).

4. Additional production activities

The proposed regulations define additional production activities in § 1.863–1(b)(3)(ii) as substantial production activities performed by the taxpayer in addition to activities relating to the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. The proposed regulations provide that generally the principles of § 1.954–3(a)(4) apply in determining whether an activity qualifies as such additional production. However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate transportation of the natural resource to or from the export terminal, be considered additional production. Thus, the proposed regulations in an example indicate liquefaction of natural gas would not constitute additional production activities.

Liquefaction is the process of liquefying natural gas so that it can be transported by tanker for sales abroad. Several commentators urged us to reconsider our position, arguing that liquefaction is an expensive, complex activity. Treasury and the IRS, however, continue to believe that liquefaction is an activity preparing the natural resource itself for export within the meaning of § 1.863–1(b)(3)(ii) of the final regulations, and that it is appropriate to exclude such activities from the definition of additional production. Even though liquefaction may be an expensive, complex process, liquefied natural gas retains its character as a natural resource, so that liquefaction should be treated no differently than other processes that prepare natural resources for export.

Several commentators requested that the regulations more precisely define the processes that constitute production of natural resources, to better differentiate those activities described in § 1.863–1(b)(1) of the proposed regulations, as being from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, from those that qualify as additional production activities within the meaning of § 1.863–1(b)(3)(ii) of the proposed regulations. In particular, a commentator requested that the final regulations specifically address this issue in the case of mining. In response to this comment, the final regulations include an example describing certain mining processes that would not qualify as additional production activities in the case of copper.

5. Treatment of partnerships

The proposed regulations provide that, in applying the rules in § 1.863–3 of the proposed regulations, a partner would be treated as engaged in the production activity of its partnership. However, that provision was not extended to § 1.863–1 of the proposed regulations, which generally provides rules for determining the source of income from sales of natural resources. The final regulations provide rules for transactions involving partners and partnerships, which apply in the same manner to sales of natural resources and to sales of other inventory. See II. 3. of this preamble for a discussion of those rules.

6. Genetically-engineered agricultural products

One commentator requested that final regulations state that natural resources do not include products, such as certain seeds, where the premium value of the product is derived from genetic traits produced by biotechnology or traditional methods, and the seeds themselves are not grown for consumption. The inherent nature of products as agricultural products, however, does not change because they may be subject to research and development. Because they remain natural resources, Treasury and the IRS rejected this comment.

II. Allocation and apportionment of income from sales of inventory other than natural resources

Section 1.863–3 of the proposed regulations provides rules for allocating and apportioning income from inventory sales other than natural resources where the taxpayer produces property in the United States and sells outside the United States, or produces property outside the United States and sells in the United States (Section 863 Sales). The proposed regulations provide three methods: the 50/50 method, the independent factory price method, and the books and records method.

1. Sales in international waters or in space

Consistent with the existing regulations, the proposed regulations limit the methods in § 1.863–3 to sales within a foreign country. The preamble, however, requests comments on whether the regulation should be expanded to cover sales made in international waters or in space. Although the statute refers to sales outside the United States, Treasury and the IRS expressed concern in that preamble that expanding the scope of the regulations to include all such sales could lead to abuses where, for example, a taxpayer produced goods in the United States, passed title to those goods outside the United States, and then sold the goods to U.S. customers. In considering whether to expand the scope of the final regulations to include such sales, Treasury and the IRS requested comments on whether to include an exception to the title passage rule for sales of goods produced in the United States and destined for the U.S. market.

In response to comments and consistent with the preamble to the proposed regulations, the final regulations expand the scope of the existing and proposed regulations to include sales outside the United States. Moreover, to prevent abuse from this expanded rule, the final regulations provide that sales of goods wholly produced in the United States and sold for use, consumption, or disposition in the United States, will be considered to take place in the United States. Income from such sales will be treated as from U.S. sources. The final regulations rely on rules in § 1.864–6(b)(3)(ii) (relating to the determination of whether foreign source income is effectively connected with a U.S. trade or business under section 864(c)(4)(iii)), for determining the country of use, consumption, or disposition. Also, property will be treated as wholly produced in the United States for this purpose if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States. See also § 1.861–7(c) to determine the source of income in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance.

Treasury and the IRS are considering whether the rules of the final regulations are appropriate where a product is produced in one country but is destined for use either on the high seas or in space. Until additional guidance is provided, taxpayers may rely upon the general rules of the final regulations for these cases.

2. Segregation and aggregation of sales

Once a taxpayer selects a method under § 1.863–3(b) for dividing gross income derived from Section 863 Sales between production activity and sales activity, § 1.863–3(a) of the proposed regulations provide that a taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. The proposed regulations also provide in § 1.863–3(a) that taxpayers must determine the source of gross income under paragraph (c) and taxable income under paragraph (d) by aggregating all Section 863 Sales to which a method described in paragraph (b) applies.

The final regulations clarify that the rules of paragraphs (c) and (d) apply separately to Section 863 Sales in the United States and to Section 863 Sales outside the United States, so that taxpayers are required to aggregate all Section 863 Sales under paragraphs (c) and (d) after the taxpayer has first separately applied the method under paragraph (b) to Section 863 Sales in the United States and to Section 863 Sales outside the United States.

3. Transactions with partnerships

The proposed regulations provide in § 1.863–3(a) that a taxpayer's production activity includes production activities conducted through a partnership of which the taxpayer is a partner either directly or through one or more partnerships. One commentator recommended that final regulations extend the partnership rules to natural resources. However, the commentator suggested that an aggregate approach to partnerships should apply only in cases where the partnership, instead of selling the property and distributing the proceeds to the partner, distributes the property to a partner. In response to the comments, the final regulations modify the proposed regulations. Under the final regulations, the aggregate approach applies to a partnership's production or sales activity only for two purposes. First, the aggregate approach applies for purposes of determining the source of a partner's distributive share of partnership income. Thus, if a partnership engages in the production of inventory property in the United States and sells such property outside the United States, a partner will be considered to have produced and sold that inventory property in the same manner as the partnership when determining the source of its distributive share of such sales income. Second, the aggregate approach applies for purposes of sourcing income from the sale of inventory property that is transferred in kind from or to a partnership. Thus, for example, where the partnership makes an in kind distribution of inventory property to its partners, the source of the partner's income from the sale of such property is determined based on both its own activity and on the partnership's activity. Similarly, the aggregate approach applies in cases where a partner contributes inventory produced by it to its partnership, if the partnership then sells the inventory (e.g., as a distributor or after further processing).

The entity approach applies for all other purposes. For example, where a partnership manufactures inventory property and sells the property to one of its partners, the source of that partner's income from the resale of the property is determined without regard to the partnership's manufacturing activity. Consistent with this modification, the final regulations also specify that assets owned by a partnership (or a partner) are not deemed owned by the partner (or the partnership) unless the aggregate approach applies to the transaction at issue.

4. Taxable income method

In response to comments, § 1.863–2(b) of the proposed regulations is clarified to provide that taxpayers may elect the principles of § 1.863–3(b)(1) and (c) to determine the source of taxable income (rather than gross income) from sales of inventory property.

5. Independent factory price (IFP) method

One commentator requested clarification that the sale establishing an IFP must be sourced under the IFP method only if a taxpayer elects the IFP method. The proposed and final regulations intend this result. The IFP method applies to either the sale establishing the IFP or to a sale applying the IFP only if the taxpayer elects the IFP method.

The proposed regulations eliminated the provision in existing regulations permitting taxpayers to establish an IFP by methods other than by sales to independent distributors. The preamble, however, requested comments on the continued utility of such a provision. Two commentators recommended that the provision be retained and expanded to permit taxpayers to establish an IFP by any method that is appropriate under section 482. The commentators stated that any evidence acceptable for proving an arm's length price under section 482 should be acceptable as an IFP. The commentators also stated that taxpayers who cannot use the IFP method must use the 50/50 method, and that the 50/50 method may not produce an equitable result for nonresidents importing goods into the United States.

After further consideration, Treasury and the IRS have decided to finalize the regulations on this point as proposed. No convincing evidence has been presented for the need of a broad-based rule permitting taxpayers to establish an IFP by any method that would otherwise be appropriate under section 482 when they can use books and records to demonstrate a more appropriate sourcing result. In view of the absence of a clearly identified benefit for taxpayers and the availability of the books and records method, Treasury and the IRS believe that expansion of the IFP rule is not justified.

6. Books and records

Under both the existing and proposed regulations, taxpayers can request permission from the District Director to use a taxpayer's books and records to allocate or apportion income between U.S. and foreign sources if this method more clearly reflects the taxpayer's income. The preamble to the proposed regulations requests comments on retaining the books and records method. Two commentators asked for retention of this method because instances may arise where a taxpayer does not have third party sales, thereby making the IFP method unavailable. In such cases, a taxpayer may find it advantageous to determine the source of its income on the basis of its books and records. These comments were accepted. The final regulations retain the books and records method, subject to an election and prior approval of the method by the District Director.

7. Determination of source of gross income from production activities

a. Definition of production assets

i. Contract manufacturing

Under the proposed regulations, production assets are limited to those owned directly by the taxpayer that are directly used by the taxpayer to produce the relevant inventory. These rules are intended to insure that taxpayers do not attribute the assets or activities of related or unrelated parties manufacturing under contract with the taxpayer. One commentator asked that the definition of production assets be expanded to include production assets owned by related or unrelated contract manufacturers. The commentator contends that by limiting production assets to those owned by the taxpayer, the regulations source income differently depending upon the form in which the taxpayer conducts business. Treasury and the IRS, however, believe it is appropriate to limit production assets in the apportionment formula to assets owned by the taxpayer and used by the taxpayer to produce the inventory. In addition, taxpayers generally do not know the contract manufacturer's basis in its production assets. Further, it would be very difficult to draw a clear line between contract manufacturers and other suppliers. Thus, Treasury and the IRS do not believe the source of a taxpayer's income should take into account activities of others or assets owned by others with whom the taxpayer has manufacturing arrangements. The final regulations clarify, however, that this rule does not override the single entity rules set forth under § 1.1502–13 (dealing with members of an affiliated group filing on a consolidated basis), or the rules under § 1.863–3(g) dealing with partnerships.

ii. Accounts receivable

One commentator also asserted that accounts receivable should be included as a production asset. This comment was rejected. The production formula is intended to approximate the location of the taxpayer's production activity. Thus, assets not directly involved in production should not be included.

b. Anti-abuse rule

The preamble to the proposed regulations indicated that the purpose of the property fraction is to attribute the source of production income to the location of production activity. Treasury and the IRS, however, were concerned that taxpayers would attempt to artificially affect the location of assets to manipulate the rules, and so solicited comments on whether an anti-abuse rule was needed. No comments were received that objected to such anti-abuse rule. After further considering the issue, Treasury and the IRS have included an anti-abuse rule in the final regulations to prevent taxpayers from manipulating the property formula to achieve inappropriate results. Therefore, the anti-abuse rule provides that if a taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by affecting the formula in a manner inconsistent with the purpose of the regulation, the District Director may make appropriate adjustments so that the source of the taxpayer's income from production activity more clearly reflects the source of that income. An example in the regulations demonstrates circumstances where the anti-abuse rule may apply. In that example, with a principal purpose of reducing its U.S. tax liability, the taxpayer leases all of its U.S. property so that it owns only property located in a foreign country. The example concludes that the District Director may ignore a sale-leaseback transaction to more clearly reflect the source of the taxpayer's production income.

8. Determination of taxable income

One commentator requested that the calculation of taxable income, when applying the 50/50 method along with the research and experimental (R&E) expense allocation rules in § 1.861–17, be clarified. The commentator suggests that the last sentence of § 1.863–3(d) of the proposed regulations can be read to conflict with the R&E set aside in § 1.861–17. The final regulations clarify that the R&E set aside remains available to taxpayers using the 50/50 method.

9. Reporting requirements

The proposed regulations, in § 1.863–3(e), require a taxpayer to fully explain the methodology used to determine the source of income, the circumstances justifying use of that method, the extent that sales are aggregated, and the amount of income so allocated. One commentator wrote that the reporting requirements in § 1.863–3(e) of the proposed regulations are unnecessary and excessively burdensome. The regulations clarify that the requirement is limited to a statement attached to the tax return, explaining the methodology used, the circumstances justifying that use, the aggregation of sales, and the amount of income allocated. Treasury and the IRS believe the reporting requirements in § 1.863–3(e) of the proposed regulations are reasonable, and serve legitimate administrative purposes.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section principally impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.863–2 also issued under 26 U.S.C. 863.

Section 1.863–3 also issued under 26 U.S.C. 863.

Section 1.863–4 also issued under 26 U.S.C. 863.

Section 1.863–6 also issued under 26 U.S.C. 863. * * *

Par. 2. Sections 1.863–3 and 1.863–3T are redesignated as §§ 1.863–3A and 1.863–3AT, respectively, and an undesignated center heading is added preceding the redesignated sections to read as follows:

Regulations Applicable to Taxable Years Prior to December 30, 1996

Par. 3. Section 1.863–0 is added to read as follows:

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Par. 4. In § 1.863–1, paragraphs (a), (b) and (c) are revised and paragraph (e) is added to read as follows:

§ 1.863–1 Allocation of gross income.

(a) *In general*. Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States. See § 1.863–2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in § 1.863–2(a). See also sections 865(b) and (e)(2). In the case of sales of property involving partners and partnerships, the rules of § 1.863–3(g) apply.

(b) *Natural resources*—(1) *In general*. Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal. For place of sale, see §§ 1.861–7(c) and 1.863–3(c)(2). The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows—

(i) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under § 1.863–3. For purposes of applying § 1.863–3, only production assets used in additional production activity subsequent to the export terminal are taken into account.

(ii) In all other cases, excess gross receipts will be from sources within the country of sale. This paragraph (b)(1)(ii) applies to a taxpayer that engages in additional production activities in the country of sale, as well as to a taxpayer that does not engage in additional production activities at all.

(2) *Additional production prior to export terminal*. Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under § 1.863–3. For purposes of applying § 1.863–3, only production assets used in the additional production activities are taken into account.

(3) *Definitions*—(i) *Production activity*. For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864–1. Except as otherwise provided in §§ 1.1502–13 or 1.863–(g)(2), only production activities conducted directly by the taxpayer are taken into account.

(ii) *Additional production activities*. For purposes of this section, additional production activities are substantial production activities performed directly by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer's activities constitute additional production activities will be determined under the principles of § 1.954–3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) *Export terminal*. Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped to the United States. If there is no such final point in a foreign country (e.g., the property is extracted and produced on the high seas), the export terminal will be the place of production. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The location of the export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) *Determination of fair market value*. For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value

under this section must be consistent with the arm's length price determined under section 482.

(5) *Determination of gross income*. To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) *Tax return disclosure*. A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by § 1.863–3.

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

Example 1. No additional production. U.S. Mines, a U.S. corporation, operates a copper mine and mill in country X. U.S. Mines extracts copper-bearing rocks from the ground and transports the rocks to the mill where the rocks are ground and processed to produce copper-bearing concentrate. The concentrate is transported to a port where it is dried in preparation for export, stored and then shipped to purchasers in the United States. Because title to the property is passed in the United States and, under the facts and circumstances, none of U.S. Mine's activities constitutes additional production prior to the export terminal within the meaning of § 1.863–1(b)(3)(ii), under § 1.863–1(b)(1) and (b)(1)(ii), gross receipts equal to the fair market value of the concentrate at the export terminal will be from sources without the United States, and excess gross receipts will be from sources within the United States.

Example 2. No additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquified in preparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under § 1.863–1(b)(1) and (b)(1)(ii), gross receipts equal to the fair market value of the liquefied natural gas at the export terminal will be from sources within the United States, and excess gross receipts will be from sources without the United States.

Example 3. Sale in third country. US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is $40, and that US Gold ultimately sells the gold jewelry in country Y for $100. Under § 1.863–1(b), $40 of US Gold's gross receipts will be allocated to sources without the United States. Under § 1.863–1(b)(1)(i), the source of the remaining $60 of gross receipts will be determined under § 1.863–3. If US Gold applies the 50/50 method described in § 1.863–3, $20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale. US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is $80, and that US Oil ultimately sells the refined product for $100. Under § 1.863–1(b)(1), $80 of US Oil's gross receipts will be allocated to sources without the United States, and under § 1.863–1(b)(1)(ii) the remaining $20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export. The facts are the same as in *Example 1*, except that U.S. Mines also operates a smelter in country X. The concentrate output from the mill is transported to the smelter where it is transformed into smelted copper. The smelted copper is exported to purchasers in the United States. Under the facts and circumstances, all of the processes applied to make copper concentrate are considered mining. Therefore, under § 1.863–1(b)(2), gross receipts equal to the fair market value of the concentrate at the smelter will be from sources without the United States. Under the facts and circumstances, the conversion of the concentrate into smelted copper is an additional production activity in a foreign country within the meaning of § 1.863–1(b)(3)(ii). Therefore, the source of U.S. Mine's excess gross receipts will be determined pursuant to § 1.863–1(b)(2).

(c) *Determination of taxable income*. The taxpayer's taxable income from sources within or without the United States will be determined under the rules of §§ 1.861–8 through 1.861–14T for determining taxable income from sources within the United States.

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(e) *Effective dates*. The rules of paragraphs (a), (b) and (c) of this section will apply to taxable years beginning December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before December 30, 1996. For years beginning before December 30, 1996, see § 1.863–1 (as contained in 26 CFR part 1 revised as of April 1, 1996).

Par. 5. Section 1.863–2 is revised to read as follows:

§ 1.863–2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income*. Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United States) will consist of gains, profits, and income

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold outside the United States or produced (in whole or in part) by the taxpayer outside the United States and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under § 1.936–6(a)(5), Q&A 7.

(b) *Determination of source of taxable income.* Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to § 1.863–1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see § 1.863–4. To determine the source of gross income described in paragraph (a)(2) of this section, see § 1.863–1 for natural resources and see § 1.863–3 for other inventory. Taxpayers, at their election, may apply the principles of § 1.863–3(b)(1) and (c) to determine the source of taxable income (rather than gross income) from sales of inventory property (other than natural resources). To determine the source of income partly from sources within a possession of the United States, including income described in paragraph (a)(3) of this section, see § 1.863–3(f).

(c) *Effective dates.* This section will apply to taxable years beginning December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and before December 30, 1996. For years beginning before December 30, 1996, see § 1.863–2 (as contained in 26 CFR part 1 revised as of April 1, 1996).

Par. 6. Section 1.863–3 is added to read as follows:

§ 1.863–3 Allocation and apportionment of income from certain sales of inventory.

(a) *In general*—(1) *Scope*. Paragraphs (a) through (e) of this section apply to determine the source of income derived from the sale of inventory property (inventory), which a taxpayer produces (in whole or in part) within the United States and sells outside the United States, or which a taxpayer produces (in whole or in part) outside the United States and sells within the United States (Section 863 Sales). A taxpayer must divide gross income from Section 863 Sales between production activity and sales activity using one of the methods described in paragraph (b) of this section. The source of gross income from production activity and from sales activity must then be determined under paragraph (c) of this section. Taxable income from Section 863 Sales is determined under paragraph (d) of this section. Paragraph (e) of this section describes the rules for electing the methods described in paragraph (b) of this section and the information that a taxpayer must disclose on a tax return. Paragraph (f) of this section applies to determine the source of certain income derived from a possession of the United States. Paragraph (g) of this section provides special rules for partnerships for all sales subject to §§ 1.863–1 through 1.863–3. Paragraph (h) of this section provides effective dates for the rules in this section.

(2) *Rules of application for Section 863 Sales*. Once a taxpayer has elected a method described in paragraph (b) of this section, the taxpayer must separately apply that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. In addition, the taxpayer must apply the rules of paragraphs (c) and (d) of this section by aggregating all Section 863 Sales to which a method described in paragraph (b) of this section applies, after separately applying that method to Section 863 Sales in the United States and to Section 863 Sales outside the United States. See section 865(i)(1) for the definition of inventory property. See also section 865(e)(2). See § 1.861–7(c) and paragraph (c)(2) of this section for the time and place of sale.

(b) *Methods to determine income attributable to production activity and sales activity*—(1) *50/50 method*—(i) *Determination of gross income.* Generally, gross income from Section 863 Sales will be apportioned between production activity and sales activity under the 50/50 method as described in this paragraph (b)(1). Under the 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (c)(1) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under the rules of paragraph (c)(2) of this section. In lieu of the 50/50 method, the taxpayer may elect to determine the source of income from Section 863 Sales under the IFP method described in paragraph (b)(2) of this section or, with the consent of the District Director, the books and records method described in paragraph (b)(3) of this section.

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

Example. 50/50 method. (i) P, a U.S. corporation, produces widgets in the United States. P sells the widgets for $100 to D, an unrelated foreign distributor, in another country. P's cost of goods sold is $40. Thus, P's gross income is $60.

(ii) Pursuant to the 50/50 method, one-half of P's gross income, or $30, is considered income attributable to production activity, and one-half of P's gross income, or $30, is considered income attributable to sales activity.

(2) *IFP method*—(i) *Establishing an IFP.* A taxpayer may elect to allocate gross income earned from production activity and sales activity using the independent factory price (IFP) method described in this paragraph (b)(2) if an IFP is fairly established. An IFP is fairly established based on a sale by the taxpayer only if the taxpayer regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity. A sale will not be considered to fairly establish an IFP if sales activity by the taxpayer with respect to that sale is significant in relation to all of the activities with respect to that product.

(ii) *Applying the IFP method.* If the taxpayer elects to use the IFP method, the amount of the gross sales price equal to the IFP will be treated as attributable to production activity, and the excess of the gross sales price over the IFP will be treated as attributable to sales activity. If a taxpayer elects to use the IFP method, the IFP must be applied to all Section 863 Sales of inventory that are substantially similar in physical characteristics and function, and are sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP. The IFP will only be applied to sales that are reasonably contemporaneous with the sale fairly establishing the IFP. An IFP cannot be applied to sales in other geographic markets if the markets are substantially different. If the taxpayer elects the IFP method, the rules of this paragraph will also apply to determine the division of gross receipts between production activity and sales activity in a Section 863 Sale that itself fairly establishes an IFP. If the taxpayer elects to apply the IFP method, the IFP method must be applied to all sales for which an IFP may be fairly established and applied for that taxable year and each subsequent taxable year. The taxpayer will apply either the 50/50 method described in paragraph (b)(1) of this section or the books and records method described in paragraph (b)(3) of this section to any other Section 863 Sale for which an IFP cannot be established or applied for each taxable year.

(iii) *Determination of gross income.* The amount of a taxpayer's gross income from production activity is determined by reducing the amount of gross receipts from production activity by the cost of goods sold properly attributable to production activity. The amount of a taxpayer's gross income from sales activity is determined by reducing the amount of gross receipts from sales activity by the cost of goods sold (if any) properly attributable to sales activity. The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, and the source of gross income from sales activity will be determined under the rules of paragraph (c)(2) of this section.

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

Example 1. IFP method. (i) P, a U.S. producer, purchases cotton and produces cloth in the United States. P sells cloth in country X to D, an unrelated foreign clothing manufacturer, for $100. Cost of goods sold for cloth is $80, entirely attributable to production activity. P does not engage in significant sales activity in relation to its other activities in the sales to D. Under these facts, the sale to D fairly establishes an IFP of $100. Assume that P elects to use the IFP method. Accordingly, $100 of the gross sales price is treated as attributable to production activity, and no amount of income from this sale is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80).

(ii) P also sells cloth in country X to A, a unrelated foreign retail outlet, for $110. Because P elected the IFP method and the cloth is substantially similar to the cloth sold to D, the IFP fairly established in the sales to D must be used to determine the amount attributable to production activity in the sale to A. Accordingly, $100 of the gross sales price is treated as attributable to production activity and $10 ($110–$100) is attributable to sales activity. After reducing the gross sales price by cost of goods sold, $20 of the gross income is treated as attributable to production activity ($100–$80) and $10 is attributable to sales activity.

Example 2. Scope of IFP Method. (i) USCo manufactures three dissimilar products. USCo elects to apply the IFP method. In year 1, an IFP can be established for sales of product X, but not for products Y and Z. In year 2, an IFP cannot be established for any of USCo's products. In year 3, an IFP can be established for products X and Y, but not for product Z.

(ii) In year 1, USCo must apply the IFP method to sales of product X. In year 2, although USCo's IFP election remains in effect, USCo is not required to apply the IFP election to any products. In year 3, USCo is required to apply the IFP method to sales of products X and Y.

(3) *Books and records method.* A taxpayer may elect to determine the amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpayer's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set forth by the District Director, the District Director may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

(c) *Determination of the source of gross income from production activity and sales activity*—(1) *Income attributable to production activity*—(i) *Production only within the United States or only within foreign countries*—(A) *Source of income.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864–1. Subject to the provisions in § 1.1502–13 or paragraph (g)(2)(ii) of this section, the only production activities that are taken into account for purposes of §§ 1.863–1, 1.863–2, and this section are those conducted directly by the taxpayer. Where the taxpayer's production assets are located only within the United States or only outside the United States, the income attributable to production activity is sourced where the taxpayer's production assets are located. For rules regarding the source of income when production assets are located both within the United States and without the United States, see paragraph (c)(1)(ii) of this section.

(B) *Definition of production assets*. Subject to the provisions of § 1.1502–13 and paragraph (g)(2)(ii) of this section, production assets include only tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section. Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (e.g., marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary.

(C) *Location of production assets*. For purposes of this section, a tangible production asset will be considered located where the asset is physically located. An intangible production asset will be considered located where the tangible production assets owned by the taxpayer to which it relates are located.

(ii) *Production both within the United States and within foreign countries*—(A) *Source of income.* Where the taxpayer's production assets are located both within and without the United States, income from sources without the United States will be determined by multiplying the income attributable to the taxpayer's production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located outside the United States and the denominator of which is the average adjusted basis of all production assets within and without the United States. The remaining income is treated as from sources within the United States.

(B) *Adjusted basis of production assets*. For purposes of paragraph (c)(1)(ii)(A) of this section, the adjusted basis of an asset is determined under section 1011. The average adjusted basis is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. If production assets are used to produce inventory sold in Section 863 Sales and are also used to produce other property during the taxable year, the portion of its adjusted basis that is included in the fraction described in paragraph (c)(1)(ii)(A) of this section will be determined under any method that reasonably reflects the portion of the assets that produces inventory sold in Section 863 Sales. For example, the portion of such an asset that is included in the formula may be determined by multiplying the asset's average adjusted basis by a fraction, the numerator of which is the gross receipts from sales of inventory from Section 863 Sales produced by the asset, and the denominator of which is the gross receipts from all property produced by that asset.

(iii) *Anti-abuse rule.* The purpose of this paragraph (c)(1) is to attribute the source of the taxpayer's production income to the location of the taxpayer's production activity. Therefore, if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section in a manner inconsistent with the purpose of this paragraph (c)(1), the District Director may make appropriate adjustments so that the source of the taxpayer's income from production activity more clearly reflects the source of that income.

(iv) *Examples*. The following examples illustrate the rules of this paragraph (c)(1):

Example 1. Source of production income. (i) A, a U.S. corporation, produces widgets that are sold both within the United States and within a foreign country. The initial manufacture of all widgets occurs in the United States. The second stage of production of widgets that are sold within a foreign country is completed within the country of sale. A's U.S. plant and machinery which is involved in the initial manufacture of the widgets has an average adjusted basis of $200. A also owns warehouses used to store work-in-process. A owns foreign equipment with an average adjusted basis of $25. A's gross receipts from all sales of widgets is $100, and its gross receipts from export sales of widgets is $25. Assume that apportioning average adjusted basis using gross receipts is reasonable. Assume A's cost of goods sold from the sale of widgets in the foreign countries is $13 and thus, its gross income from widgets sold in foreign countries is $12. A uses the 50/50 method to divide its gross income between production activity and sales activity.

(ii) A determines its production gross income from sources without the United States by multiplying one-half of A's $12 of gross income from sales of widgets in foreign countries, or $6, by a fraction, the numerator of which is all relevant foreign production assets, or $25, and the denominator of which is all relevant production assets, or $75 ($25 foreign assets + ($200 U.S. assets X $25 gross receipts from export sales/$100 gross receipts from all sales)). Therefore, A's gross production income from sources without the United States is $2 ($6 X ($25/$75)).

Example 2. Location of intangible property. Assume the same facts as *Example 1,* except that A employs a patented process that applies only to the initial production of widgets. In computing the formula used to determine the source of income from production activity, A's patent, if it has an average adjusted basis, would be located in the United States.

Example 3. Anti-abuse rule. (i) Assume the same facts as *Example 1.* A sells its U.S. assets to B, an unrelated U.S. corporation, with a principal purpose of reducing its U.S. tax liability by manipulating the property fraction. A then leases these assets from B. After this transaction, under the general rule of paragraph (c)(1)(ii) of this section, all of A's production income would be considered from sources without the United States, because all of A's relevant production assets are located within a foreign country. Since the leased property is not owned by the taxpayer, it is not included in the fraction.

(ii) Because A has entered into a transaction with a principal purpose of reducing its U.S. tax liability by manipulating the formula described in paragraph (c)(1)(ii)(A) of this section, A's income must be adjusted to more clearly reflect the source of that income. In this case, the District Director may redetermine the source of A's production income by ignoring the sale-leaseback transactions.

(2) *Income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity will be determined under the provisions of § 1.861–7(c). However, notwithstanding any other provision, for purposes of section 863, the place of sale will be presumed to be the United States if personal property is wholly produced in the United States and the property is sold for use, consumption, or disposition in the United States. See § 1.864–6(b)(3)(ii) to determine the country of use, consumption, or disposition. Also, in applying this paragraph, property will be treated as wholly produced in the United States if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States, within the meaning of § 1.954–3(a)(4)(iii)(property manufactured or produced by a controlled foreign corporation).

(d) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion separately under §§ 1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Sales determined separately under each method described in paragraph (b) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Sales under § 1.861–8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of § 1.861–8(e)(3)(i)(A). In the case of gross income from Section 863 Sales determined under the IFP method or the books and records method, the rules of §§ 1.861–8 through 1.861–14T must apply to properly allocate or apportion amounts of expenses, losses and other deductions allocated and apportioned to such gross income between gross income from sources within and without the United States. In the case of gross income from Section 863 Sales determined under the 50/50 method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under the 50/50 method. Research and experimental expenditures qualifying under § 1.861–17 are allocated under that section, and are not allocated and apportioned pro rata under the 50/50 method.

(e) *Election and reporting rules*—(1) *Elections under paragraph (b) of this section.* If a taxpayer does not elect a method specified in paragraph (b)(2) or (3) of this section, the taxpayer must apply the method specified in paragraph (b)(1) of this section. The taxpayer may elect to apply the method specified in paragraph (b)(2) of this section by using the method on a timely filed original return (including extensions). A taxpayer may elect to apply the method specified in paragraph (b)(3) of this section by using the method on a timely filed original return (including extensions), but only if the taxpayer has received permission from the District Director to apply that method. Once a method under paragraph (b) of this section has been used, that method must be used in later taxable years unless the Commissioner consents to a change. However, if a taxpayer elects to change to or from the method specified in paragraph (b)(3) of this section, the taxpayer must obtain permission from the District Director instead of the Commissioner. Permission to change methods from one year to another year will not be withheld unless the change would result in a substantial distortion of the source of the taxpayer's income.

(2) *Disclosure on tax return*. A taxpayer who uses one of the methods described in paragraph (b) of this section must fully explain in a statement attached to the return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

(f) *Income partly from sources within a possession of the United States*. Taxpayers with income partly from sources within a possession of the United States must apply the rules of § 1.863–3A(c).

(g) *Special rules for partnerships*—(1) *General rule*. For purposes of § 1.863–1 and this section, a taxpayer's production or sales activity does not include production and sales activities conducted by a partnership of which the taxpayer is a partner either directly or through one or more partnerships, except as otherwise provided in paragraph (g)(2) of this section.

(2) *Exceptions*—(i) *In general*. For purposes of determining the source of the partner's distributive share of partnership income or determining the source of the partner's income from the sale of inventory property which the partnership distributes to the partner in kind, the partner's production or sales activity includes an activity conducted by the partnership. In addition, the production activity of a partnership includes the production activity of a taxpayer that is a partner either directly or through one or more partnerships, to the extent that the partner's production activity is related to inventory that the partner contributes to the partnership in a transaction described under section 721.

(ii) *Attribution of production assets to or from a partnership.* A partner will be treated as owning its proportionate share of the partnership's production assets only to the extent that, under paragraph (g)(2)(i) of this section, the partner's activity includes production activity conducted through a partnership. A partner's share of partnership assets will be determined by reference to the partner's distributive share of partnership income for the year attributable to such production assets. Similarly, to the extent a partnership's activities include the production activities of a partner, the partnership will be treated as owning the partner's production assets related to the inventory that is contributed in kind to the partnership. See paragraph (c)(1)(ii)(B) of this section for rules apportioning the basis of assets to Section 863 Sales.

(iii) *Basis*. For purposes of this section, in those cases where the partner is treated as owning its proportionate share of the partnership's production assets, the partner's basis in production assets held through a partnership shall be determined by reference to the partnership's adjusted basis in its assets (including a partner's special basis adjustment, if any, under section 743). Similarly, a partnership's basis in a partner's production assets is determined with reference to the partner's adjusted basis in its assets.

(iv) *Separate application of methods*. If, under paragraph (g)(2) of this section, a partner is treated as conducting the activity of a partnership, and is treated as owning its proportionate share of a partnership's production assets, a partner must apply the method it has elected under paragraph (b) of this section separately to Section 863 Sales described in this paragraph (g) and all other Section 863 Sales.

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

Example 1. Distributive share of partnership income. A, a U.S. corporation, forms a partnership in the United States with B, a country X corporation. A and B each have a 50 percent interest in the income, gains, losses, deductions and credits of the partnership. The partnership is engaged in the manufacture and sale of widgets. The widgets are manufactured in the partnership's plant located in the United States and are sold by the partnership outside the United States. The partnership owns the manufacturing facility and all other production assets used to produce the widgets. A's distributive share of partnership income includes 50 percent of the sales income from these sales. In applying the rules of section 863 to determine the source of its distributive share of partnership income from the export sales of widgets, A is treated as carrying on the activity of the partnership related to production of these widgets and as owning a proportionate share of the partnership's assets related to production of the widgets, based upon its distributive share of partnership income.

Example 2. Distribution in kind. Assume the same facts as in *Example 1* except that the partnership, instead of selling the widgets, distributes the widgets to A and B. A then further processes the widgets and then sells them outside the United States. In determining the source of the income earned by A on the sales outside the United States, A is treated as conducting the activities of the partnership related to production of the distributed widgets. Thus, the source of gross income on the sale of the widgets is determined under section 863 and these regulations. A applies the 50/50 method described in paragraph (b)(1) of this section to determine the source of income from the sales. In applying paragraph (c)(1) of this section, A is treated as owning its proportionate share of the partnership's production assets based upon its distributive share of partnership income.

(h) *Effective dates*. The rules of this section apply to taxable years beginning December 30, 1996. However, taxpayers may apply these regulations for taxable years beginning after July 11, 1995, and before December 30, 1996. For years beginning before December 30, 1996, see §§ 1.863–3A and 1.863–3AT.

Par. 7. Section 1.863–4 is amended by revising the section heading and paragraph (a) to read as follows:

§ 1.863–4 Certain transportation services.

(a) *General*. A taxpayer carrying on the business of transportation service (other than an activity giving rise to transportation income described in section 863(c) or to income subject to other specific provisions of this title) between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

* * * * *

§ 1.863–5 [Removed]

Par. 8. Section 1.863–5 is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 10. In § 602.101, paragraph (c) is amended by adding entries for 1.863–1 and 1.863–3A, and revising the entry for 1.863–3 to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.863–1	1545–1476
1.863–3	1545–1476
* * * * *	
1.863–3A	1545–0126
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 25, 1996.

Donald C. Lubick,
Acting Assistant Secretary of Tax Policy.

(Filed by the Office of the Federal Register on November 27, 1996, 8:45 a.m., and published in the issue of the Federal Register for November 29, 1996, 61 F.R. 60540)

Section 1491.—Imposition of Tax

If the status of a trust changes from domestic to foreign, what are the consequences for purposes of the section 1491 excise tax? See Notice 96–65, page 28.

Section 2056A.—Qualified Domestic Trust

26 CFR 20.2056A–2: Requirements for qualified domestic trusts.

T.D. 8686

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 20 and 602

Requirements to Ensure Collection of Section 2056A Estate Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance relating to the additional requirements necessary to ensure the collection of the estate tax imposed under section 2056A(b) with respect to taxable events involving qualified domestic trusts (QDOTs) described in section 2056A(a).

DATES: These regulations are effective November 29, 1996.

For dates of applicability, see § 20.2056A–2(d).

FOR FURTHER INFORMATION CONTACT: Susan Hurwitz (202) 622–3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1443. Responses to this collection of information are required in order for an estate to be eligible for the estate tax marital deduction in cases where the surviving spouse is not a United States citizen.

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

The estimated annual burden per respondent varies from 30 minutes to 3 hours, depending on individual circumstances, with an estimated average of 1.39 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 T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

A notice of proposed rulemaking was published in the Federal Register on January 5, 1993 (58 FR 305), reflecting amendments to the Internal Revenue Code by the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100–647), the Revenue Reconciliation Act of 1989 (Public Law 101–239), and the Revenue Reconciliation Act of 1990 (Public Law 101–508). The amendments generally relate to sections 2056 and 2523, and affect the availability of the estate and gift tax marital deduction when the surviving spouse or the donee spouse is not a United States citizen. Part of the NPRM was published in the Federal Register as final regulations, in TD 8612, on August 22, 1995 (60 FR 43531 [1995–2 C.B. 192]). That part of the NPRM that addressed the regulatory requirements to ensure the collection of the estate tax imposed by section 2056A(b)(1)(A) and (B) was published in the Federal Register on August 22, 1995, in the form of temporary and proposed regulations, (60 FR 43554 and 60 FR 43575, respectively) in order to afford the public a further opportunity to comment on these security arrangements.

On January 16, 1996, the IRS held a hearing on the temporary and proposed regulations. These final regulations reflect the comments received in response to the temporary and proposed regulations.

Explanation of Provisions

The following is a summary of the significant comments received and the reasons for accepting or rejecting those comments in the final regulations.

Under the temporary regulations, a qualified domestic trust (QDOT) that has assets in excess of $2 million, may alternate among the three security arrangements provided in the regulations (U.S. bank trustee, bond or letter of credit), provided that at all times, at least one of the three arrangements is in effect. A QDOT with assets of $2 million or less need not satisfy these requirements, if, in general, the trust holdings of foreign situs real property are limited to 35 percent of the fair market value of the trust corpus.

Comments were received that trusts in actual compliance with these regulatory requirements, but which do not explicitly include the required language, will not qualify as a QDOT. In addition, comments suggested that the imposition of numerous governing instrument requirements will increase the difficulty of drafting a QDOT and result in a trust document that will have to include detailed provisions, many of which are not likely to be applicable. A suggestion was made that if the governing instrument requirement is retained in the regulations, then the required security provisions should be permitted to be incorporated by reference in a trust document. This suggestion was adopted. However, in order to assist taxpayers who may wish to specify the required provisions in the governing instrument, the IRS has published guidance in the Internal Revenue Bulletin (see § 602.101(d)(2) of this chapter) providing sample language that may be used in a QDOT instrument to satisfy the additional security requirements contained in the final regulations.

In response to comments, the language of the regulations has been modified to clarify that the QDOT may alternate among the three arrangements provided in the regulations as long as, at any given time, one of the three arrangements is required to be operative.

Comments suggested that the temporary regulations may be viewed as requiring that a QDOT that initially employs the bank trustee security alternative must, irrespective of whether the QDOT has switched to another security option, continue to have at least one U.S. Bank acting as a trustee. In response to this comment, the final regulations clarify that, if the QDOT changes to a different security arrangement, a U.S. bank need not continue to act as trustee.

Under the temporary regulations, in determining whether the value of the assets passing to a QDOT are in excess of, or less than, $2 million, indebtedness with respect to the assets is not taken into account to reduce value. Similarly, under the temporary regulations, the amount of the bond or letter of credit that is furnished to the IRS must be equal to 65 percent of the fair market value of the trust assets determined ‘‘without regard to any indebtedness thereon.’’ Comments suggested that indebtedness should be taken into account in determining whether the $2 million dollar threshold has been exceeded and the amount of the bond or letter of credit required. This change has not been made. The IRS and Treasury believe that the retention of the rule that indebtedness on the property is not taken into account to reduce value most effectively ensures collection of the estate tax imposed under section

2056A(b). For the limited purpose under this section (i.e., to determine whether the $2 million threshold is exceeded and the amount of the bond or letter of credit to be furnished to the IRS) the complexity that would be involved in drafting rules to determine which debts qualify to be taken into account and which do not is not warranted.

Under the temporary regulations, with regard to the bond and letter of credit security options, if the fair market value of the trust assets, is ''finally determined'' to be in excess of the value of the trust assets as originally reported, the trustee has a reasonable period of time (not exceeding sixty days from the date of the final determination) to adjust the amount of the bond or letter of credit. The temporary regulations also use the term ''finally determined'' in addressing substantial undervaluations of property passing to a QDOT and the grace period provided to meet the security requirements when a QDOT is determined to contain assets in excess of $2 million. Comments were received suggesting that the regulations provide a definition of ''finally determined''.

Accordingly, the final regulations provide that the value of the assets will be finally determined on the earliest to occur of—

1. The entry of a decision, judgment, decree, or other order by any court of competent jurisdiction that has become final;

2. The execution of a closing agreement made under section 7121;

3. Any final disposition by the IRS of a claim for refund;

4. The issuance of an estate tax closing letter (if no claim for refund is filed); or

5. The expiration of the statute of limitations for assessment with respect to the decedent's estate tax liability.

In response to comments, the regulation addressing the required duration of the bond or letter of credit has been clarified to provide that the security arrangement must remain in effect until the trust ceases to function as a QDOT.

Comments have been received regarding the amount of the bond or letter of credit that must be furnished to the IRS. One commentator stated that, since the purpose of the bond or letter of credit requirement is to provide a source of funds for the payment of the section 2056A(b) estate tax, the amount of the required bond or letter of credit should be based on either the maximum federal estate tax rate, or the amount of estate tax deferred, rather than 65% of the value of the QDOT, as provided in the regulations. This suggestion has not been adopted. Generally, the regulation requires a bond of 65 percent of the initial fair market value of the trust assets to ensure that the potential estate tax liability is adequately secured if the trust property appreciates in value.

The temporary regulations providing that notice of failure to renew a bond or letter of credit must be ''received by the IRS at least 60 days prior to the end of the term of the bond or letter of credit'' has been changed to reference the date the notice is ''mailed to'' the IRS. Further, under the final regulations, the notice must also be mailed to the U.S. Trustee of the QDOT.

Under the regulations, in the case of a QDOT of less than $2 million, if on the last day of a taxable year of the QDOT, the value of foreign real property owned by the QDOT exceeds 35 percent of the QDOT assets because of distributions of principal during that year, or because of fluctuations in the value of the foreign currency in the jurisdiction where the real property is located, a grace period of one year is provided to allow the trustee to comply with the 35 percent limit. Comments suggested that changes in the relative value of the trust assets would also cause the trust to fail to satisfy the 35 percent limit, and failure to comply due to such changes that are beyond the control of the trustee should also be eligible for the grace period. Accordingly, under the final regulations, the trustee will also be accorded the grace period to satisfy the 35 percent limit if, as a result of changes in the relative values of the trust assets, more than 35 percent of the value of the trust consists of foreign real estate.

Under the temporary regulations, for purposes of determining whether the $2 million threshold has been exceeded, and for purposes of determining the amount of the bond or letter of credit, the executor of the decedent's estate may exclude up to $600,000 in value attributable to real property wherever situated (and related furnishings) owned directly by the QDOT that is used by the surviving spouse as the spouse's principal residence. Comments were received that the regulations should be expanded to allow the exclusion of all residential real property that is actually used by the surviving spouse. Thus, a vacation home or second home would qualify for the exclusion. It was also suggested that all personally used residential real property, regardless of value, should be eligible for the exclusion. The final regulations do not change the monetary limit of $600,000 for the exclusion. The $600,000 limit for the exclusion facilitates the reduction of the costs associated with providing security while adequately ensuring the collection of the section 2056A(b) tax. This is especially the case in situations where the residential real property is situated outside the United States so that a significant collection risk is presented. However, under the final regulations the exclusion has been redesignated as a ''personal residence'' exclusion. The exclusion is now available for the principal residence of the surviving spouse and one additional residence, to the extent the combined value excluded does not exceed $600,000. The second residence will be eligible for the exclusion only if the residence is used by the surviving spouse as a personal residence and not subject to any rental arrangement with any person.

Under the temporary regulations, the residence exclusion election is made by attaching a written statement to the estate tax return on which the QDOT election is made. Commentators suggested that the final regulations allow the election to be made at any time during the term of the QDOT, and not necessarily at the time of filing of the decedent's estate tax return. For example, if the bank trustee alternative is selected by the trustee of the QDOT, but at some future date the trustee desires to change to the bond or letter of credit security arrangement, the trustee should be given the opportunity to make a delayed election of the exclusion. In response to these comments, the final regulations provide that the election may be made at any time during the term of the QDOT. In addition, the final regulation provides for the cancellation of a prior election.

Under the temporary regulations, the U.S. Trustee of a QDOT is required to file an annual statement with the IRS containing specified items of information (including a list of all assets held by the QDOT together with the fair market value of each asset determined as of the last day of the taxable year) if the residence exclusion applies during the taxable year. Comments were received suggesting that the cost of compliance with this annual reporting requirement will limit the utility of the residence exclusion. In response to these comments, annual reporting is no longer required solely because the personal residence exclusion was elected. However, the regulations retain the annual reporting requirement where the residence previously subject to the exclusion is sold, or where the residence ceases to be used as a personal residence during the taxable or calendar year.

Under the temporary regulations, if a residence that is subject to the exclusion is sold during the term of the QDOT, the exclusion will continue to apply if, within 12 months of the date of sale, the amount of the adjusted sales price (as defined in section 1034(d)(1)) is used to purchase a new residence for the spouse. In response to comments, this provision has been amended to provide that if a residence ceases to be used as the personal residence of the spouse, or if the residence is sold during the term of the QDOT, the exclusion may be applied to another residence that is held in either the same QDOT or in another QDOT, if the other residence is used as a personal residence of the spouse. The amount of exclusion that may be applied to the new personal residence under these circumstances can be up to $600,000 (less that amount previously allocated to a residence that continues to qualify for the exclusion) even if the entire $600,000 exclusion was not previously used for the initial personal residence(s).

Also, under the temporary regulations, on the sale of a residence, if less than the entire adjusted sales price is reinvested in a new residence, then the amount of the exclusion initially claimed by the QDOT is reduced proportionately. For example, if a residence is sold for an adjusted sales price of $1,000,000 and a new residence is acquired for $800,000, then, the original exclusion would be reduced by $120,000 to $480,000: $200,000 (adjusted sales price not reinvested)/ $1,000,000 (adjusted sales price) x $600,000. Comments were received suggesting that this rule be changed to provide that the amount of the exclusion as adjusted not be reduced below the amount actually reinvested (up to $600,000). This suggestion was adopted in the final regulations, reflecting that two residences can now qualify for the $600,000 exclusion.

Special Analyses

It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 20 and 602 are amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. In § 20.2056A–0, the table of contents is amended by revising the entry for § 20.2056A–2(d) to read as follows:

§ 20.2056A–0 Table of contents.

* * * * *

§ 20.2056A–2 Requirements for qualified domestic trust.

* * * * *

(d) Additional requirements to ensure collection of the section 2056A estate tax.

(1) Security and other arrangements for payment of estate tax imposed under section 2056A(b)(1).

(2) Individual trustees.

(3) Annual reporting requirements.

(4) Request for alternate arrangement or waiver.

(5) Adjustment of dollar threshold and exclusion.

(6) Effective date and special rules.

* * * * *

Par. 3. In § 20.2056A–2, paragraph (d) is added to read as follows:

§ 20.2056A–2 Requirements for qualified domestic trust.

* * * * *

(d) *Additional requirements to ensure collection of the section 2056A estate tax*—(1) *Security and other arrangements for payment of estate tax imposed under section 2056A(b)(1)*—(i) *QDOTs with assets in excess of $2 million.* If the fair market value of the assets passing, treated, or deemed to have passed to the QDOT (or in the form of a QDOT), determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes, exceeds $2 million as of the date of the decedent's death or, if applicable, the alternate valuation date (adjusted as provided in paragraph (d)(1)(iii) of this section), the trust instrument must meet the requirements of either paragraph (d)(1)(i)(A), (B), or (C) of this section at all times during the term of the QDOT. The QDOT may alternate between any of the arrangements provided in paragraphs (d)(1)(i)-(A), (B), and (C) of this section provided that, at any given time, one of the arrangements must be operative. See paragraph (d)(1)(iii) of this section for the definition of finally determined. The QDOT may provide that the trustee has the discretion to use any one of the security arrangements or may provide that the trustee is limited to using only one or two of the arrangements specified in the trust instrument. A trust instrument that specifically states that the trust must be administered in compliance with paragraph (d)(1)(i)(A), (B), or (C) of this section is treated as meeting the requirements of paragraphs (d)(1)(i)(A), (B), or (C) for purposes of paragraphs (d)(1)(i) and, if applicable, (d)(1)(ii) of this section.

(A) *Bank Trustee.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must provide that whenever the Bank Trustee security alternative is used for the QDOT, at least one U.S. Trustee must be a bank as defined in section 581. Alternatively, except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, at least one trustee must be a United States branch of a foreign bank, provided that, in such cases, during the entire term of the QDOT a U.S. Trustee must act as a trustee with the foreign bank trustee.

(B) *Bond.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must provide that whenever the bond security arrangement alternative is used for the QDOT, the U.S. Trustee must furnish a bond in favor of the Internal Revenue Service in an amount equal to 65 percent of the fair market value of the trust assets (determined without regard to any indebtedness with respect to the assets) as of the date of the decedent's death (or alternate valuation date, if applicable), as finally determined for federal estate tax purposes (and as further adjusted as provided in paragraph (d)(1)(iv) of this section). If, after examination of the estate tax return, the fair market value of the trust assets, as originally reported on the estate tax return, is adjusted (pursuant to a judicial proceeding or otherwise) resulting in a final determination of the value of the assets as reported on the return, the U.S. Trustee has a reasonable period of time (not exceeding sixty days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to adjust the amount of the bond accordingly. But see, paragraph (d)(1)(i)(D) of this section for a special rule in the case of a substantial undervaluation of QDOT assets. Unless an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) of this section, or an arrangement prescribed under paragraph (d)(4) of this section, is provided, or the trust is otherwise no longer subject to the requirements of section 2056A pursuant to section 2056A(b)(12), the bond must remain in effect until the trust ceases to function as a QDOT and any tax liability finally determined to be due under section 2056A(b) is paid, or is finally determined to be zero.

(*1*) *Requirements for the bond.* The bond must be with a satisfactory surety, as prescribed under section 7101 and § 301.7101–1 of this chapter (Regulations on Procedure and Administration), and is subject to Internal Revenue Service review as may be prescribed by the Commissioner. The bond may not be cancelled. The bond must be for a term of at least one year and must be automatically renewable at the end of that term, on an annual basis thereafter, unless notice of failure to renew is mailed to the U.S. Trustee and the Internal Revenue Service at least 60 days prior to the end of the term, including periods of automatic extensions. Any notice of failure to renew required to be sent to the Internal Revenue Service must be sent to the Estate and Gift Tax Group in the District Office of the Internal Revenue Service that has examination jurisdiction over the decedent's estate (Internal Revenue Service, District Director, [*specify location*] District Office, Estate and Gift Tax Examination Group, [specify Street Address, City, State, Zip Code]) (or in the case of noncitizen decedents and United States citizens who die domiciled outside the United States, Estate Tax Group, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:-EX:HQ:1114, Washington, DC 20024). The Internal Revenue Service will not draw on the bond if, within 30 days of receipt of the notice of failure to renew, the U.S. Trustee notifies the Internal Revenue Service (at the same address to which notice of failure to renew is to be sent) that an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) or (d)(4) of this section, has been secured and that the arrangement will take effect immediately prior to or upon expiration of the bond.

(*2*) *Form of bond.* The bond must be in the following form (or in a form that is the same as the following form in all material respects), or in such alternative form as the Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter):

Bond in Favor of the Internal Revenue Service To Secure Payment of Section 2056A Estate Tax Imposed Under Section 2056A(b) of the Internal Revenue Code.

KNOW ALL PERSONS BY THESE PRESENTS, That the undersigned, ____________, the SURETY, and ____________, the PRINCIPAL, are irrevocably held and firmly bound to pay the Internal Revenue Service upon written demand that amount of any tax up to *$[amount determined under paragraph (d)(1)(i)(B) of this section]*, imposed under section 2056A(b)(1) of the Internal Revenue Code (including penalties and interest on said tax) determined by the Internal Revenue Service to be payable with respect to the principal as trustee for: *[Identify trust and governing instrument, name and address of trustee]*, a qualified domestic trust as defined in section 2056A(a) of the Internal Revenue Code, for the payment of which the said Principal and said Surety, bind themselves, their heirs, executors, administrators, successors and assigns, jointly and severally, firmly by these presents.

WHEREAS, The Internal Revenue Service may demand payment under this bond at any time if the Internal Revenue Service in its sole discretion determines that a taxable event with respect to the trust has occurred; the trust no longer qualifies as a qualified domestic trust as described in section 2056A(a) of the Internal Revenue Code and the regulations promulgated thereunder, or a distribution subject to the tax imposed under section 2056A(b)(1) has been made. Demand by the Internal Revenue Service for payment may be made whether or not the tax and tax return (Form 706–QDT) with respect to the taxable event is due at the time of such demand, or an assessment has been made by the Internal Revenue Service with respect to the tax.

NOW THEREFORE, The condition of this obligation is such that it must not be cancelled and, if payment of all tax liability finally determined to be imposed under section 2056A(b) is made, then this obligation is null and void; otherwise, this obligation is to remain in full force and effect for one year from its effective date and is to be automatically renewable on an annual basis unless, at least 60 days prior to the expiration date, including periods of automatic renewals, the surety mails to the U.S. Trustee and the Internal Revenue Service by Registered or Certified Mail, return receipt requested, notice of the failure to renew. Receipt of this notice of failure to renew by the Internal Revenue Service may be considered a taxable event. The Internal Revenue Service will not draw upon the bond if, within 30 days of receipt of the notice of failure to renew, the trustee notifies the Internal Revenue Service that an alternate security arrangement has been secured and that the arrangement will take effect immediately prior to or upon expiration of the bond. The surety remains liable for all taxable events occurring prior to the date of expiration. All notices required to be sent to the Internal Revenue Service under this instrument should be sent to District Director, *[specify location]* District Office, Estate and Gift Tax Examination Group, Street Address, City, State, Zip Code. (In the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States, all notices should be sent to Estate Tax Group, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:EX:HQ:1114, Washington, DC 20024).

This bond shall be effective as of ___________ . Principal ___________
Date _______ Surety _____________
Date _______

(*3*) *Additional governing instrument requirements.* The trust instrument must provide that in the event the Internal Revenue Service draws on the bond, in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15th of the calendar year following the year in which the bond is drawn upon. After that date, any such remittance will be treated as a deposit and returned (without interest) upon request of the U.S. Trustee, unless it is determined that assessment or collection of the tax imposed by section 2056A(b)(1) is in jeopardy, within the meaning of section 6861. If an assessment under section 6861 is made, the remittance will first be credited to any tax liability reported on the Form 706–QDT, then to any unpaid balance of a section 2056A(b)(1)(A) tax liability (plus interest and penalties) for any prior taxable years, and any balance will then be returned to the U.S. Trustee.

(*4*) *Procedure.* The bond is to be filed with the decedent's federal estate tax return, Form 706 or 706NA (unless an extension for filing the bond is granted under § 301.9100 of this chapter). The U.S. Trustee must provide a written statement with the bond that provides a list of the assets that will be used to fund the QDOT and the respective values of the assets. The written statement must also indicate whether any exclusions under paragraph (d)(1)(iv) of this section are claimed.

(C) *Letter of credit.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must provide that whenever the letter of credit security arrangement is used for the QDOT, the U.S. Trustee must furnish an irrevocable letter of credit issued by a bank as defined in section 581, a United States branch of a foreign bank, or a foreign bank with a confirmation by a bank as defined in section 581. The letter of credit must be for an amount equal to 65 percent of the fair market value of the trust assets (determined without regard to any indebtedness with respect to the assets) as of the date of the decedent's death (or alternate valuation date, if applicable), as finally determined for federal estate tax purposes (and as further adjusted as provided in paragraph (d)(1)(iv) of this section). If, after examination of the estate tax return, the fair market value of the trust assets, as originally reported on the estate tax return, is adjusted (pursuant to a judicial proceeding or otherwise) resulting in a final determination of the value of the assets as reported on the return, the U.S. Trustee has a reasonable period of time (not exceeding 60 days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to adjust the amount of the letter of credit accordingly. But see, paragraph (d)(1)(i)(D) of this section for a special rule in the case of a substantial undervaluation of QDOT assets. Unless an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) of this section, or an arrangement prescribed under paragraph (d)(4) of this section, is provided, or the trust is otherwise no longer subject to the requirements of section 2056A pursuant to section 2056A(b)(12), the letter of credit must remain in effect until the trust ceases to function as a QDOT and any tax liability finally determined to be due under section 2056A(b) is paid or is finally determined to be zero.

(*1*) *Requirements for the letter of credit.* The letter of credit must be irrevocable and provide for sight payment. The letter of credit must have a term of at least one year and must be automatically renewable at the end of the term, at least on an annual basis, unless notice of failure to renew is mailed to the U.S. Trustee and the Internal Revenue Service at least sixty days prior to the end of the term, including periods of automatic renewals. If the letter of credit is issued by the U.S. branch of a foreign bank and the U.S. branch is closing, the branch (or foreign bank) must notify the U.S. Trustee and the Internal Revenue Service of the closure and the notice of closure must be mailed at least 60 days prior to the date of closure. Any notice of failure to renew or closure of a U.S. branch of a foreign bank required to be sent to the Internal Revenue Service must be sent to the Estate and Gift Tax Group in the District Office of the Internal Revenue Service that has examination jurisdiction over the decedent's estate (Internal Revenue Service, District Director, *[specify location]* District Office, Estate and Gift Tax Examination Group, [Street Address, City State, Zip Code]) (or in the case of noncitizen decedents and United States citizens who die domiciled outside the United States, Estate Tax, Assistant Commissioner (International), 950 L'Enfant Plaza, CP:IN:D:C:EX:HQ:1114, Washington, DC 20024). The Internal Revenue Service will not draw on the letter of credit if, within 30 days of receipt of the notice of failure to renew or closure of the U.S. branch of a foreign bank, the U.S. Trustee notifies the Internal Revenue Service (at the same address to which notice is to be sent) that an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C), or (d)(4) of this section, has been secured and that the arrangement will take effect immediately prior to or upon expiration of the letter of credit or closure of the U.S. branch of the foreign bank.

(*2*) *Form of letter of credit.* The letter of credit must be made in the following form (or in a form that is the same as the following form in all material respects), or an alternative form that the Commissioner prescribes by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter):

[Issue Date]

To: Internal Revenue Service
Attention: District Director, *[specify location]* District Office
Estate and Gift Tax Examination Group
[Street Address, City, State, ZIP Code]

[Or in the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States,

To: Estate Tax Group,
Assistant Commissioner (International)
950 L'Enfant Plaza
CP:IN:D:C:EX:HQ:1114
Washington, DC 20024].

Dear Sirs:

We hereby establish our irrevocable Letter of Credit No. ____ in your favor for drawings up to U.S. $ [*Applicant should provide bank with amount which Applicant determined under paragraph (d)(1)(i)(C)*] effective immediately. This Letter of Credit is issued, presentable and payable at our office at ____________________ and expires at 3:00 p.m. [EDT, EST, CDT, CST, MDT, MST, PDT, PST] on _______ at said office.

For information and reference only, we are informed that this Letter of Credit relates to [*Applicant should provide bank with the identity of qualified domestic trust and governing instrument*], and the name, address, and identifying number of the trustee is [*Applicant should provide bank with the trustee name, address and the QDOT's TIN number, if any*].

Drawings on this Letter of Credit are available upon presentation of the following documents:

1. Your draft drawn at sight on us bearing our Letter of Credit No. _____ ; and

2. Your signed statement as follows:

The amount of the accompanying draft is payable under [*identify bank*] irrevocable Letter of Credit No. ___________ pursuant to section 2056A of the Internal Revenue Code and the regulations promulgated thereunder, because the Internal Revenue Service in its sole discretion has determined that a ''taxable event'' with respect to the trust has occurred; e.g., the trust no longer qualifies as a qualified domestic trust as described in section 2056A of the Internal Revenue Code and regulations promulgated thereunder, or a distribution subject to the tax imposed under section 2056A(b)(1) of the Internal Revenue Code has been made.

Except as expressly stated herein, this undertaking is not subject to any agreement, requirement or qualification. The obligation of [*Name of Issuing Bank*] under this Letter of Credit is the individual obligation of [*Name of Issuing Bank*] and is in no way contingent upon reimbursement with respect thereto.

It is a condition of this Letter of Credit that it is deemed to be automatically extended without amendment for a period of one year from the expiration date hereof, or any future expiration date, unless at least 60 days prior to any expiration date, we mail to you and to the U.S. Trustee notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your and the trustee's address indicated above, that we elect not to consider this Letter of Credit renewed for any such additional period. Upon receipt of this notice, you may draw hereunder on or before the then current expiration date, by presentation of your draft and statement as stipulated above.

[In the case of a letter of credit issued by a U.S. branch of a foreign bank the following language must be added]. It is a further condition of this Letter of Credit that if the U.S. branch of *[name of foreign bank]* is to be closed, that at least sixty days prior to closing, we mail to you and the U.S. Trustee notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your and the U.S. Trustee's address indicated above, that this branch will be closing. This notice will specify the actual date of closing. Upon receipt of the notice, you may draw hereunder on or before the date of closure, by presentation of your draft and statement as stipulated above.

Except where otherwise stated herein, this Letter of Credit is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500. If we notify you of our election not to consider this Letter of Credit renewed and the expiration date occurs during an interruption of business described in Article 17 of said Publication 500, unless you had consented to cancellation prior to the expiration date, the bank hereby specifically agrees to effect payment if this Letter of Credit is drawn against within 30 days after the resumption of business.

Except as stated herein, this Letter of Credit cannot be modified or revoked without your consent.

Authorized Signature ___________
Date _______

(*3*) *Form of confirmation.* If the requirements of this paragraph (d)(1)(i)(C) are satisfied by the issuance of a letter of credit by a foreign bank with confirmation by a bank as defined in section 581, the confirmation must be made in the following form (or in a form that is the same as the following form in all material respects), or an alternative form as the Commissioner prescribes by guidance published in the Internal Revenue Bulletin (see § 602.101(d)(2) of this chapter):

[Issue Date]

To: Internal Revenue Service
Attention: District Director,
[specify location]
District Office
Estate and Gift Tax
Examination Group
[State Address, City,
State, ZIP Code]

[or in the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States,

To: Estate Tax Group,
Assistant Commissioner
(International)
950 L'Enfant Plaza
CP:IN:D:C:EX:HQ:1114
Washington, DC 20024].

Dear Sirs:

We hereby confirm the enclosed irrevocable Letter of Credit No. _______ , and amendments thereto, if any, in your favor by ___________ [Issuing Bank] for drawings up to U.S. $___________ [same amount as in initial Letter of Credit] effective immediately. This confirmation is issued, presentable and payable at our office at ___________ and expires at 3:00 p.m. [EDT, EST, CDT, CST, MDT, MST, PDT, PST] on _______ at said office.

For information and reference only, we are informed that this Confirmation relates to [Applicant should provide bank with the identity of qualified domestic trust and governing instrument], and the name, address, and identifying number of the trustee is [Applicant should provide bank with the trustee name, address and the QDOT's TIN number, if any].

We hereby undertake to honor your sight draft(s) drawn as specified in the Letter of Credit.

Except as expressly stated herein, this undertaking is not subject to any agreement, condition or qualification. The obligation of [*Name of Confirming Bank*] under this Confirmation is the individual obligation of [*Name of Confirming Bank*] and is in no way contingent upon reimbursement with respect thereto.

It is a condition of this Confirmation that it is deemed to be automatically extended without amendment for a period of one year from the expiry date hereof, or any future expiration date, unless at least sixty days prior to the expiration date, we send to you and to the U.S. Trustee notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your and the trustee's addresses, respectively, indicated above, that we elect not to consider this Confirmation renewed for any additional period. Upon receipt of this notice by you, you may draw hereunder on or before the then current expiration date, by presentation of your draft and statement as stipulated above.

Except where otherwise stated herein, this Confirmation is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500. If we notify you of our election not to consider this Confirmation renewed and the expiration date occurs during an interruption of business described in Article 17 of said Publication 500, unless you had consented to cancellation prior to the expiration date, the bank hereby specifically agrees to effect payment if this Confirmation is drawn against within 30 days after the resumption of business.

Except as stated herein, this Confirmation cannot be modified or revoked without your consent.

Authorized Signature ___________
Date _______

(*4*) *Additional governing instrument requirements.* The trust instrument must provide that if the Internal Revenue Service draws on the letter of credit (or confirmation) in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until April 15th of the calendar year following the year in which the letter of credit (or confirmation) is drawn upon. After that date, any such remittance will be treated as a deposit and returned (without interest) upon request of the U.S. Trustee after the date specified above, unless it is determined that assessment or collection of the tax imposed by section 2056A(b)(1) is in jeopardy, within the meaning of section 6861. If an assessment under section 6861 is made, the remittance will first be credited to any tax liability reported on the Form 706–QDT, then to any unpaid balance of a section 2056A(b)(1)(A) tax liability (plus interest and penalties) for any prior taxable years, and any balance will then be returned to the U.S. Trustee.

(*5*) *Procedure.* The letter of credit (and confirmation, if applicable) is to be filed with the decedent's federal estate tax return, Form 706 or 706NA (unless an extension for filing the letter of credit is granted under § 301.9100 of this chapter). The U.S. Trustee must provide a written statement with the letter of credit that provides a list of the assets that will be used to fund the QDOT and the respective values of the assets. The written statement must also indicate whether any exclusions under paragraph (d)(1)(iv) of this section are claimed.

(D) *Disallowance of marital deduction for substantial undervaluation of QDOT property in certain situations.* (*1*) If either—

(*i*) The bond or letter of credit security arrangement under paragraph (d)(1)(i)(B) or (C) of this section is chosen by the U.S. Trustee; or

(*ii*) The QDOT property as originally reported on the decedent's estate tax return is valued at $2 million or less but, as finally determined for federal estate tax purposes, the QDOT property is determined to be in excess of $2 million, then the marital deduction will be disallowed in its entirety for failure to comply with the requirements of section 2056A if the value of the QDOT property reported on the estate tax return is 50 percent or less of the amount finally determined to be the correct value of the property for federal estate tax purposes.

(*2*) The preceding sentence does not apply if—

(*i*) There was reasonable cause for the undervaluation; and

(*ii*) The fiduciary of the estate acted in good faith with respect to the undervaluation. For this purpose, § 1.6664–4(b) of this chapter applies, to the extent applicable, with respect to the facts and circumstances to be taken into account in making this determination.

(ii) *QDOTs with assets of $2 million or less.* If the fair market value of the assets passing, treated, or deemed to have passed to the QDOT (or in the form of a QDOT), determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes, is $2 million or less as of the date of the decedent's death or, if applicable, the alternate valuation date (adjusted as provided in paragraph (d)(1)(iv) of this section), the trust instrument must provide that either no more than 35 percent of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust (or on the last day of the calendar year if the QDOT does not have a taxable year), will consist of real property located outside of the United States, or the trust will meet the requirements prescribed by paragraph (d)(1)(i)(A), (B), or (C) of this section. See paragraph (d)(1)(ii)(D) of this section for special rules in the case of principal distributions from a QDOT, fluctuations in the value of foreign real property held by a QDOT due to changes in value of foreign currency, and fluctuations in the fair market value of assets held by the QDOT. See paragraph (d)(1)(iv) of this section for a special rule for personal residences. If the fair market value, as originally reported on the decedent's estate tax return, of the assets passing or deemed to have passed to the QDOT (determined without reduction for any indebtedness with respect to the assets) is $2 million or less, but the fair market value of the assets as finally determined for federal estate tax purposes is more than $2 million, the U.S. Trustee has a reasonable period of time (not exceeding sixty days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to meet the requirements prescribed by paragraph (d)(1)(i)(A), (B), or (C) of this section. However, see paragraph (d)(1)(i)(D) of this section in the case of a substantial undervaluation of QDOT assets. See § 20.2056A–2(d)(1)(iii) for the definition of finally determined.

(A) *Multiple QDOTs.* For purposes of this paragraph (d)(1)(ii), if more than one QDOT is established for the benefit of the surviving spouse, the fair market value of all the QDOTs are aggregated in determining whether the $2 million threshold under this paragraph (d)(1)(ii) is exceeded.

(B) *Look-through rule.* For purposes of determining whether no more than 35 percent of the fair market value of the QDOT assets consists of foreign real property, if the QDOT owns more than 20% of the voting stock or value in a corporation with 15 or fewer shareholders, or more than 20% of the capital interest of a partnership with 15 or fewer partners, then all assets owned by the corporation or partnership are deemed to be owned directly by the QDOT to the extent of the QDOT's pro rata share of the assets of that corporation or partnership. For a partnership, the QDOT partner's pro rata share is based on the greater of its interest in the capital or profits of the partnership. For purposes of this paragraph, all stock in the corporation, or interests in the partnership, as the case may be, owned by or held for the benefit of the surviving spouse, or any members of the surviving spouse's family (within the meaning of section 267(c)(4)), are treated as owned by the QDOT solely for purposes of determining the number of partners or shareholders in the entity and the QDOT's percentage voting interest or value in the corporation or capital interest in the partnership, but not for the purpose of determining the QDOT's pro rata share of the assets of the entity.

(C) *Interests in other entities.* Interests owned by the QDOT in other entities (such as an interest in a trust) are accorded treatment consistent with that described in paragraph (d)(1)(ii)(B) of this section.

(D) *Special rule for foreign real property.* For purposes of this paragraph (d)(1)(ii), if, on the last day of any taxable year during the term of the QDOT (or the last day of the calendar year if the QDOT does not have a taxable year), the value of foreign real property owned by the QDOT exceeds 35 percent of the fair market value of the trust assets due to: distributions of QDOT principal during that year; fluctuations in the value of the foreign currency in the jurisdiction where the real estate is located; or fluctuations in the fair market value of any assets held in the QDOT, then the QDOT will not be treated as failing to meet the requirements of this paragraph (d)(1). Accordingly, the QDOT will not cease to be a QDOT within the meaning of § 20.2056A–5(b)(3) if, by the end of the taxable year (or the last day of the calendar year if the QDOT does not have a taxable year) of the QDOT immediately following the year in which the 35 percent limit was exceeded, the value of the foreign real property held by the QDOT does not exceed 35 percent of the fair market value of the trust assets or, alternatively, the QDOT meets the requirements of either paragraph (d)(1)(i)(A), (B), or (C) of this section on or before the close of that succeeding year.

(iii) *Definition of finally determined.* For purposes of § 20.2056A–2(d)(1)(i) and (ii), the fair market value of assets will be treated as finally determined on the earliest to occur of—

(A) The entry of a decision, judgment, decree, or other order by any court of competent jurisdiction that has become final;

(B) The execution of a closing agreement made under section 7121;

(C) Any final disposition by the Internal Revenue Service of a claim for refund;

(D) The issuance of an estate tax closing letter (Form L–154 or equivalent) if no claim for refund is filed; or

(E) The expiration of the period of assessment.

(iv) *Special rules for personal residence and related personal effects*—(A) *Two million dollar threshold.* For purposes of determining whether the $2 million threshold under paragraphs (d)(1)(i) and (ii) of this section has been exceeded, the executor of the estate may elect to exclude up to $600,000 in value attributable to real property (and related furnishings) owned directly by the QDOT that is used by, or held for the use of the surviving spouse as a personal residence and that passes, or is treated as passing, to the QDOT under section 2056(d). The election may be made regardless of whether the real property is situated within or without the United States. The election is made by attaching to the estate tax return on which the QDOT election is made a written statement claiming the exclusion. The statement must clearly identify the property or properties (i.e. address and location) for which the election is being made.

(B) *Security requirement.* For purposes of determining the amount of the bond or letter of credit required when paragraph (d)(1)(i)(B) or (C) of this section applies, the executor of the estate may elect to exclude, during the term of the QDOT, up to $600,000 in value attributable to real property (and related furnishings) owned directly by the QDOT that is used by, or held for the use of the surviving spouse as a personal residence and that passes, or is treated as passing, to the QDOT under section 2056(d). The election may be made regardless of whether the real property is situated within or without the United States. The election is made by attaching to the estate tax return on which the QDOT election is made a written statement claiming the exclusion. If an election is not made on the decedent's estate tax return, the election may be made, prospectively, at any time, during the term of the QDOT, by attaching to the Form 706–QDT a written statement claiming the exclusion. A statement may also be attached to the Form 706–QDT that cancels a prior election of the personal residence exclusion that was made under this paragraph, either on the decedent's estate tax return or on a Form 706–QDT.

(C) *Foreign real property limitation.* The special rules of this paragraph (d)(1)(iv) do not apply for purposes of determining whether more than 35 percent of the QDOT assets consist of foreign real property under paragraph (d)(1)(ii) of this section.

(D) *Personal residence.* For purposes of this paragraph (d)(1)(iv), a *personal residence* is either the principal residence of the surviving spouse within the meaning of section 1034 or one other residence of the surviving spouse. In order to be used by or held for the use of the spouse as a personal residence, the residence must be available at all times for use by the surviving spouse. The residence may not be rented to another party, even when not occupied by the spouse. A personal residence may include appurtenant structures used by the surviving spouse for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location).

(E) *Related furnishings.* The term *related furnishings* means furniture and commonly included items such as appliances, fixtures, decorative items and china, that are not beyond the value associated with normal household and decorative use. Rare artwork, valuable antiques, and automobiles of any kind or class are not within the meaning of this term.

(F) *Required statement.* If one or both of the exclusions provided in paragraph (d)(1)(iv)(A) or (B) of this section are elected by the executor of the estate and the personal residence is later sold or ceases to be used, or held for use as a personal residence, the U.S. Trustee must file the statement that is required under paragraph (d)(3) of this section at the time and in the manner provided in paragraphs (d)(3)(ii) and (iii) of this section.

(G) *Cessation of use.* Except as provided in this paragraph (d)(1)(iv)(G), if the residence ceases to be used by, or held for the use of, the spouse as a personal residence of the spouse, or if the residence is sold during the term of the QDOT, the exclusions provided in paragraphs (d)(1)(iv)(A) and (B) of this section cease to apply. However, if the residence is sold, the exclusion continues to apply if, within 12 months of the date of sale, the amount of the adjusted sales price (as defined in section 1034(b)(1)) is reinvested to purchase a new personal residence for the spouse. If less than the amount of the adjusted sales price is reinvested, the amount of the exclusion equals the amount reinvested in the new residence plus any amount previously allocated to a residence that continues to qualify for the exclusion, up to a total of $600,000. If the QDOT ceases to qualify for all or any portion of the initially claimed exclusions, paragraph (d)(1)(i) of this section, if applicable (determined as if the portion of the exclusions disallowed had not been initially claimed by the QDOT), must be complied with no later than 120 days after the effective date of the cessation. In addition, if a residence ceases to be used by, or held for the use of the spouse as a personal residence of the spouse or if the personal residence is sold during the term of the QDOT, the personal residence exclusion may be allocated to another residence that is held in either the same QDOT or in another QDOT that is established for the surviving spouse, if the other residence qualifies as being used by, or held for the use of the spouse as a personal residence. The trustee may allocate up to $600,000 to the new personal residence (less the amount previously allocated to a residence that continues to qualify for the exclusion) even if the entire $600,000 exclusion was not previously utilized with respect to the original personal residence(s).

(v) *Anti-abuse rule.* Regardless of whether the QDOT designates a bank as the U.S. Trustee under paragraph (d)(1)(i)(A) of this section (or otherwise complies with paragraph (d)(1)(i)(A) of this section by naming a foreign bank with a United States branch as a trustee to serve with the U.S. Trustee), complies with paragraph (d)(1)(i)(B) or (C) of this section, or is subject to and complies with the foreign real property requirements of paragraph (d)(1)(ii) of this section, the trust immediately ceases to qualify as a QDOT if the trust utilizes any device or arrangement that has, as a principal purpose, the avoidance of liability for the estate tax imposed under section 2056A(b)(1), or the prevention of the collection of the tax. For example, the trust may become subject to this paragraph (d)(1)(v) if the U.S. Trustee that is selected is a domestic corporation established with insubstantial capitalization by the surviving spouse or members of the spouse's family.

(2) *Individual trustees.* If the U.S. Trustee is an individual United States citizen, the individual must have a tax home (as defined in section 911(d)(3)) in the United States.

(3) *Annual reporting requirements*—(i) *In general.* The U.S. Trustee must file a written statement described in paragraph (d)(3)(iii) of this section, if the QDOT satisfies any one of the following criteria for the applicable reporting years—

(A) The QDOT directly owns any foreign real property on the last day of its taxable year (or the last day of the calendar year if it has no taxable year), and the QDOT does not satisfy the requirements of paragraph (d)(1)(i)(A), (B), or (C) or (d)(4) of this section by employing a bank as trustee or providing security; or

(B) The personal residence previously subject to the exclusion under paragraph (d)(1)(iv) of this section is sold, or that personal residence ceases to be used, or held for use, as a personal residence, during the taxable year (or during the calendar year if the QDOT does not have a taxable year); or

(C) After the application of the look-through rule contained in paragraph (d)(1)(ii)(B) of this section, the QDOT is treated as owning any foreign real property on the last day of the taxable year (or the last day of the calendar year if the QDOT has no taxable year), and the QDOT does not satisfy the requirements of paragraph (d)(1)(A), (B), (C) or (d)(4) of this section by employing a bank as trustee or providing security.

(ii) *Time and manner of filing.* The written statement, containing the information described in paragraph (d)(3)(iii) of this section, is to be filed for the taxable year of the QDOT (calendar year if the QDOT does not have a taxable year) for which any of the events or conditions requiring the filing of a statement under paragraph (d)(3)(i) of this section have occurred or have been satisfied. The written statement is to be submitted to the Internal Revenue Service by filing a Form 706–QDT, with the statement attached, no later than April 15th of the calendar year following the calendar year in which or with which the taxable year of the QDOT ends (or by April 15th of the following year if the QDOT has no taxable year), unless an extension of time is obtained under § 20.2056A–11(a). The Form 706–QDT, with attached statement, must be filed regardless of whether the Form 706–QDT is otherwise required to be filed under the provisions of this chapter. Failure to file timely the statement may subject the QDOT to the rules of paragraph (d)(1)(v) of this section.

(iii) *Contents of statement.* The written statement must contain the following information—

(A) The name, address, and taxpayer identification number, if any, of the U.S. Trustee and the QDOT; and

(B) A list summarizing the assets held by the QDOT, together with the fair market value of each listed QDOT asset, determined as of the last day of the taxable year (December 31 if the QDOT does not have a taxable year) for which the written statement is filed. If the look-through rule contained in paragraph (d)(1)(ii)(B) of this section applies, then the partnership, corporation, trust or other entity must be identified and the QDOT's pro rata share of the foreign real property and other assets owned by that entity must be listed on the statement as if directly owned by the QDOT; and

(C) If a personal residence previously subject to the exclusion under paragraph (d)(1)(iv) of this section is sold during the taxable year (or during the calendar year if the QDOT does not have a taxable year), the statement must provide the date of sale, the adjusted sales price (as defined in section 1034(b)(1)), the extent to which the amount of the adjusted sales price has been or will be used to purchase a new personal residence and, if not timely reinvested, the steps that will or have been taken to comply with paragraph (d)(1)(i) of this section, if applicable; and

(D) If the personal residence ceases to be used, or held for use, as a personal residence by the surviving spouse during the taxable year (or during the calendar year if the QDOT does not have a taxable year), the written statement must describe the steps that will or have been taken to comply with paragraph (d)(1)(i) of this section, if applicable.

(4) *Request for alternate arrangement or waiver.* If the Commissioner provides guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) pursuant to which a testator, executor, or the U.S. Trustee may adopt an alternate plan or arrangement to assure collection of the section 2056A estate tax, and if the alternate plan or arrangement is adopted in accordance with the published guidance, then the QDOT will be treated, subject to paragraph (d)(1)(v) of this section, as meeting the requirements of paragraph (d)(1) of this section. Until this guidance is published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), taxpayers may submit a request for a private letter ruling for the approval of an alternate plan or arrangement proposed to be adopted to assure collection of the section 2056A estate tax in lieu of the requirements prescribed in this paragraph (d)(4).

(5) *djustment of dollar threshold and exclusion.* The Commissioner may increase or decrease the dollar amounts referred to in paragraph (d)(1)(i), (ii) or (iv) of this section in accordance with guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(6) *Effective date and special rules.* (i) This paragraph (d) is effective for estates of decedents dying after February 19, 1996.

(ii) *Special rule in the case of incompetency.* A revocable trust or a trust created under the terms of a will is deemed to meet the governing instrument requirements of this paragraph (d) notwithstanding that the requirements are not contained in the governing instrument (or otherwise incorporated by reference) if the trust instrument (or will) was executed on or before November 20, 1995, and—

(A) The testator or settlor dies after February 19, 1996;

(B) The testator or settlor is, on November 20, 1995, and at all times thereafter, under a legal disability to amend the will or trust instrument;

(C) The will or trust instrument does not provide the executor or the U.S. Trustee with a power to amend the instrument in order to meet the requirements of section 2056A; and

(D) The U.S. Trustee provides a written statement with the federal estate tax return (Form 706 or 706NA) that the trust is being administered (or will be administered) so as to be in actual compliance with the requirements of this paragraph (d) and will continue to be administered so as to be in actual compliance with this paragraph (d) for the duration of the trust. This statement must be binding on all successor trustees.

(iii) *Special rule in the case of certain irrevocable trusts.* An irrevocable trust is deemed to meet the governing instrument requirements of this paragraph (d) notwithstanding that the requirements are not contained in the governing instrument (or otherwise incorporated by reference) if the trust was executed on or before November 20, 1995, and:

(A) The settlor dies after February 19, 1996;

(B) The trust instrument does not provide the U.S. Trustee with a power to amend the trust instrument in order to meet the requirements of section 2056A; and

(C) The U.S. Trustee provides a written statement with the decedent's federal estate tax return (Form 706 or 706NA) that the trust is being administered in actual compliance with the requirements of this paragraph (d) and will continue to be administered so as to be in actual compliance with this paragraph (d) for the duration of the trust. This statement must be binding on all successor trustees.

§ 20.2056A–2T [Removed]

Par. 3a. Section 20.2056A–2T is removed.

PART 602—0MB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:
Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101, paragraph (c) is amended by:

1. Removing the following entry from the table:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
20.2056A–2T(d)	1545–1443
* * * * *	

2. Adding the following entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
20.2056A–2	1545–1443
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved September 19, 1996.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 27, 1996, 8:45 a.m., and published in the issue of the Federal Register for November 29, 1996, 61 F.R. 60551)

Section 6621.— Determination of Interest Rate

26 CFR 301.6621–1: Interest rate

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 1996, will be 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 is 6.5 percent.

Rev. Rul. 96–61

Section 6621 of the Internal Revenue Code establishes different rates for interest on tax overpayments and interest on tax underpayments. Under § 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points, except the rate for the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under § 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See § 6621(c) and § 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable rate. Section 6621(c) and § 301.6621–3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under § 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) provides that in determining the addition to tax under § 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate that applies during the third month following such taxable year also applies during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88–59, 1988–1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under § 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with § 6621 which, pursuant to § 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of October 1996 is 6 percent. Accordingly, an overpayment rate of 8 percent and an underpayment rate of 9 percent are established for the calendar quarter beginning January 1, 1997. The overpayment rate for the portion of corporate overpayments exceeding $10,000 for the calendar quarter beginning January 1, 1997, is 6.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning January 1, 1997, is 11 percent. These rates apply to amounts bearing interest during that calendar quarter.

The 9 percent rate also applies to estimated tax underpayments for the first calendar quarter in 1997 and for the first 15 days in April 1997.

Interest factors for daily compound interest for annual rates of 6.5 percent, 8 percent, 9 percent, and 11 percent are published in Tables 18, 21, 23, and 27, of Rev. Proc. 95–17, 1995–1 C.B. 556, 572, 575, 577, and 581.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Marcia Rachy of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Rachy on (202) 622–6232 (not a toll-free call).

TABLE OF INTEREST RATES

PERIODS BEFORE JUL. 1, 1975—PERIODS ENDING DEC. 31, 1986

OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	DAILY RATE TABLE IN 1995-1 C.B.
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25 pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES

FROM JAN. 1, 1987—PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE	TABLE	PG 1995-1 C.B.	RATE	TABLE	PG 1995-1 C.B.
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579

TABLE OF INTEREST RATES—Continued

FROM JAN. 1, 1987—PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE	TABLE	PG 1995-1 C.B.	RATE	TABLE	PG 1995-1 C.B.
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991—PRESENT

	RATE	TABLE	PG 1995-1 C.B.
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581

TABLE OF INTEREST RATES FOR CORPORATE OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995—PRESENT

		RATE TABLE 1995-1 C.B.	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan, 1, 1997—Mar. 31, 1997	6.5%	18	572

Part III. Administrative, Procedural, and Miscellaneous

Treatment of a Trust as Domestic or Foreign—Changes Made by the Small Business Job Protection Act

Notice 96–65

This notice provides guidance with respect to certain provisions of the Small Business Job Protection Act of 1996 (the ''Act''), Public Law 104–188, 110 Stat. 1755 (August 20, 1996), dealing with the status of a trust as domestic or foreign under sections 7701(a)(30) and 7701(a)(31) of the Internal Revenue Code (the ''Code''). The first section of this notice grants trusts that meet the conditions specified in this notice additional time to comply with the new domestic trust criteria contained in the Act and allows such trusts to continue to file as a domestic trusts during this period. The second section of this notice addresses the time and manner for making the election provided by the Act to apply the new trust criteria retroactively. The third section of this notice provides guidance regarding the application of sections 1491 through 1494 of the Code if the status of a trust changes from domestic to foreign.

BACKGROUND

Prior to the Act, the status of a trust as domestic or foreign turned upon the subjective determination of whether the trust was more comparable to a resident or a nonresident alien individual. See Rev. Rul. 60–181, 1960–1 C.B. 257, citing *B.W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943). Section 1907(a) of the Act amended sections 7701(a)(30) and (31) of the Code to provide more objective criteria for determining the status of a trust. New section 7701(a)(30) provides that a trust will be treated as a domestic trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. New section 7701(a)(31) provides that a foreign trust is any trust that is not a domestic trust.

Section 1491 imposes a 35 percent excise tax on a transfer of property by a U.S. person, including a domestic trust, to a foreign trust. In general, the excise tax is imposed on the excess of the fair market value of the property transferred over the adjusted basis of such property plus any gain recognized on the transfer by the U.S. person.

If a domestic trust becomes a foreign trust, such trust shall be treated for purposes of section 1491 as having transferred, upon becoming a foreign trust, all of its assets to a foreign trust. Act section 1907(b), amending section 1491. However, to the extent that a grantor or another person is treated as the owner of all or a portion of the trust under sections 673 through 679 when such trust becomes a foreign trust, the portion of the trust owned by such person is not taken into account in determining the assets treated as transferred to the foreign trust for purposes of section 1491. *See, e.g.*, Rev. Rul. 87–61, 1987–2 C.B. 219.

New sections 7701(a)(30) and (31) apply in determining the status of a trust for taxable years beginning after December 31, 1996. A trustee of a trust may, however, elect to have the new criteria apply to the first taxable year of the trust ending after August 20, 1996 (the date of enactment of the Act). Act section 1907(a)(3).

ADDITIONAL TIME TO COMPLY WITH NEW DOMESTIC TRUST CRITERIA

In the first taxable year that new section 7701(a)(30) applies, it is possible for a trust treated as a domestic trust under prior law to become a foreign trust solely by operation of the new law, notwithstanding that the trust may prefer to remain a domestic trust for U.S. tax purposes. In that event, the domestic trust may be subject to the 35 percent excise tax on any built-in gain in its assets as of the date of its change in status.

Certain existing domestic trusts that desire to remain domestic trusts may have difficulty meeting the new domestic trust criteria in section 7701(a)(30) prior to the first taxable year beginning after December 31, 1996. Treasury and the Service believe that these trusts should have a reasonable amount of time to comply with the new domestic trust criteria. Accordingly, a domestic trust in existence on August 20, 1996 (''existing trust''), may continue to file tax returns as a domestic trust for taxable years of the trust beginning after December 31, 1996, if the trust satisfies the conditions of this notice. This relief is not available to a trust if an election has been made pursuant to section 1907(a)(3)(B) of the Act to apply the new trust criteria to the first taxable year of the trust ending after August 20, 1996.

An existing domestic trust must satisfy the following conditions to qualify for the relief provided by this section of the notice: (1) the trustee must initiate modification of the trust to conform with the domestic trust criteria by the due date (including extensions) for filing the trust's income tax return for its first taxable year beginning after December 31, 1996; (2) the trustee must complete the modification within two years of that date (''two-year period''); and (3) the trustee must attach a statement to the trust's income tax return as described below. If an existing domestic trust meets these conditions, it may continue to file as a domestic trust for taxable years of the trust beginning after December 31, 1996. For purposes of this notice, ''modification'' includes any action taken (judicial or nonjudicial) to reform, amend, modify, or alter the trust that is effective under local law.

The statement referred to above must be entitled ''Election to Rely on Notice 96–65 to File as a Domestic Trust,'' and must be attached to the trust's income tax return for each taxable year that this notice is relied on to file as a domestic trust. The statement must be signed under penalties of perjury by the trustee and contain the following information:

(1) A statement that the trust is relying on this notice to file as a domestic trust for the taxable year;

(2) A statement that the trustee filed original income tax returns treating the trust as a domestic trust for each taxable year of the trust beginning after 1994, and will continue to file as a domestic trust while actions are being taken to meet the domestic trust criteria;

(3) The date on which actions to modify the trust to meet the domestic trust criteria were initiated and a brief description of both completed and forthcoming actions necessary to meet the domestic trust criteria;

(4) The name, taxpayer identification number, and address of any U.S. person who, but for the relief provided in this notice, would be treated as the owner of all or a portion of the trust under section 679 for any taxable year of the trust beginning after December 31, 1996; and

(5) A statement that, if the trust does not meet the domestic trust criteria in section 7701(a)(30) by the end of the two-year period, the trustee will file all of the trust's applicable returns (whether original or amended) for taxable years of the trust beginning after December 31, 1996, treating the trust as a foreign trust.

If the trust satisfies the trust criteria in section 7701(a)(30) by the end of the two-year period, the trust will be treated as a domestic trust during this period for all purposes of the Code. In the case of an existing domestic trust that fails to meet the conditions set forth in this notice to continue to file as a domestic trust, such trust will be treated as a foreign trust for all taxable years of the trust beginning after December 31, 1996, for all purposes of the Code. In that event, any U.S. person who is treated as owning all or a portion of the trust for any taxable year of the trust beginning after December 31, 1996, and any beneficiary whose tax liability was affected by the change in the trust's status must file amended returns in order to correctly report their income tax liability for any taxable year that the trust relied on this notice to file as a domestic trust.

If reasonable actions have been taken to meet the domestic trust criteria, but due to circumstances beyond the trustee's control the trust is unable to meet such criteria by the date set forth in this notice, the trustee may provide a written statement to the District Director having jurisdiction over the trust's return setting forth the reasons for failing to meet the domestic trust criteria in a timely manner. If the District Director determines that the failure was due to reasonable cause, the District Director may grant the trust an extension of time to meet such criteria. Whether an extension of time is granted shall be in the sole discretion of the District Director and, if granted, may contain such terms with respect to assessment as may be necessary to ensure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries. If the trust does not obtain an extension from the District Director before the end of the two-year period, then the trustee must treat the trust as a foreign trust for all taxable years of the trust beginning after December 31, 1996.

The following example illustrates the relief provided by this section of the notice. Assume a U.S. court has primary supervision over an existing domestic trust with a single foreign trustee. The trust, a calendar year taxpayer, is not treated as owned by the grantor or another person under sections 673 through 679. On April 1, 1998, the foreign trustee tenders his letter of resignation to take effect upon appointment of a new U.S. trustee. The trustee attaches the statement described in this notice to the trust's 1997 tax return. A new U.S. trustee is appointed on July 30, 1998, and the trustee attaches the required statement to the trust's 1998 tax return.

The trust may continue to file as a domestic trust for the 1997 and 1998 taxable years because (1) the trustee initiated modification of the trust by the due date for filing the trust's income tax return for its first taxable year beginning after December 31, 1996; (2) the modification was completed within two years of the due date for filing the trust's 1997 return; and (3) the trustee attached the required statement to the trust's 1997 and 1998 income tax returns.

If, however, a new U.S. trustee had not been appointed by the end of the two-year period, and an extension of time had not been granted by the District Director, the trust would have been treated as a foreign trust for all taxable years beginning after December 31, 1996. For purposes of section 1491 such trust would have been treated as having transferred all of its assets to a foreign trust upon becoming a foreign trust on January 1, 1997.

ELECTION TO APPLY NEW TRUST CRITERIA RETROACTIVELY

New sections 7701(a)(30) and (31) apply to determine whether a trust is domestic or foreign for taxable years beginning after December 31, 1996. However, under section 1907(a)(3)(B) of the Act, a trustee of a trust may elect to apply the new trust criteria to the first taxable year of the trust ending after August 20, 1996 (''the election year''). This section of the notice announces the time and manner for making the election.

If an election is made to apply new sections 7701(a)(30) and (31) to the trust's first taxable year ending after August 20, 1996, the new trust criteria must be applied for the entire election year. Thus, for example, if a domestic trust with the calendar year as its taxable year has a single foreign trustee, and that trustee elects to apply new sections 7701(a)(30) and (31) to the trust's 1996 taxable year, then the trust will be treated as a foreign trust beginning on January 1, 1996.

To make the election, the trustee must attach a statement entitled ''Election Under Section 1907(a)(3)(B) of the Small Business Job Protection Act of 1996 to Apply New Trust Criteria Retroactively,'' to the trust's income tax return for its first taxable year ending after August 20, 1996. The statement must be signed under penalties of perjury by the trustee and contain the following information:

(1) A statement that the trust is relying on this notice to apply the new trust criteria for its first taxable year ending after August 20, 1996;

(2) A declaration stating whether the trustee has filed an original U.S. income tax return treating the trust as a domestic trust for any of the three immediately preceding taxable years; and

(3) A declaration stating whether, during the election year, there has been a change in trust status.

If a trust changes status from domestic to foreign as a result of this election, the trustee must, as a condition of making the election, attach a statement agreeing to treat the change in trust status as a transfer of the trust's assets to a foreign trust for purposes of section 1491, except to the extent the grantor or another person is treated as the owner of the trust under sections 673 through 679 when such trust becomes a foreign trust.

APPLICATION OF SECTIONS 1491 THROUGH 1494

If the status of a trust changes from domestic to foreign as a result of the new law, whether or not by reason of an election to apply the new trust criteria retroactively, for purposes of section 1491 the trust will be treated as having made a transfer of all of its assets to a foreign trust upon becoming a foreign trust, except to the extent a grantor or another person is treated as the owner of the trust under sections 673 through 679 when such trust becomes a foreign trust. Act section 1907(b); *See also* H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 338 (1996). In the case of an existing domestic trust that fails to meet the conditions set forth earlier in this notice to continue to file as a domestic trust, then to the extent there is a transfer of assets to the foreign trust for purposes of section 1491, such transfer will occur upon the trust becoming a foreign trust at the beginning of the first taxable year beginning after December 31, 1996.

Under section 1494(a), the excise tax imposed by section 1491 is due and payable at the time of the transfer. Treasury and the Service expect to issue regulations under section 1494 that will provide that any excise tax due on a transfer of assets to a foreign trust as a result of a change in trust status may be paid by attaching Form 926, and any applicable excise tax, to the trust's income tax return for the taxable year in which the transfer occurs. If the excise tax is not paid until the trust's income tax return for the year is filed, interest must be paid on the amount of excise tax due at the rates determined under section 6621, with respect to the period between the date on which the transfer occurred and the date on which the excise tax is actually paid. Until regulations are issued, the guidance provided by this section of the notice may be relied on by taxpayers. For penalties applicable for failure to report a transfer of property described in section 1491, *see* Act section 1902, adding section 1494(c) and Notice 96–60, 1996–49 I.R.B. 7.

In the case of an existing domestic trust that has relied in good faith on the first section of this notice to continue to file as a domestic trust, but fails to meet the criteria in section 7701(a)(30) by the end of the two-year period, the trustee must make a return on Form 926 no later than thirty day after the end of the two-year period to report a section 1491 transfer that occurs on the change in the trust's status, and to pay any excise tax and interest due. Form 926 may be attached to an amended return filed by the trustee for the first taxable year of the trust ending after December 31, 1996. If Form 926 is filed no later than thirty days after the end of the two-year period, no penalties will be imposed under section 1494(c).

Under section 1492, the excise tax imposed by section 1491 shall not apply to: transfers to certain exempt organizations (section 1492(1)); transfers described in section 367 (section 1492(2)(A)); transfers with respect to which an election has been made to apply principles similar to the principles of section 367 (section 1492(2)(B)); or transfers with respect to which an election has been made under section 1057 (section 1492(3)). A transfer to a foreign trust that occurs as a result of a change in trust status from domestic to foreign may be nontaxable under sections 1492(1) and (3). Such a transfer cannot be nontaxable under section 1492(2)(A) because the transfers described in section 367 are limited to transfers to foreign corporations.

Treasury and the Service are studying whether it is appropriate to allow a domestic trust that becomes a foreign trust to elect to apply principles similar to the principles of section 367 under section 1492(2)(B) and, if so, how such principles should be applied. Until further guidance is provided, a domestic trust that becomes a foreign trust may not avoid the section 1491 excise tax by electing principles similar to the principles of section 367, unless the trust obtains a private letter ruling with respect to the application of the principles of section 367 to its particular facts.

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1506.

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

The collections of information in this notice are in the sections headed *Additional Time to Comply with New Domestic Trust Criteria* and *Election to Apply New Trust Criteria Retroactively.* This information is required by the IRS to assure compliance with the new provisions of the Small Business Job Protection Act of 1996. The likely respondents are individuals, business or other for-profit institutions, and not-for-profit institutions.

The estimated total annual reporting burden is 550 hours.

The estimated average annual burden per respondent is 27 minutes. The estimated number of respondents is 1,200.

The estimated annual frequency of responses is annually.

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.

DRAFTING INFORMATION

The principal author of this notice is Wendy Stanley of the Office of Associate Chief Counsel (International). For further information regarding sections 1491 through 1494 contact Ms. Stanley on (202) 622–3860 (not a toll-free call). For further information regarding sections 7701(a)(30) and (31) contact James A. Quinn on (202) 622–3060 (not a toll-free call).

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26 CFR 1.127-2: Educational Assistance Programs.

Definitions Relating to Application of Exclusion Under Section 127 of the Internal Revenue Code

Notice 96-68

This notice provides guidance regarding certain definitions affecting the proper tax treatment of educational assistance received by employees under § 127 of the Internal Revenue Code as amended by the Small Business Job Protection Act of 1996, Pub. L. 104-188 (the "Act").

Section 1202 of the Act restores the exclusion from gross income for up to $5,250 of educational assistance provided under an educational assistance program described in § 127, effective for an employee's first taxable year beginning after December 31, 1994. The Act amends the definition of "educational assistance" to provide that, for graduate level courses, the exclusion does not apply to expenses relating to courses "beginning after June 30, 1996." For this purpose, a "graduate level course" will be treated as meaning any course taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree. Section 127(c)(1). This is the same definition set forth in Notice 89–33, 1989-1 C.B. 674, with respect to amendments made by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, relating to graduate level courses.

The amendment of the term "educational assistance" to exclude graduate level courses applies to courses beginning after June 30, 1996. Similarly, the § 127 exclusion only applies with respect to "courses beginning" before a specified date in 1997. For purposes of both of these provisions, a course ordinarily will be considered to begin on the first regular day of class for the course. The first regular day of class for any course that is offered during a regular academic term at an educational institution will be considered to be the first day on which regular classes generally begin for courses offered during that term. A regular academic term during which a course is offered might be, for example, a semester or, if the semester consists of more than one session, the session during which the course is offered. The date on which an individual registers for or enrolls in a course does not determine when the course begins.

For example, assume an employee registers in January 1996 for a graduate level independent study course for the upcoming summer term. The course consists of working with a professor to write a paper. Other courses offered for the summer term hold their first regular class during the first week of June 1996. The first day on which regular classes are held in the term is Monday, June 3, 1996, and classes continue until August. The employee does not meet with the professor until the second week of July 1996. Under the preceding paragraph, the independent study course would be treated as beginning on or before June 30, 1996 for purposes of § 127. This is because regular classes for courses offered during the summer term in which this course was taken generally began on June 3, 1996.

The amendments to § 127 do not affect the tax treatment of educational benefits under any other section of the Internal Revenue Code including employment related education described in Treas. Reg. § 1.162-5.

FURTHER INFORMATION

For further information regarding this Notice, contact Monice Rosenbaum of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) at (202) 622-6070 (not a toll-free number).

Part IV. Items of General Interest

Excise Tax Changes

Announcement 96–130

The changes listed below are effective after December 31, 1996, and will be reflected on Form 720, Quarterly Federal Excise Tax Return for the first quarter of 1997, as well as the 1997 revisions of Form 4136, Credit for Federal Tax Paid on Fuels, and Form 8849, Claim for Refund of Excise Taxes. If these rates are modified by legislation, the IRS will issue another announcement and will revise all forms accordingly.

I. TAX ON AVIATION GASOLINE

Tax is imposed on aviation gasoline (IRS No. 14) at a rate of 4.3 cents per gallon beginning on January 1, 1997.

II. TAX ON AVIATION FUEL (OTHER THAN GASOLINE)

Tax is imposed on aviation fuel (other than gasoline) (IRS No. 69) at a rate of 4.3 cents per gallon beginning on January 1, 1997.

III. AIR TRANSPORTATION TAXES

The excise tax on transportation of persons and property by air and use of international air travel facilities (IRS Nos. 26, 28, and 27) expires after December 31, 1996. No tax applies to amounts paid for transportation beginning after December 31, 1996.

Passengers from whom tax was collected on amounts paid for travel beginning after December 31, 1996, may be entitled to a refund of the tax. Refunds may be obtained either from the airlines or from the IRS. Direct refunds from the IRS are claimed on Form 8849, Claim for Refund of Excise Taxes. An original passenger receipt must be submitted with the passenger's Form 8849.

IV. OZONE-DEPLETING CHEMICALS

Tax is imposed on ozone-depleting chemicals (IRS Nos. 98 and 19) at the rates shown beginning on January 1, 1997. The rate is per pound.

CFC–11	$ 6.25
CFC–12	6.25
CFC–113	5.00
CFC–114	6.25
CFC–115	3.75
Halon–1211	18.75
Halon–1301	62.50
Halon–2402	37.50
Carbon tetrachloride	6.875
Methyl chloroform	0.625
CFC–13, CFC–111, and CFC–112 CFC–211 through CFC–217	6.25

V. LUXURY TAX

Tax is imposed on passenger automobiles (IRS No. 92) at 8% of the amount by which the sales price exceeds $36,000 beginning January 1, 1997. For example, if the sales price of the automobile is $38,000, the tax is $160 (8% of $2,000).

VI. HOW TO GET FORMS

IRS Forms can be obtained by calling 1–800–829–3676 or downloaded from:

- FTP — ftp://irs.ustreas.gov
- World Wide Web—http://www.irs.ustreas.gov
- IRIS at FedWorld—(703) 321–8020

Foundations Status of Certain Organizations

Announcement 96–131

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

Affordable Housing Corporation, Montgomery, AL
Aleut Foundation, Anchorage, AK
Alleghany Highlands Housing Alliance, Covington, VA
ALS Recovery Foundation Inc., Miami, FL
Baltimore County Literacy Works Inc., Baltimore, MD
Best HOUSE Inc., Oakland, CA
Big Brothers and Big Sisters of South Big Horn Basin Inc., Worland, WY
Bloomington Blades High School Association Incorporated, Bloomington, IN
Blue Water Charity Sports, Inc., Port Huron, MI
Candlelighters Childhood Cancer Foundation, Toledo, OH
Cherokee Affiliated Services, Inc., Canton, GA
Children's Visitation Program, Ann Arbor, MI
Comprehensive Christian Counseling, Inc., Xenia, OH
Elks No. 273 Ladies Auxiliary, Inc., Cold Spring, KY
Ermine Meadows, Incorporated, Elkhart, IN
E S Haven Academy, Dallas, TX
Exodua Ministries, Grand Rapids, MI
Exodus Community Preservation Corporation, Los Angeles, CA
Faith in Action, Inc., Columbus, OH
Family Support Network, Goldsboro, NC
Firelands Archaeological Research Center, Milan, OH
Flouride Commemorative Committee, Grand Rapids, MI
F M Ministry, Grand Rapids, MI
Fort Wayne Healthly Cities Committee, Inc., Fort Wayne, IN
Foster Parents United, Inc., Ashland, OH
Foundation for Endowment and Reconstruction of Noah's Ark, Inc., Princeton, WV
Foundation for International Development Inc. F I D, Washington, DC
Foundation to Preserve Access to Abortion, Alexandria, VA
Friends of Friends, Inc., Crawfordsville, IN
Friends of North Florida Environment, Inc., Jacksonville, FL
Friends of the Cotillion Club, Detroit, MI
Friends of the Quilt Detroit Metro Chapter, Romulus, MI
Friendship House, Inc., Louisville, KY
Future Mobility Institute, San Francisco, CA
Generation Gap Inc., Wooster, OH
Good Shepherd Enterprises Incorporation, Louisville, KY
Grand Rapids Job Corps Center Community Relations Council, Inc., Grand Rapids, MI

Green Local Schools Foundation, Greensburg, OH
Gary Urban Enterprise Association, Inc., Gary, IN
Grimes Memorial, Inc., Columbus, OH
Halhul Alms Committee, Westerville, OH
Hands on Battle Creek Museum, Battle Creek, MI
Harrison County Young Peoples Orchestras, Inc., Bridgeport, WV
Heartfelt Ministries, Inc., Louisville, KY
Hellenic Preservation Society of Northeastern Ohio, Cleveland, OH
Hillcrest Christian Center, Inc., Sylvania, OH
Histiocytosis Association of Indiana, Indianapolis, IN
HIV AIDS Housing Coalition, Inc., Grand Rapids, MI
Homes for the Homeless Foundation, Inc., Owensboro, KY
Hope Senior Nonprofit Housing Corporation, Oxford, MI
Huron Village, Inc., Milford, MI
In Defense of Endangered Species, Columbus, OH
Indiana Association for Social Work Education, Inc., Evansville, IN
Indiana Korean Association of Retired Persons, Inc., Indianapolis, IN
Innovation Alliance, Inc., Worthington, OH
Institute of New Construction Achievements, Inc., Gary IN
Intercessors International, Flint, MI
Intercultural Scholarship Foundation Incorporated, Perrysburg, OH
Isabella Community Soup Kitchen, Mt. Pleasant, MI
Isabelle Ridgway Community Service Agency, Columbus, OH
Jackson County Christians, Jackson, MI
Jeff Lisath Summer Basketball League, Portsmouth, OH
Jesus Bridges the Gap After Care Ministry, Inc., Indianapolis, IN
Joe Sparma Community Center, Massillon, OH
Jor-Lee Inc., Mechanicstown, OH
Kalamazoo Mass Choir, Kalamazoo, MI
Kelly-Morang Center, Roseville, MI
Kentucky School Reform Corporation/Partnership for Kentucky School Reform, Lexington, KY
Kenwood Place II, Inc., Indianapolis, IN
Kurdish Children Emergency Fund, Westerville, OH
Kush Empowerment Center, Inc., Detroit, MI
Lipscomb Family Foundation, Columbia, SC
Main Street Gary, Gary, IN
Mary Alice Fortin Child Care Foundation, Inc., Palm Beach, FL
Mays Lick Community Development, Inc., Mays Lick, KY
Muncie Coalition of 100 Women Incorporated, Muncie, IN
Namos, Inc. National Art Museum of Sport, Indianapolis, IN
Newburg Volunteer Rescue Squad Inc., Newburg, MD
Northcoast Orthopaedic Research and Educational Foundation, South Euclid, OH
Oakland County Area Service Committee Of Narcotics Anonymous, Pleasant Ridge, MI
Pierson Area Fire Association, Pierson, MI
Rotary Club of Cambria Foundation, Cambria, CA
Skin Phototrauma Foundation Inc., Parsippany, NJ
T A S K Ministries Inc., Nacogdoches, TX
West Milton Players, Milton, OH
Young Artists, Inc., Parkersburg, WV
Youth Foundation of Louisiana, Baton Rouge, LA

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

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

Announcement 96–132

The name of an organization that no longer qualifies as an organization described in section 170(c)(2) of the Internal Revenue Code of 1986 is listed below.

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

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on December 23, 1996, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Orthopaedic Development Foundation Hilton Head, SC

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

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

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

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

Name	Address	Designation	Date of Suspension
Sherman, Richard M.	Crystal Lake, IL	CPA	October 18, 1996 to July 17, 1997
Hunter, Lewis	Jacksonville, FL	CPA	October 25, 1996 to January 24, 1997
Hisken, Donald	Red Bluff, CA	CPA	November 1, 1996 to March 31, 1997
Byrne, Steven P.	Arcadia, CA	Attorney	November 1, 1996 to January 31, 1997
Mulrey, Robert M.	Milton, MA	CPA	November 1, 1996 to October 31, 1997
Edwards, Ronald A.	Plymouth, MI	CPA	November 1, 1996 to April 30, 1998
Hart Jr., Charles E.	Wilmington, OH	Attorney	November 1, 1996 to October 31, 1998
Willner, Peter D.	Stowe, VT	CPA	November 1, 1996 to April 30, 1997
May, Gary	Madison, WI	Attorney	November 1, 1996 to October 31, 1998
Josephson, Elliott	Northbrook, IL	CPA	November 1, 1996 to October 31, 1998
Capwill Jr., James A.	Solon, OH	CPA	November 1, 1996 to February 28, 1997
Hazel, John J.	Ridgefield, CT	Enrolled Agent	November 1, 1996 to January 31, 1997
Jacobs, Patrick	St. Paul, MN	CPA	November 1, 1996 to December 31, 1996
Lau, William	Crete, IL	CPA	November 1, 1996 to June 30, 1997
Franklin, Gene L.	Lees Summit, MO	Enrolled Agent	November 1, 1996 to January 31, 1997
Winterhalter, Charles L.	Cincinnati, OH	CPA	November 1, 1996 to April 30, 1998
Cremer, Patricia L.	Roundup, MT	CPA	November 5, 1996 to May 4, 1997
Gardner, Stephen A.	Dallas, TX	Attorney	November 7, 1996 to May 6, 1999
Masini, David	Wheat Ridge, CO	CPA	November 12, 1996 to November 11, 1997
Cunningham, Michael	Lafayette, IN	CPA	November 12, 1996 to August 11, 1997
Smith, Robert	Chicago, IL	CPA	January 1, 1997 to December 31, 1997

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

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

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

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

Name	Address	Designation	Date of Suspension
Pacchiana, Paul	Chappaqua, NY	Attorney	Indefinite from October 9, 1996
Rosenberger, David H.	Centerville, OH	Enrolled Agent	Indefinite from October 21, 1996
Gudes, Gerald	W. Bloomfield, MI	CPA	Indefinite from October 22, 1996
Donnelly, Richard S.	Asheville, NC	CPA	Indefinite from October 22, 1996
Burrows, William D.	Dallas, TX	Attorney	Indefinite from November 13, 1996
Klausner, Julius	Scarsdale, NY	CPA	Indefinite from November 13, 1996
Glessner, Randy	Omak, WA	CPA	Indefinite from November 13, 1996
Aspland, Frieda R.	Greenville, SC	CPA	Indefinite from November 13, 1996

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[1] See footnote at end of list.

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[1]A cumulative list of all Revenue Rulings, Revenue Procedures, Treasury Decisions, etc., published in Internal Revenue Bulletins 1996–1 through 1996–26 will be found in Internal Revenue Bulletin 1996–27, dated July 1, 1996.

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[1] A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1996–1 through 1996–26 will be found in Internal Revenue Bulletin 1996–27, dated July 1, 1996.