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(Miscellaneous Stamp Tax Regulations). For regulations relating to the manufacture of opium suitable for smoking purposes, see 26 CFR (1939) 150 (Narcotics Regulations 3, 3 FR 1402) as made applicable to section 7641 by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167).

POSSESSIONS

§ 301.7654–1 Coordination of U.S. and Guam individual income taxes.

(a) *Application of section*—(1) *Scope.* Section 7654 and this section set forth the general procedures to be followed by the Government of the United States and the Government of Guam in the division between the two governments of revenue derived from collections of the income taxes imposed for any taxable year beginning after December 31, 1972, with respect to any individual described in subparagraph (2) of this paragraph (a), and paragraph (e) of this section. To the extent that section 7654 and this section are inconsistent with the provisions of section 30 of the Organic Act of Guam (48 U.S.C. 1421h), relating to duties and taxes to be covered into the treasury of Guam and held in account for the Government of Guam, such section 30 is superseded.

(2) *Individuals covered.* Paragraph (b) of this section applies only to an individual who, for a taxable year, is described in paragraph (a)(2) of § 1.935–1 of this chapter (Income Tax Regulations) and has (or in the case of a joint return, such individual and his spouse have)—

(i) Adjusted gross income of $50,000 or more, and

(ii) Gross income of $5,000 or more from sources within the jurisdiction (either the United States or Guam) other than the jurisdiction with which the individual is required to file his income tax return under paragraph (b) of § 1.935–1 of this chapter.

For the determination of gross income and adjusted gross income see sections 61 and 62, and the regulations thereunder, or, when applicable, the corresponding provisions as made applicable in Guam by the Guam Territorial income tax (48 U.S.C. 1421i). For purposes of this paragraph, gross income consisting of compensation for military or naval service shall be taken into account notwithstanding section 514 of the Soldiers' and Sailors' Civil Relief Act of 1940 (50 App. U.S.C. 574). However, see paragraph (e) of this section.

(b) *Allocation of tax.* (1) Net collections of income taxes imposed for each taxable year beginning after December 31, 1972, with respect to each individual described in paragraph (a)(2) of this section for such year shall be divided between the United States and Guam by the Commissioner of Internal Revenue and the Commissioner of Revenue and Taxation of Guam as follows:

(i) Net collections attributable to income from sources within the United States shall be covered into the Treasury of the United States.

(ii) Net collections attributable to income from sources within Guam shall be covered into the treasury of Guam, and

(iii) Net collections not described in subdivision (i) or (ii) of this subparagraph (i.e., net collections attributable to income from sources other than within the United States or Guam) shall be covered into the treasury of the jurisdiction (either the United States or Guam) with which the individual is required to file his return under paragraph (b) of § 1.935–1 of this chapter for such year.

(2) The amount of tax of any individual for a taxable year which shall be allocated to Guam for purposes of determining the portion of the net collections from such individual which shall be covered into the treasury of Guam by the United States for such year shall be that amount which bears the same ratio to such amount of tax as the adjusted gross income of that individual for such year which is allocable to sources in Guam bears to the total adjusted gross income of such individual for such year. For purposes of such allocation by the United States, the adjusted gross income of the taxpayer shall be determined by taking into account any compensation of any member of the Armed Forces for services performed in Guam the withheld tax on which is paid into the treasury of Guam pursuant to paragraph (e) of this section. The amount of tax of any

individual for any taxable year which shall be allocated to the United States for purposes of determining the portion of the net collections from such individual which shall be covered into the Treasury of the United States by Guam for such year shall be that amount which bears the same ratio to such amount of tax as the adjusted gross income of that individual for such year which is allocable to sources in the United States bears to the total adjusted gross income of such individual for such year.

(c) *Definitions and special rules.* For purposes of this section—

(1) *Net collections.* (i) In determining net collections for a taxable year, appropriate adjustment between the two jurisdictions shall be made on a proportionate basis for underpayments of income taxes for such taxable year, credits allowed against the income tax for such taxable year (other than the credit for taxes withheld under section 3402 on wages), and refunds made of income taxes paid with respect to such taxable year. Thus, if a net operating loss results in a carryback to an earlier taxable year which gives rise to a refund for that earlier year, an adjustment must be made based upon the proportion which the amount of tax covered by one jurisdiction into the treasury of the other jurisdiction for that earlier year bears to the total amount of tax paid for that earlier year, even though the loss may have resulted from activities in one jurisdiction and the income, against which the loss was offset, was earned in the other jurisdiction. Similar adjustments must be made for foreign tax credit carrybacks even though different jurisdictions are involved. If, for example, an individual pays income tax of $30,000 to the United States for 1974 and $10,000 of such tax is covered into the treasury of Guam, and if for 1975 such individual has a net operating loss attributable to a trade or business carried on in the United States which loss is carried back to 1974 and gives rise to a refund of $15,000 by the United States, Guam must cover into the Treasury of the United States the amount of $5,000 which is the adjustment based upon the refund ($15,000×$10,000/$30,000=$5,000).

(ii) Tax withheld from the compensation of any member of the Armed Forces described in paragraph (a)(2) of this section which is paid to Guam pursuant to section 7654(d) and paragraph (e) of this section shall be taken into account in determining the amount required to be covered into the treasury of Guam under paragraph (b)(1)(ii) of this section.

(iii) For purposes of this subparagraph, any underpayment of tax is treated as attributable on a pro rata basis to income from sources within the United States, Guam, and sources other than within the United States or Guam, respectively, and is divided between the United States and Guam under the rules in paragraph (b) of this section.

(2) *Income taxes.* The term ''income taxes'' means—

(i) With respect to taxes imposed by the United States, the income taxes imposed by chapter 1 of the Code, and

(ii) With respect to taxes imposed by Guam, the Guam Territorial income tax (48 U.S.C. 1421i).

(3) *Source rules.* The determination of the source of income shall be based on the principles contained in sections 861 through 863, and the regulations thereunder, or, when applicable, in those sections as made applicable in Guam by the Guam Territorial income tax. For such purposes the provisions of section 514 of the Soldiers' and Sailors' Civil Relief Act of 1940 (50 App. U.S.C. 574) relating to the determination of the source of income of members of the Armed Forces shall not be taken into account. For purposes of this subparagraph, the provisions in section 935(c) treating Guam as part of the United States, and vice versa, do not apply. For definition of the terms ''United States'' and ''Guam'' (see section 7701(a)(9) of the Code and section 2 of the Organic Act of Guam (48 U.S.C. 1421).

(d) *Information return.* Each individual described in paragraph (a)(2) of this section for a taxable year who is required by paragraph (b)(1) of §1.935–1 of this chapter to file his return of income for such year with the United

States shall timely file a properly executed Form 5074 (Allocation of Individual Income Tax to Guam) by attaching such form to his income tax return. Each individual described in paragraph (a)(2) of this section for a taxable year who is required by paragraph (b)(1) of § 1.935–1 of this chapter to file his return of income for such year with Guam shall timely file such information as may be required by the Commissioner of Revenue and Taxation with respect to his income derived from sources within the United States. See section 6688 and § 301.6688–1 for the penalty for failure to comply with this paragraph.

(e) *Military personnel in Guam.* The Commissioner of Internal Revenue shall arrange to pay to Guam the amount of the taxes deducted and withheld by the United States under section 3402 from wages paid to members of the Armed Forces who are stationed in Guam but who have no income tax liability to Guam with respect to such wages by reason of section 514 of the Soldiers' and Sailors' Civil Relief Act of 1940 (50 App. U.S.C. 574). Section 514 of that Act provides in effect that for purposes of the taxation of income by Guam a person shall not be deemed to have lost a residence or domicile in the United States solely by reason of being absent therefrom in compliance with military or naval orders and the compensation for military or naval service of such a person who is not a resident of, or domiciled in, Guam shall not be deemed income for services performed within, or from sources within, Guam. Any amount paid to Guam under this paragraph in respect of a member of the Armed Forces described in paragraph (a)(2) of this section shall be taken into account in determining the amount required to be covered into the treasury of Guam under paragraph (b)(1)(ii) of this section. For purposes of this paragraph, the term ''Armed Forces of the United States'' has the meaning provided by § 301.7701–8 of this chapter. This paragraph does not apply to wages for services performed in Guam by members of the Armed Forces of the United States which are not compensation for military or naval service. In determining the amount of tax to be covered into the treasury of Guam under this paragraph with respect to remuneration for services performed in Guam by members of the Armed Forces of the United States, the special procedure agreed upon with the Department of Defense in 1951 shall not apply to remuneration paid after December 31, 1974. Under that procedure the tax withheld under section 3402 upon such remuneration for services performed in Guam during April and October of each year was to be projected for the appropriate six-month period of which the base month is a part, thereby arriving at an estimated figure for semiannual withholding tax to be covered over.

(f) *Transfers of funds.* The transfers of funds between the United States and Guam required to effectuate the provisions of this section shall be made when convenient for the two governments, but not less frequently than once in each calendar year. In complying with paragraph (b) of this section, only net balances will be transferred between the two governments. Further, amounts transferred pursuant to paragraph (b) of this section may be determined on the basis of estimates rather than the actual amounts derived from information furnished by taxpayers, except that the net collections for 1973 and every third calendar year thereafter are to be transferred on the basis of the information furnished by taxpayers pursuant to paragraph (d) of this section. In order to facilitate the transfer of funds pursuant to this section, the Commissioner of Internal Revenue and the Commissioner of Revenue and Taxation of Guam shall exchange such information, including copies of income tax returns, as will ensure that the provisions of section 7654 and this section are being properly implemented.

[T.D. 7385, 40 FR 50265, Oct. 29, 1975]

DEFINITIONS

§ 301.7701–1 Classification of organizations for federal tax purposes.

(a) *Organizations for federal tax purposes*—(1) *In general.* The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for

federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

(2) *Certain joint undertakings give rise to entities for federal tax purposes.* A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co- owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

(3) *Certain local law entities not recognized.* An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State. Similarly, tribes incorporated under section 17 of the Indian Reorganization Act of 1934, as amended, 25 U.S.C. 477, or under section 3 of the Oklahoma Indian Welfare Act, as amended, 25 U.S.C. 503, are not recognized as separate entities for federal tax purposes.

(4) *Single owner organizations.* Under §§ 301.7701–2 and 301.7701–3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.

(b) *Classification of organizations.* The classification of organizations that are recognized as separate entities is determined under §§ 301.7701–2, 301.7701–3, and 301.7701–4 unless a provision of the Internal Revenue Code (such as section 860A addressing Real Estate Mortgage Investment Conduits (REMICs)) provides for special treatment of that organization. For the classification of organizations as trusts, see § 301.7701–4. That section provides that trusts generally do not have associates or an objective to carry on business for profit. Sections 301.7701–2 and 301.7701–3 provide rules for classifying organizations that are not classified as trusts.

(c) *Qualified cost sharing arrangements.* A qualified cost sharing arrangement that is described in § 1.482–7 of this chapter and any arrangement that is treated by the Commissioner as a qualified cost sharing arrangement under § 1.482–7 of this chapter is not recognized as a separate entity for purposes of the Internal Revenue Code. See § 1.482–7 of this chapter for the proper treatment of qualified cost sharing arrangements.

(d) *Domestic and foreign entities.* For purposes of this section and §§ 301.7701–2 and 301.7701–3, an entity is a domestic entity if it is created or organized in the United States or under the law of the United States or of any State; an entity is foreign if it is not domestic. See sections 7701(a)(4) and (a)(5).

(e) *State.* For purposes of this section and § 301.7701–2, the term *State* includes the District of Columbia.

(f) *Effective date.* The rules of this section are effective as of January 1, 1997.

[T.D. 8697, 61 FR 66588, Dec. 18, 1996]

§ 301.7701–2 Business entities; definitions.

(a) *Business entities.* For purposes of this section and § 301.7701–3, a *business entity* is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701–3) that is not properly classified as a trust under § 301.7701–4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are

treated in the same manner as a sole proprietorship, branch, or division of the owner.

(b) *Corporations.* For federal tax purposes, the term *corporation* means—

(1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association (as determined under § 301.7701–3);

(3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) An insurance company;

(5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 *et seq.*, or a similar federal statute;

(6) A business entity wholly owned by a State or any political subdivision thereof;

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and

(8) *Certain foreign entities*—(i) *In general.* Except as provided in paragraphs (b)(8)(ii) and (d) of this section, the following business entities formed in the following jurisdictions:

American Samoa, Corporation
Argentina, Sociedad Anonima
Australia, Public Limited Company
Austria, Aktiengesellschaft
Barbados, Limited Company
Belgium, Societe Anonyme
Belize, Public Limited Company
Bolivia, Sociedad Anonima
Brazil, Sociedade Anonima
Canada, Corporation and Company
Chile, Sociedad Anonima
People's Republic of China, Gufen Youxian Gongsi
Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu
Colombia, Sociedad Anonima
Costa Rica, Sociedad Anonima
Cyprus, Public Limited Company
Czech Republic, Akciova Spolecnost
Denmark, Aktieselskab
Ecuador, Sociedad Anonima or Compania Anonima
Egypt, Sharikat Al-Mossahamah
El Salvador, Sociedad Anonima
Finland, Julkinen Osakeyhtio/Publikt Aktiebolag
France, Societe Anonyme
Germany, Aktiengesellschaft
Greece, Anonymos Etairia
Guam, Corporation
Guatemala, Sociedad Anonima
Guyana, Public Limited Company
Honduras, Sociedad Anonima
Hong Kong, Public Limited Company
Hungary, Reszvenytarsasag
Iceland, Hlutafelag
India, Public Limited Company
Indonesia, Perseroan Terbuka
Ireland, Public Limited Company
Israel, Public Limited Company
Italy, Societa per Azioni
Jamaica, Public Limited Company
Japan, Kabushiki Kaisha
Kazakstan, Ashyk Aktsionerlik Kogham
Republic of Korea, Chusik Hoesa
Liberia, Corporation
Luxembourg, Societe Anonyme
Malaysia, Berhad
Malta, Public Limited Company
Mexico, Sociedad Anonima
Morocco, Societe Anonyme
Netherlands, Naamloze Vennootschap
New Zealand, Limited Company
Nicaragua, Compania Anonima
Nigeria, Public Limited Company
Northern Mariana Islands, Corporation
Norway, Allment Aksjeselskap
Pakistan, Public Limited Company
Panama, Sociedad Anonima
Paraguay, Sociedad Anonima
Peru, Sociedad Anonima
Philippines, Stock Corporation
Poland, Spolka Akcyjna
Portugal, Sociedade Anonima
Puerto Rico, Corporation
Romania, Societe pe Actiuni
Russia, Otkrytoye Aktsionernoy Obshchestvo
Saudi Arabia, Sharikat Al-Mossahamah
Singapore, Public Limited Company
Slovak Republic, Akciova Spolocnost
South Africa, Public Limited Company
Spain, Sociedad Anonima
Surinam, Naamloze Vennootschap
Sweden, Publika Aktiebolag
Switzerland, Aktiengesellschaft
Thailand, Borisat Chamkad (Mahachon)
Trinidad and Tobago, Limited Company
Tunisia, Societe Anonyme
Turkey, Anonim Sirket
Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu
United Kingdom, Public Limited Company
United States Virgin Islands, Corporation
Uruguay, Sociedad Anonima
Venezuela, Sociedad Anonima or Compania Anonima

(ii) *Clarification of list of corporations in paragraph (b)(8)(i) of this section—(A)*

Exceptions in certain cases. The following entities will not be treated as corporations under paragraph (b)(8)(i) of this section:

(*1*) With regard to Canada, a Nova Scotia Unlimited Liability Company (or any other company or corporation all of whose owners have unlimited liability pursuant to federal or provincial law).

(*2*) With regard to India, a company deemed to be a public limited company solely by operation of section 43A(1) (relating to corporate ownership of the company), section 43A(1A) (relating to annual average turnover), or section 43A(1B) (relating to ownership interests in other companies) of the Companies Act, 1956 (or any combination of these), provided that the organizational documents of such deemed public limited company continue to meet the requirements of section 3(1)(iii) of the Companies Act, 1956.

(*3*) With regard to Malaysia, a Sendirian Berhad.

(B) *Inclusions in certain cases.* With regard to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable).

(iii) *Public companies.* For purposes of paragraph (b)(8)(i) of this section, with regard to Cyprus, Hong Kong, and Jamaica, the term Public Limited Company includes any Limited Company that is not defined as a private company under the corporate laws of those jurisdictions. In all other cases, where the term Public Limited Company is not defined, that term shall include any Limited Company defined as a public company under the corporate laws of the relevant jurisdiction.

(iv) *Limited companies.* For purposes of this paragraph (b)(8), any reference to a Limited Company includes, as the case may be, companies limited by shares and companies limited by guarantee.

(v) *Multilingual countries.* Different linguistic renderings of the name of an entity listed in paragraph (b)(8)(i) of this section shall be disregarded. For example, an entity formed under the laws of Switzerland as a Societe Anonyme will be a corporation and treated in the same manner as an Aktiengesellschaft.

(c) *Other business entities.* For federal tax purposes—

(1) The term *partnership* means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

(2) *Wholly owned entities*—(i) *In general.* A business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

(ii) *Special rule for certain business entities.* If the single owner of a business entity is a bank (as defined in section 581), then the special rules applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity.

(d) *Special rule for certain foreign business entities*—(1) *In general.* Except as provided in paragraph (d)(3) of this section, a foreign business entity described in paragraph (b)(8)(i) of this section will not be treated as a corporation under paragraph (b)(8)(i) of this section if—

(i) The entity was in existence on May 8, 1996;

(ii) The entity's classification was relevant (as defined in § 301.7701–3(d)) on May 8, 1996;

(iii) No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the taxable year including May 8, 1996;

(iv) Any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to May 8, 1996;

(v) A reasonable basis (within the meaning of section 6662) existed on May 8, 1996, for treating the entity as other than a corporation; and

(vi) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of

the entity was under examination (in which case the entity's classification will be determined in the examination).

(2) *Binding contract rule.* If a foreign business entity described in paragraph (b)(8)(i) of this section is formed after May 8, 1996, pursuant to a written binding contract (including an accepted bid to develop a project) in effect on May 8, 1996, and all times thereafter, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, paragraph (d)(1) of this section will be applied to that entity by substituting the date of the entity's formation for May 8, 1996.

(3) *Termination of grandfather status*—(i) *In general.* An entity that is not treated as a corporation under paragraph (b)(8)(i) of this section by reason of paragraph (d)(1) or (d)(2) of this section will be treated permanently as a corporation under paragraph (b)(8)(i) of this section from the earliest of:

(A) The effective date of an election to be treated as an association under § 301.7701–3;

(B) A termination of the partnership under section 708(b)(1)(B) (regarding sale or exchange of 50 percent or more of the total interest in an entity's capital or profits within a twelve month period); or

(C) A division of the partnership under section 708(b)(2)(B).

(ii) *Special rule for certain entities.* For purposes of paragraph (d)(2) of this section, paragraph (d)(3)(i)(B) of this section shall not apply if the sale or exchange of interests in the entity is to a related person (within the meaning of sections 267(b) and 707(b)) and occurs no later than twelve months after the date of the formation of the entity.

(e) *Effective date.* Except as otherwise provided in this paragraph (e), the rules of this section apply as of January 1, 1997. The reference to the Finnish, Maltese, and Norwegian entities in paragraph (b)(8)(i) of this section is applicable on November 29, 1999. The reference to the Trinidadian entity in paragraph (b)(8)(i) of this section applies to entities formed on or after November 29, 1999. Any Maltese or Norwegian entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on November 29, 1999 may elect by February 14, 2000 to be classified for federal tax purposes as an entity other than a corporation retroactive to any period from and including January 1, 1997. Any Finnish entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on November 29, 1999 may elect by February 14, 2000 to be classified for federal tax purposes as an entity other than a corporation retroactive to any period from and including September 1, 1997.

[T.D. 8697, 61 FR 66589, Dec. 18, 1996, as amended by T.D. 8844, 64 FR 66583, Nov. 29, 1999]

§ 301.7701–3 Classification of certain business entities.

(a) *In general.* A business entity that is not classified as a corporation under § 301.7701–2(b) (1), (3), (4), (5), (6), (7), or (8) (an *eligible entity*) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701–2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections. Paragraph (d) of this section provides

special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods.

(b) *Classification of eligible entities that do not file an election*—(1) *Domestic eligible entities.* Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is—

(i) A partnership if it has two or more members; or

(ii) Disregarded as an entity separate from its owner if it has a single owner.

(2) *Foreign eligible entities*—(i) *In general.* Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a foreign eligible entity is—

(A) A partnership if it has two or more members and at least one member does not have limited liability;

(B) An association if all members have limited liability; or

(C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

(ii) *Definition of limited liability.* For purposes of paragraph (b)(2)(i) of this section, a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

(3) *Existing eligible entities*—(i) *In general.* Unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under §§ 301.7701–1 through 301.7701–3 as in effect on the date prior to the effective date of this section; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this paragraph (b)(3)(i). For special rules regarding the classification of such entities for periods prior to the effective date of this section, see paragraph (f)(2) of this section.

(ii) *Special rules.* For purposes of paragraph (b)(3)(i) of this section, a foreign eligible entity is treated as being in existence prior to the effective date of this section only if the entity's classification was relevant (as defined in paragraph (d) of this section) at any time during the sixty months prior to the effective date of this section. If an entity claimed different classifications prior to the effective date of this section, the entity's classification for purposes of paragraph (b)(3)(i) of this section is the last classification claimed by the entity. If a foreign eligible entity's classification is relevant prior to the effective date of this section, but no federal tax or information return is filed or the federal tax or information return does not indicate the classification of the entity, the entity's classification for the period prior to the effective date of this section is determined under the regulations in effect on the date prior to the effective date of this section.

(c) *Elections*—(1) *Time and place for filing*—(i) *In general.* Except as provided in paragraphs (c)(1) (iv) and (v) of this section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See § 301.6109–1 for rules on

applying for and displaying Employer Identification Numbers.

(ii) *Further notification of elections.* An eligible entity required to file a federal tax or information return for the taxable year for which an election is made under paragraph (c)(1)(i) of this section must attach a copy of its Form 8832 to its federal tax or information return for that year. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the federal income tax or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the Form 8832 to its return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a Form 8832 to its return as directed in this section, an otherwise valid election under paragraph (c)(1)(i) of this section will not be invalidated, but the non-filing party may be subject to penalties, including any applicable penalties if the federal tax or information returns are inconsistent with the entity's election under paragraph (c)(1)(i) of this section.

(iii) *Effective date of election.* An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

(iv) *Limitation.* If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election. An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv).

(v) *Deemed elections*—(A) *Exempt organizations.* An eligible entity that has been determined to be, or claims to be, exempt from taxation under section 501(a) is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made under paragraph (c)(1)(i) of this section after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

(B) *Real estate investment trusts.* An eligible entity that files an election under section 856(c)(1) to be treated as a real estate investment trust is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day the entity is treated as a real estate investment trust.

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

Example 1. On July 1, 1998, X, a domestic corporation, purchases a 10% interest in Y, an eligible entity formed under Country A law in 1990. The entity's classification was not relevant to any person for federal tax or information purposes prior to X's acquisition of an interest in Y. Thus, Y is not considered to be in existence on the effective date of this section for purposes of paragraph (b)(3) of this section. Under the applicable Country A statute, all members of Y have limited liability as defined in paragraph (b)(2)(ii) of this section. Accordingly, Y is classified as an association under paragraph (b)(2)(i)(B) of this section unless it elects under this paragraph (c) to be classified as a partnership. To be classified as a partnership as of July 1, 1998, Y must file a Form 8832 by September 14, 1998. See paragraph (c)(1)(i) of this section. Because an election cannot be effective more than 75 days prior to the date on which it is filed, if Y files its Form 8832 after September 14, 1998, it will be classified as an association from July 1, 1998, until the effective date of the election. In that case, it could not change its classification by election under this paragraph (c) during the sixty months succeeding the effective date of the election.

Example 2. (i) Z is an eligible entity formed under Country B law and is in existence on the effective date of this section within the meaning of paragraph (b)(3) of this section. Prior to the effective date of this section, Z claimed to be classified as an association. Unless Z files an election under this paragraph (c), it will continue to be classified as an association under paragraph (b)(3) of this section.

(ii) Z files a Form 8832 pursuant to this paragraph (c) to be classified as a partnership, effective as of the effective date of this section. Z can file an election to be classified as an association at any time thereafter, but then would not be permitted to change its classification by election during the sixty months succeeding the effective date of that subsequent election.

(2) *Authorized signatures*—(i) *In general.* An election made under paragraph (c)(1)(i) of this section must be signed by—

(A) Each member of the electing entity who is an owner at the time the election is filed; or

(B) Any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

(ii) *Retroactive elections.* For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is to be effective for any period prior to the time that it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election.

(iii) *Changes in classification.* For paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is made to change the classification of an entity, each person who was an owner on the date that any transactions under paragraph (g) of this section are deemed to occur, and who is not an owner at the time the election is filed, must also sign the election. This paragraph (c)(2)(iii) applies to elections filed on or after November 29, 1999.

(d) *Special rules for foreign eligible entities*—(1) *Definition of relevance.* For purposes of this section, a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. For example, a foreign entity's classification would be relevant if U.S. income was paid to the entity and the determination by the withholding agent of the amount to be withheld under chapter 3 of the Internal Revenue Code (if any) would vary depending upon whether the entity is classified as a partnership or as an association. Thus, the classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared. The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined. Thus, the classification of a foreign entity is relevant, for example, on the date that an interest in the entity is acquired which will require a U.S. person to file an information return on Form 5471.

(2) *Special rule when classification is no longer relevant.* If the classification of a

foreign eligible entity which was previously relevant for federal tax purposes ceases to be relevant for sixty consecutive months, the entity's classification will initially be determined under the default classification when the classification of the foreign eligible entity again becomes relevant. The date that the classification of a foreign entity ceases to be relevant is the date an event occurs that causes the classification to no longer be relevant, or, if no event occurs in a taxable year that causes the classification to be relevant, then the date is the first day of that taxable year.

(e) *Coordination with section 708(b).* Except as provided in §301.7701–2(d)(3) (regarding termination of grandfather status for certain foreign business entities), an entity resulting from a transaction described in section 708(b)(1)(B) (partnership termination due to sales or exchanges) or section 708(b)(2)(B) (partnership division) is a partnership.

(f) *Changes in number of members of an entity*—(1) *Associations.* The classification of an eligible entity as an association is not affected by any change in the number of members of the entity.

(2) *Partnerships and single member entities.* An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member. A single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member. If an elective classification change under paragraph (c) of this section is effective at the same time as a membership change described in this paragraph (f)(2), the deemed transactions in paragraph (g) of this section resulting from the elective change preempt the transactions that would result from the change in membership.

(3) *Effect on sixty month limitation.* A change in the number of members of an entity does not result in the creation of a new entity for purposes of the sixty month limitation on elections under paragraph (c)(1)(iv) of this section.

(4) *Examples.* The following examples illustrate the application of this paragraph (f):

Example 1. *A*, a U.S. person, owns a domestic eligible entity that is disregarded as an entity separate from its owner. On January 1, 1998, *B*, a U.S. person, buys a 50 percent interest in the entity from *A*. Under this paragraph (f), the entity is classified as a partnership when *B* acquires an interest in the entity. However, *A* and *B* elect to have the entity classified as an association effective on January 1, 1998. Thus, *B* is treated as buying shares of stock on January 1, 1998. (Under paragraph (c)(1)(iv) of this section, this election is treated as a change in classification so that the entity generally cannot change its classification by election again during the sixty months succeeding the effective date of the election.) Under paragraph (g)(1) of this section, *A* is treated as contributing the assets and liabilities of the entity to the newly formed association immediately before the close of December 31, 1997. Because *A* does not retain control of the association as required by section 351, *A*'s contribution will be a taxable event. Therefore, under section 1012, the association will take a fair market value basis in the assets contributed by *A*, and *A* will have a fair market value basis in the stock received. *A* will have no additional gain upon the sale of stock to *B*, and *B* will have a cost basis in the stock purchased from *A*.

Example 2. (i) On April 1, 1998, *A* and *B*, U.S. persons, form *X*, a foreign eligible entity. *X* is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and *X* does not make an election to be classified as a partnership. *A* subsequently purchases all of *B*'s interest in *X*.

(ii) Under paragraph (f)(1) of this section, *X* continues to be classified as an association. *X*, however, can subsequently elect to be disregarded as an entity separate from *A*. The sixty month limitation of paragraph (c)(1)(iv) of this section does not prevent *X* from making an election because *X* has not made a prior election under paragraph (c)(1)(i) of this section.

Example 3. (i) On April 1, 1998, *A* and *B*, U.S. persons, form *X*, a foreign eligible entity. *X* is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and *X* does not make an election to be classified as a partnership. On January 1, 1999, *X* elects to be classified as a partnership effective on that date. Under the sixty month limitation of paragraph (c)(1)(iv) of this section, *X* cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after the effective date of the election to be classified as a partnership).

(ii) On June 1, 2000, *A* purchases all of *B*'s interest in *X*. After *A*'s purchase of *B*'s interest, *X* can no longer be classified as a partnership because *X* has only one member. Under paragraph (f)(2) of this section, *X* is disregarded as an entity separate from *A* when *A* becomes the only member of *X*. *X*,

however, is not treated as a new entity for purposes of paragraph (c)(1)(iv) of this section. As a result, the sixty month limitation of paragraph (c)(1)(iv) of this section continues to apply to *X*, and *X* cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after January 1, 1999, the effective date of the election by *X* to be classified as a partnership).

(5) *Effective date.* This paragraph (f) applies as of November 29, 1999.

(g) *Elective changes in classification*—(1) *Deemed treatment of elective change*—(i) *Partnership to association.* If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

(ii) *Association to partnership.* If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

(iii) *Association to disregarded entity.* If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

(iv) *Disregarded entity to an association.* If an eligible entity that is disregarded as an entity separate from its owner elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.

(2) *Effect of elective changes.* The tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of this section is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(3) *Timing of election*—(i) *In general.* An election under paragraph (c)(1)(i) of this section that changes the classification of an eligible entity for federal tax purposes is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur under this paragraph (g) as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification of an entity from an association to a partnership effective on January 1, the deemed transactions specified in paragraph (g)(1)(ii) of this section (including the liquidation of the association) are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

(ii) *Coordination with section 338 election.* A purchasing corporation that makes a qualified stock purchase of an eligible entity taxed as a corporation may make an election under section 338 regarding the acquisition if it satisfies the requirements for the election, and may also make an election to change the classification of the target corporation. If a taxpayer makes an election under section 338 regarding its acquisition of another entity taxable as a corporation and makes an election under paragraph (c) of this section for the acquired corporation (effective at the earliest possible date as provided by paragraph (c)(1)(iii) of this section), the transactions under paragraph (g) of this section are deemed to occur immediately after the deemed asset purchase by the new target corporation under section 338.

(iii) *Application to successive elections in tiered situations.* When elections under paragraph (c)(1)(i) of this section

for a series of tiered entities are effective on the same date, the eligible entities may specify the order of the elections on Form 8832. If no order is specified for the elections, any transactions that are deemed to occur in this paragraph (g) as a result of the classification change will be treated as occurring first for the highest tier entity's classification change, then for the next highest tier entity's classification change, and so forth down the chain of entities until all the transactions under this paragraph (g) have occurred. For example, Parent, a corporation, wholly owns all of the interest of an eligible entity classified as an association (S1), which wholly owns another eligible entity classified as an association (S2), which wholly owns another eligible entity classified as an association (S3). Elections under paragraph (c)(1)(i) of this section are filed to classify S1, S2, and S3 each as disregarded as an entity separate from its owner effective on the same day. If no order is specified for the elections, the following transactions are deemed to occur under this paragraph (g) as a result of the elections, with each successive transaction occurring on the same day immediately after the preceding transaction S1 is treated as liquidating into Parent, then S2 is treated as liquidating into Parent, and finally S3 is treated as liquidating into Parent.

(4) *Effective date.* This paragraph (g) applies to elections that are filed on or after November 29, 1999. Taxpayers may apply this paragraph (g) retroactively to elections filed before November 29, 1999 if all taxpayers affected by the deemed transactions file consistently with this paragraph (g).

(h) *Effective date*—(1) *In general.* Except as otherwise provided in this section, the rules of this section are applicable as of January 1, 1997.

(2) *Prior treatment of existing entities.* In the case of a business entity that is not described in § 301.7701–2(b) (1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification(s) will be respected for all periods prior to January 1, 1997, if—

(i) The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;

(ii) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and

(iii) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

[T.D. 8697, 61 FR 66590, Dec. 18, 1996; 62 FR 11769, Mar. 13, 1997, as amended by T.D. 8767, 63 FR 14619, Mar. 26, 1998; T.D. 8827, 64 FR 37678, July 13, 1999; 64 FR 58782, Nov. 1, 1999; T.D. 8844, 64 FR 66583, Nov. 29, 1999]

§ 301.7701–4 Trusts.

(a) *Ordinary trusts.* In general, the term ''trust'' as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

(b) *Business trusts.* There are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of

beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code. However, the fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership. The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under §301.7701–2.

(c) *Certain investment trusts*—(1) An ''investment'' trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. *See Commissioner v. North American Bond Trust*, 122 F. 2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders. An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under §301.7701–2; however, an investment trust with multiple classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

(2) The provisions of paragraph (c)(1) of this section may be illustated by the following examples:

Example 1. A corporation purchases a portfolio of residential mortgages and transfers the mortgages to a bank under a trust agreement. At the same time, the bank as trustee delivers to the corporation certificates evidencing rights to payments from the pooled mortgages; the corporation sells the certificates to the public. The trustee holds legal title to the mortgages in the pool for the benefit of the certificate holders but has no power to reinvest proceeds attributable to the mortgages in the pool or to vary investments in the pool in any other manner. There are two classes of certificates. Holders of class A certificates are entitled to all payments of mortgage principal, both scheduled and prepaid, until their certificates are retired; holders of class B certificates receive payments of principal only after all class A certificates have been retired. The different rights of the class A and class B certificates serve to shift to the holders of the class A certificates, in addition to the earlier scheduled payments of principal, the risk that mortgages in the pool will be prepaid so that the holders of the class B certificates will have ''call protection'' (freedom from premature termination of their interests on account of prepayments). The trust thus serves to create investment interests with respect to the mortgages held by the trust that differ significantly from direct investment in the mortgages. As a consequence, the existence of multiple classes of trust ownership is not incidental to any purpose of the trust to facilitate direct investment, and, accordingly, the trust is classified as a business entity under §301.7701–2.

Example 2. Corporation M is the originator of a portfolio of residential mortgages and transfers the mortgages to a bank under a trust agreement. At the same time, the bank as trustee delivers to M certificates evidencing rights to payments from the pooled mortgages. The trustee holds legal title to the mortgages in the pool for the benefit of the certificate holders, but has no power to reinvest proceeds attributable to the mortgages in the pool or to vary investments in the pool in any other manner. There are two classes of certificates. Holders of class C certificates are entitled to receive 90 percent of the payments of principal and interest on the mortgages; class D certificate holders are entitled to receive the other ten percent. The two classes of certificates are identical except that, in the event of a default on the underlying mortgages, the payment rights of class D certificate holders are subordinated to the rights of class C certificate holders. M sells the class C certificates to investors and retains the class D certificates. The trust has multiple classes of ownership interests, given the greater security provided to holders of class C certificates. The interests of certificate holders, however, are substantially equivalent to undivided interests in

the pool of mortgages, coupled with a limited recourse guarantee running from M to the holders of class C certificates. In such circumstances, the existence of multiple classes of ownership interests is incidental to the trust's purpose of facilitating direct investment in the assets of the trust. Accordingly, the trust is classified as a trust.

Example 3. A promoter forms a trust in which shareholders of a publicly traded corporation can deposit their stock. For each share of stock deposited with the trust, the participant receives two certificates that are initially attached, but may be separated and traded independently of each other. One certificate represents the right to dividends and the value of the underlying stock up to a specified amount; the other certificate represents the right to appreciation in the stock's value above the specified amount. The separate certificates represent two different classes of ownership interest in the trust, which effectively separate dividend rights on the stock held by the trust from a portion of the right to appreciation in the value of such stock. The multiple classes of ownership interests are designed to permit investors, by transferring one of the certificates and retaining the other, to fulfill their varying investment objectives of seeking primarily either dividend income or capital appreciation from the stock held by the trust. Given that the trust serves to create investment interests with respect to the stock held by the trust that differ significantly from direct investment in such stock, the trust is not formed to facilitate direct investment in the assets of the trust. Accordingly, the trust is classified as a business entity under § 301.7701–2.

Example 4. Corporation N purchases a portfolio of bonds and transfers the bonds to a bank under a trust agreement. At the same time, the trustee delivers to N certificates evidencing interests in the bonds. These certificates are sold to public investors. Each certificate represents the right to receive a particular payment with respect to a specific bond. Under section 1286, stripped coupons and stripped bonds are treated as separate bonds for federal income tax purposes. Although the interest of each certificate holder is different from that of each other certificate holder, and the trust thus has multiple classes of ownership, the multiple classes simply provide each certificate holder with a direct interest in what is treated under section 1286 as a separate bond. Given the similarity of the interests acquired by the certificate holders to the interests that could be acquired by direct investment, the multiple classes of trust interests merely facilitate direct investment in the assets held by the trust. Accordingly, the trust is classified as a trust.

(d) *Liquidating trusts.* Certain organizations which are commonly known as liquidating trusts are treated as trusts for purposes of the Internal Revenue Code. An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for purposes of the Internal Revenue Code because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust. Bondholders' protective committees, voting trusts, and other agencies formed to protect the interests of security holders during insolvency, bankruptcy, or corporate reorganization proceedings are analogous to liquidating trusts but if subsequently utilized to further the control or profitable operation of a going business on a permanent continuing basis, they will lose their classification as trusts for purposes of the Internal Revenue Code.

(e) *Environmental remediation trusts.* (1) An environmental remediation trust is considered a trust for purposes of the Internal Revenue Code. For purposes of this paragraph (e), an organization is an environmental remediation trust if the organization is organized under state law as a trust; the primary purpose of the trust is collecting and disbursing amounts for environmental remediation of an existing waste site to resolve, satisfy, mitigate, address, or prevent the liability or potential liability of persons imposed by federal, state, or local environmental laws; all contributors to the trust have (at the time of contribution and thereafter)

actual or potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site; and the trust is not a qualified settlement fund within the meaning of §1.468B–1(a) of this chapter. An environmental remediation trust is classified as a trust because its primary purpose is environmental remediation of an existing waste site and not the carrying on of a profit-making business that normally would be conducted through business organizations classified as corporations or partnerships. However, if the remedial purpose is altered or becomes so obscured by business or investment activities that the declared remedial purpose is no longer controlling, the organization will no longer be classified as a trust. For purposes of this paragraph (e), environmental remediation includes the costs of assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, and collecting amounts from persons liable or potentially liable for the costs of these activities. For purposes of this paragraph (e), persons have potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for remediation of the existing waste site if there is authority under a federal, state, or local law that requires or could reasonably be expected to require such persons to satisfy all or a portion of the costs of the environmental remediation.

(2) Each contributor (grantor) to the trust is treated as the owner of the portion of the trust contributed by that grantor under rules provided in section 677 and §1.677(a)–1(d) of this chapter. Section 677 and §1.677(a)–1(d) of this chapter provide rules regarding the treatment of a grantor as the owner of a portion of a trust applied in discharge of the grantor's legal obligation. Items of income, deduction, and credit attributable to an environmental remediation trust are not reported by the trust on Form 1041, but are shown on a separate statement to be attached to that form. See §1.671–4(a) of this chapter. The trustee must also furnish to each grantor a statement that shows all items of income, deduction, and credit of the trust for the grantor's taxable year attributable to the portion of the trust treated as owned by the grantor. The statement must provide the grantor with the information necessary to take the items into account in computing the grantor's taxable income, including information necessary to determine the federal tax treatment of the items (for example, whether an item is a deductible expense under section 162(a) or a capital expenditure under section 263(a)) and how the item should be taken into account under the economic performance rules of section 461(h) and the regulations thereunder. See §1.461–4 of this chapter for rules relating to economic performance.

(3) All amounts contributed to an environmental remediation trust by a grantor (cash-out grantor) who, pursuant to an agreement with the other grantors, contributes a fixed amount to the trust and is relieved by the other grantors of any further obligation to make contributions to the trust, but remains liable or potentially liable under the applicable environmental laws, will be considered amounts contributed for remediation. An environmental remediation trust agreement may direct the trustee to expend amounts contributed by a cash-out grantor (and the earnings thereon) before expending amounts contributed by other grantors (and the earnings thereon). A cash-out grantor will cease to be treated as an owner of a portion of the trust when the grantor's portion is fully expended by the trust.

(4) The provisions of this paragraph (e) may be illustrated by the following example:

Example. (a) *X*, *Y*, and *Z* are calendar year corporations that are liable for the remediation of an existing waste site under applicable federal environmental laws. On June 1, 1996, pursuant to an agreement with the governing federal agency, *X*, *Y*, and *Z* create an environmental remediation trust within the meaning of paragraph (e)(1) of this section to collect funds contributed to the trust by *X*, *Y*, and *Z* and to carry out the remediation of the waste site to the satisfaction of the federal agency. *X*, *Y*, and *Z* are jointly and severally liable under the federal environmental laws for the remediation of the waste site,

and the federal agency will not release *X*, *Y*, or *Z* from liability until the waste site is remediated to the satisfaction of the agency.

(b) The estimated cost of the remediation is $20,000,000. *X*, *Y*, and *Z* agree that, if *Z* contributes $1,000,000 to the trust, *Z* will not be required to make any additional contributions to the trust, and *X* and *Y* will complete the remediation of the waste site and make additional contributions if necessary.

(c) On June 1, 1996, *X*, *Y*, and *Z* each contribute $1,000,000 to the trust. The trust agreement directs the trustee to spend *Z*'s contributions to the trust and the income allocable to *Z*'s portion before spending *X*'s and *Y*'s portions. On November 30, 1996, the trustee disburses $2,000,000 for remediation work performed from June 1, 1996, through September 30, 1996. For the six-month period ending November 30, 1996, the interest earned on the funds in the trust was $75,000, which is allocated in equal shares of $25,000 to *X*'s, *Y*'s, and *Z*'s portions of the trust.

(d) *Z* made no further contributions to the trust. Pursuant to the trust agreement, the trustee expended *Z*'s portion of the trust before expending *X*'s and *Y*'s portion. Therefore, *Z*'s share of the remediation disbursement made in 1996 is $1,025,000 ($1,000,000 contribution by *Z* plus $25,000 of interest allocated to *Z*'s portion of the trust). *Z* takes the $1,025,000 disbursement into account under the appropriate federal tax accounting rules. In addition, *X*'s share of the remediation disbursement made in 1996 is $487,500, and *Y*'s share of the remediation disbursement made in 1996 is $487,500. *X* and *Y* take their respective shares of the disbursement into account under the appropriate federal tax accounting rules.

(e) The trustee made no further remediation disbursements in 1996, and *X* and *Y* made no further contributions in 1996. From December 1, 1996, to December 31, 1996, the interest earned on the funds remaining in the trust was $5,000, which is allocated $2,500 to *X*'s portion and $2,500 to *Y*'s portion. Accordingly, for 1996, *X* and *Y* each had interest income of $27,500 from the trust and *Z* had interest income of $25,000 from the trust.

(5) This paragraph (e) is applicable to trusts meeting the requirements of paragraph (e)(1) of this section that are formed on or after May 1, 1996. This paragraph (e) may be relied on by trusts formed before May 1, 1996, if the trust has at all times met all requirements of this paragraph (e) and the grantors have reported items of ,income and deduction consistent with this paragraph (e) on original or amended returns. For trusts formed before May 1, 1996, that are not described in the preceding sentence, the Commissioner may permit by letter ruling, in appropriate circumstances, this paragraph (e) to be applied subject to appropriate terms and conditions.

(f) *Effective date.* The rules of this section generally apply to taxable years beginning after December 31, 1960. Paragraph (e)(5) of this section contains rules of applicability for paragraph (e) of this section. In addition, the last sentences of paragraphs (b), (c)(1), and (c)(2) *Example 1* and *Example 3* of this section are effective as of January 1, 1997.

[32 FR 15241, Nov. 3, 1967, as amended by T.D. 8080, 51 FR 9952, Mar. 24, 1986; T.D. 8668, 61 FR 19191, May 1, 1996; T.D. 8697, 61 FR 66592, Dec. 18, 1996]

§ 301.7701–5 Domestic, foreign, resident, and nonresident persons.

A domestic corporation is one organized or created in the United States, including only the States (and during the periods when not States, the Territories of Alaska and Hawaii), and the District of Columbia, or under the law of the United States or of any State or Territory. A foreign corporation is one which is not domestic. A domestic corporation is a resident corporation even though it does no business and owns no property in the United States. A foreign corporation engaged in trade or business within the United States is referred to in the regulations in this chapter as a resident foreign corporation, and a foreign corporation not engaged in trade or business within the United States, as a nonresident foreign corporation. A partnership engaged in trade or business within the United States is referred to in the regulations in this chapter as a resident partnership, and a partnership not engaged in trade or business within the United States, as a nonresident partnership. Whether a partnership is to be regarded as resident or nonresident is not determined by the nationality or residence of its members or by the place in which it was created or organized.

[32 FR 15231, Nov. 3, 1967, as amended by T.D. 8813, 64 FR 4970, Feb. 2, 1999]

§ 301.7701–6 Definitions; person, fiduciary.

(a) *Person.* The term *person* includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group. The term also includes a guardian, committee, trustee, executor, administrator, trustee in bankruptcy, receiver, assignee for the benefit of creditors, conservator, or any person acting in a fiduciary capacity.

(b) *Fiduciary*—(1) *In general.* Fiduciary is a term that applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another, as in the case of receivers. A committee or guardian of the property of an incompetent person is a fiduciary.

(2) *Fiduciary distinguished from agent.* There may be a fiduciary relationship between an agent and a principal, but the word agent does not denote a fiduciary. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the Internal Revenue Code. In cases when no legal trust has been created in the estate controlled by the agent and attorney, the liability to make a return rests with the principal.

(c) *Effective date.* The rules of this section are effective as of January 1, 1997.

[T.D. 8697, 61 FR 66593, Dec. 18, 1996]

§ 301.7701–7 Trusts—domestic and foreign.

(a) *In general.* (1) A trust is a United States person if—

(i) A court within the United States is able to exercise primary supervision over the administration of the trust (court test); and

(ii) One or more United States persons have the authority to control all substantial decisions of the trust (control test).

(2) A trust is a United States person for purposes of the Internal Revenue Code (Code) on any day that the trust meets both the court test and the control test. For purposes of the regulations in this chapter, the term *domestic trust* means a trust that is a United States person. The term *foreign trust* means any trust other than a domestic trust.

(3) Except as otherwise provided in part I, subchapter J, chapter 1 of the Code, the taxable income of a foreign trust is computed in the same manner as the taxable income of a nonresident alien individual who is not present in the United States at any time. Section 641(b). Section 7701(b) is not applicable to trusts because it only applies to individuals. In addition, a foreign trust is not considered to be present in the United States at any time for purposes of section 871(a)(2), which deals with capital gains of nonresident aliens present in the United States for 183 days or more.

(b) *Applicable law.* The terms of the trust instrument and applicable law must be applied to determine whether the court test and the control test are met.

(c) *The court test*—(1) *Safe harbor.* A trust satisfies the court test if—

(i) The trust instrument does not direct that the trust be administered outside of the United States;

(ii) The trust in fact is administered exclusively in the United States; and

(iii) The trust is not subject to an automatic migration provision described in paragraph (c)(4)(ii) of this section.

(2) *Example.* The following example illustrates the rule of paragraph (c)(1) of this section:

Example. A creates a trust for the equal benefit of *A*'s two children, *B* and *C*. The trust instrument provides that *DC*, a State *Y* corporation, is the trustee of the trust. State *Y* is a state within the United States. *DC* administers the trust exclusively in State *Y* and the trust instrument is silent as to where the trust is to be administered. The trust is not subject to an automatic migration provision described in paragraph (c)(4)(ii) of this section. The trust satisfies

the safe harbor of paragraph (c)(1) of this section and the court test.

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

(i) *Court.* The term *court* includes any federal, state, or local court.

(ii) *The United States.* The term *the United States* is used in this section in a geographical sense. Thus, for purposes of the court test, the United States includes only the States and the District of Columbia. See section 7701(a)(9). Accordingly, a court within a territory or possession of the United States or within a foreign country is not a court within the United States.

(iii) *Is able to exercise.* The term *is able to exercise* means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust.

(iv) *Primary supervision.* The term *primary supervision* means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. A court may have primary supervision under this paragraph (c)(3)(iv) notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.

(v) *Administration.* The term *administration* of the trust means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.

(4) *Situations that cause a trust to satisfy or fail to satisfy the court test.* (i) Except as provided in paragraph (c)(4)(ii) of this section, paragraphs (c)(4)(i) (A) through (D) of this section set forth some specific situations in which a trust satisfies the court test. The four situations described are not intended to be an exclusive list.

(A) *Uniform Probate Code.* A trust meets the court test if the trust is registered by an authorized fiduciary or fiduciaries of the trust in a court within the United States pursuant to a state statute that has provisions substantially similar to Article VII, *Trust Administration*, of the Uniform Probate Code, 8 Uniform Laws Annotated 1 (West Supp. 1998), available from the National Conference of Commissioners on Uniform State Laws, 676 North St. Clair Street, Suite 1700, Chicago, Illinois 60611.

(B) *Testamentary trust.* In the case of a trust created pursuant to the terms of a will probated within the United States (other than an ancillary probate), if all fiduciaries of the trust have been qualified as trustees of the trust by a court within the United States, the trust meets the court test.

(C) *Inter vivos trust.* In the case of a trust other than a testamentary trust, if the fiduciaries and/or beneficiaries take steps with a court within the United States that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the court test.

(D) *A United States court and a foreign court are able to exercise primary supervision over the administration of the trust.* If both a United States court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust meets the court test.

(ii) *Automatic migration provisions.* Notwithstanding any other provision in this section, a court within the United States is not considered to have primary supervision over the administration of the trust if the trust instrument provides that a United States court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the United States. However, this paragraph (c)(4)(ii) will not apply if the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States.

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

Example 1. A, a United States citizen, creates a trust for the equal benefit of *A*'s two children, both of whom are United States citizens. The trust instrument provides that *DC*, a domestic corporation, is to act as trustee of the trust and that the trust is to

be administered in Country *X*, a foreign country. *DC* maintains a branch office in Country *X* with personnel authorized to act as trustees in Country *X*. The trust instrument provides that the law of State *Y*, a state within the United States, is to govern the interpretation of the trust. Under the law of Country *X*, a court within Country *X* is able to exercise primary supervision over the administration of the trust. Pursuant to the trust instrument, the Country *X* court applies the law of State *Y* to the trust. Under the terms of the trust instrument the trust is administered in Country *X*. No court within the United States is able to exercise primary supervision over the administration of the trust. The trust fails to satisfy the court test and therefore is a foreign trust.

Example 2. A, a United States citizen, creates a trust for *A*'s own benefit and the benefit of *A*'s spouse, *B*, a United States citizen. The trust instrument provides that the trust is to be administered in State *Y*, a state within the United States, by *DC*, a State *Y* corporation. The trust instrument further provides that in the event that a creditor sues the trustee in a United States court, the trust will automatically migrate from State *Y* to Country *Z*, a foreign country, so that no United States court will have jurisdiction over the trust. A court within the United States is not able to exercise primary supervision over the administration of the trust because the United States court's jurisdiction over the administration of the trust is automatically terminated in the event the court attempts to assert jurisdiction. Therefore, the trust fails to satisfy the court test from the time of its creation and is a foreign trust.

(d) *Control test*—(1) *Definitions*—(i) *United States person*. The term *United States person* means a United States person within the meaning of section 7701(a)(30). For example, a domestic corporation is a United States person, regardless of whether its shareholders are United States persons.

(ii) *Substantial decisions*. The term *substantial decisions* means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Decisions that are ministerial include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions. Substantial decisions include, but are not limited to, decisions concerning—

(A) Whether and when to distribute income or corpus;

(B) The amount of any distributions;

(C) The selection of a beneficiary;

(D) Whether a receipt is allocable to income or principal;

(E) Whether to terminate the trust;

(F) Whether to compromise, arbitrate, or abandon claims of the trust;

(G) Whether to sue on behalf of the trust or to defend suits against the trust;

(H) Whether to remove, add, or replace a trustee;

(I) Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and

(J) Investment decisions; however, if a United States person under section 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.

(iii) *Control*. The term *control* means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

(iv) *Treatment of certain employee benefit trusts*. Provided that United States fiduciaries control all of the substantial decisions made by the trustees or fiduciaries, the following types of trusts are deemed to satisfy the control test set forth in paragraph (a)(1)(ii) of this section—

(A) A qualified trust described in section 401(a);

(B) A trust described in section 457(g);

(C) A trust that is an individual retirement account described in section 408(a);

(D) A trust that is an individual retirement account described in section 408(k) or 408(p);

(E) A trust that is a Roth IRA described in section 408A;

(F) A trust that is an education individual retirement account described in section 530;

(G) A trust that is a voluntary employees' beneficiary association described in section 501(c)(9);

(H) Such additional categories of trusts as the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*)).

(v) *Examples.* The following examples illustrate the rules of paragraph (d)(1) of this section:

Example 1. Trust has three fiduciaries, *A*, *B*, and *C*. *A* and *B* are United States citizens and *C* is a nonresident alien. No persons except the fiduciaries have authority to make any decisions of the trust. The trust instrument provides that no substantial decisions of the trust can be made unless there is unanimity among the fiduciaries. The control test is not satisfied because United States persons do not control all the substantial decisions of the trust. No substantial decisions can be made without *C*'s agreement.

Example 2. Assume the same facts as in *Example 1*, except that the trust instrument provides that all substantial decisions of the trust are to be decided by a majority vote among the fiduciaries. The control test is satisfied because a majority of the fiduciaries are United States persons and therefore United States persons control all the substantial decisions of the trust.

Example 3. Assume the same facts as in *Example 2*, except that the trust instrument directs that *C* is to make all of the trust's investment decisions, but that *A* and *B* may veto *C*'s investment decisions. *A* and *B* cannot act to make the investment decisions on their own. The control test is not satisfied because the United States persons, *A* and *B*, do not have the power to make all of the substantial decisions of the trust.

Example 4. Assume the same facts as in *Example 3*, except *A* and *B* may accept or veto *C*'s investment decisions and can make investments that *C* has not recommended. The control test is satisfied because the United States persons control all substantial decisions of the trust.

(2) *Replacement of any person who had authority to make a substantial decision of the trust*—(i) *Replacement within 12 months.* In the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change, the trust is allowed 12 months from the date of the change to make necessary changes either with respect to the persons who control the substantial decisions or with respect to the residence of such persons to avoid a change in the trust's residency. For purposes of this section, an inadvertent change means the death, incapacity, resignation, change in residency or other change with respect to a person that has a power to make a substantial decision of the trust that would cause a change to the residency of the trust but that was not intended to change the residency of the trust. If the necessary change is made within 12 months, the trust is treated as retaining its pre-change residency during the 12-month period. If the necessary change is not made within 12 months, the trust's residency changes as of the date of the inadvertent change.

(ii) *Request for extension of time.* If reasonable actions have been taken to make the necessary change to prevent a change in trust residency, but due to circumstances beyond the trust's control the trust is unable to make the modification within 12 months, the trust may provide a written statement to the district director having jurisdiction over the trust's return setting forth the reasons for failing to make the necessary change within the required time period. 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 make the necessary change. Whether an extension of time is granted is 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 district director does not grant an extension, the trust's residency changes as of the date of the inadvertent change.

(iii) *Examples.* The following examples illustrate the rules of paragraphs (d)(2)(i) and (ii) of this section:

Example 1. A trust that satisfies the court test has three fiduciaries, *A*, *B*, and *C*. *A* and

B are United States citizens and *C* is a nonresident alien. All decisions of the trust are made by majority vote of the fiduciaries. The trust instrument provides that upon the death or resignation of any of the fiduciaries, *D*, is the successor fiduciary. *A* dies and *D* automatically becomes a fiduciary of the trust. When *D* becomes a fiduciary of the trust, *D* is a nonresident alien. Two months after *A* dies, *B* replaces *D* with *E*, a United States person. Because *D* was replaced with *E* within 12 months after the date of *A*'s death, during the period after *A*'s death and before *E* begins to serve, the trust satisfies the control test and remains a domestic trust.

Example 2. Assume the same facts as in *Example 1* except that at the end of the 12-month period after *A*'s death, *D* has not been replaced and remains a fiduciary of the trust. The trust becomes a foreign trust on the date *A* died unless the district director grants an extension of the time period to make the necessary change.

(3) *Automatic migration provisions.* Notwithstanding any other provision in this section, United States persons are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States persons.

(4) *Examples.* The following examples illustrate the rules of this paragraph (d):

Example 1. A, a nonresident alien individual, is the grantor and, during *A*'s lifetime, the sole beneficiary of a trust that qualifies as an individual retirement account (IRA). *A* has the exclusive power to make decisions regarding withdrawals from the IRA and to direct its investments. The IRA's sole trustee is a United States person within the meaning of section 7701(a)(30). The control test is satisfied with respect to this trust because the special rule of paragraph (d)(1)(iv) of this section applies.

Example 2. A, a nonresident alien individual, is the grantor of a trust and has the power to revoke the trust, in whole or in part, and revest assets in *A*. *A* is treated as the owner of the trust under sections 672(f) and 676. *A* is not a fiduciary of the trust. The trust has one trustee, *B*, a United States person, and the trust has one beneficiary, *C*. *B* has the discretion to distribute corpus or income to *C*. In this case, decisions exercisable by *A* to have trust assets distributed to *A* are substantial decisions. Therefore, the trust is a foreign trust because *B* does not control all substantial decisions of the trust.

Example 3. A trust, Trust T, has two fiduciaries, *A* and *B*. Both *A* and *B* are United States persons. *A* and *B* hire *C*, an investment advisor who is a foreign person, and may terminate *C*'s employment at will. The investment advisor makes the investment decisions for the trust. *A* and *B* control all other decisions of the trust. Although *C* has the power to make investment decisions, *A* and *B* are treated as controlling these decisions. Therefore, the control test is satisfied.

Example 4. G, a United States citizen, creates a trust. The trust provides for income to *A* and *B* for life, remainder to *A*'s and *B*'s descendants. *A* is a nonresident alien and *B* is a United States person. The trustee of the trust is a United States person. The trust instrument authorizes *A* to replace the trustee. The power to replace the trustee is a substantial decision. Because *A*, a nonresident alien, controls a substantial decision, the control test is not satisfied.

(e) *Effective date*—(1) *General rule.* Except for the election to remain a domestic trust provided in paragraph (f) of this section, this section is applicable to trusts for taxable years ending after February 2, 1999. This section may be relied on by trusts for taxable years beginning after December 31, 1996, and also may be relied on by trusts whose trustees have elected to apply sections 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996, under section 1907(a)(3)(B) of the Small Business Job Protection Act of 1996, (the SBJP Act) Public Law 104–188, 110 Stat. 1755 (26 U.S.C. 7701 note).

(2) *Trusts created after August 19, 1996.* If a trust is created after August 19, 1996, and before April 5, 1999, and the trust satisfies the control test set forth in the regulations project REG–251703–96 published under section 7701(a)(30) and (31) (1997–1 C.B. 795) (See § 601.601(d)(2) of this chapter), but does not satisfy the control test set forth in paragraph (d) of this section, the trust may be modified to satisfy the control test of paragraph (d) by December 31, 1999. If the modification is completed by December 31, 1999, the trust will be treated as satisfying the control test of paragraph (d) for taxable years beginning after December 31, 1996, (and for taxable years ending after August 20, 1996, if the election under section 1907(a)(3)(B) of the SBJP Act has been made for the trust).

(f) *Election to remain a domestic trust*—(1) *Trusts eligible to make the election to remain domestic.* A trust that was in existence on August 20, 1996, and that was treated as a domestic trust on August 19, 1996, as provided in paragraph (f)(2) of this section, may elect to continue treatment as a domestic trust notwithstanding section 7701(a)(30)(E). This election is not available to a trust that was wholly-owned by its grantor under subpart E, part I, subchapter J, chapter 1, of the Code on August 20, 1996. The election is available to a trust if only a portion of the trust was treated as owned by the grantor under subpart E on August 20, 1996. If a partially-owned grantor trust makes the election, the election is effective for the entire trust. Also, a trust may not make the election if the trust has made an election pursuant to section 1907(a)(3)(B) of the SBJP Act to apply the new trust criteria to the first taxable year of the trust ending after August 20, 1996, because that election, once made, is irrevocable.

(2) *Determining whether a trust was treated as a domestic trust on August 19, 1996*—(i) *Trusts filing Form 1041 for the taxable year that includes August 19, 1996.* For purposes of the election, a trust is considered to have been treated as a domestic trust on August 19, 1996, if: the trustee filed a Form 1041, ''U.S. Income Tax Return for Estates and Trusts,'' for the trust for the period that includes August 19, 1996 (and did not file a Form 1040NR, ''U.S. Nonresident Alien Income Tax Return,'' for that year); and the trust had a reasonable basis (within the meaning of section 6662) under section 7701(a)(30) prior to amendment by the SBJP Act (prior law) for reporting as a domestic trust for that period.

(ii) *Trusts not filing a Form 1041.* Some domestic trusts are not required to file Form 1041. For example, certain group trusts described in Rev. Rul. 81–100 (1981–1 C.B. 326) (See § 601.601(d)(2) of this chapter) consisting of trusts that are parts of qualified retirement plans and individual retirement accounts are not required to file Form 1041. Also, a domestic trust whose gross income for the taxable year is less than the amount required for filing an income tax return and that has no taxable income is not required to file a Form 1041. Section 6012(a)(4). For purposes of the election, a trust that filed neither a Form 1041 nor a Form 1040NR for the period that includes August 19, 1996, will be considered to have been treated as a domestic trust on August 19, 1996, if the trust had a reasonable basis (within the meaning of section 6662) under prior law for being treated as a domestic trust for that period and for filing neither a Form 1041 nor a Form 1040NR for that period.

(3) *Procedure for making the election to remain domestic*—(i) *Required Statement.* To make the election, a statement must be filed with the Internal Revenue Service in the manner and time described in this section. The statement must be entitled ''Election to Remain a Domestic Trust under Section 1161 of the Taxpayer Relief Act of 1997,'' be signed under penalties of perjury by at least one trustee of the trust, and contain the following information—

(A) A statement that the trust is electing to continue to be treated as a domestic trust under section 1161 of the Taxpayer Relief Act of 1997;

(B) A statement that the trustee had a reasonable basis (within the meaning of section 6662) under prior law for treating the trust as a domestic trust on August 19, 1996. (The trustee need not explain the reasonable basis on the election statement.);

(C) A statement either that the trust filed a Form 1041 treating the trust as a domestic trust for the period that includes August 19, 1996, (and that the trust did not file a Form 1040NR for that period), or that the trust was not required to file a Form 1041 or a Form 1040NR for the period that includes August 19, 1996, with an accompanying brief explanation as to why a Form 1041 was not required to be filed; and

(D) The name, address, and employer identification number of the trust.

(ii) *Filing the required statement with the Internal Revenue Service.* (A) Except as provided in paragraphs (f)(3)(ii)(E) through (G) of this section, the trust must attach the statement to a Form 1041. The statement may be attached to either the Form 1041 that is filed for the first taxable year of the trust beginning after December 31, 1996 (1997

taxable year), or to the Form 1041 filed for the first taxable year of the trust beginning after December 31, 1997 (1998 taxable year). The statement, however, must be filed no later than the due date for filing a Form 1041 for the 1998 taxable year, plus extensions. The election will be effective for the 1997 taxable year, and thereafter, until revoked or terminated. If the trust filed a Form 1041 for the 1997 taxable year without the statement attached, the statement should be attached to the Form 1041 filed for the 1998 taxable year.

(B) If the trust has insufficient gross income and no taxable income for its 1997 or 1998 taxable year, or both, and therefore is not required to file a Form 1041 for either or both years, the trust must make the election by filing a Form 1041 for either the 1997 or 1998 taxable year with the statement attached (even though not otherwise required to file a Form 1041 for that year). The trust should only provide on the Form 1041 the trust's name, name and title of fiduciary, address, employer identification number, date created, and type of entity. The statement must be attached to a Form 1041 that is filed no later than October 15, 1999.

(C) If the trust files a Form 1040NR for the 1997 taxable year based on application of new section 7701(a)(30)(E) to the trust, and satisfies paragraph (f)(1) of this section, in order for the trust to make the election the trust must file an amended Form 1040NR return for the 1997 taxable year. The trust must note on the amended Form 1040NR that it is making an election under section 1161 of the Taxpayer Relief Act of 1997. The trust must attach to the amended Form 1040NR the statement required by paragraph (f)(3)(i) of this section and a completed Form 1041 for the 1997 taxable year. The items of income, deduction and credit of the trust must be excluded from the amended Form 1040NR and reported on the Form 1041. The amended Form 1040NR for the 1997 taxable year, with the statement and the Form 1041 attached, must be filed with the Philadelphia Service Center no later than the due date, plus extensions, for filing a Form 1041 for the 1998 taxable year.

(D) If a trust has made estimated tax payments as a foreign trust based on application of section 7701(a)(30)(E) to the trust, but has not yet filed a Form 1040NR for the 1997 taxable year, when the trust files its Form 1041 for the 1997 taxable year it must note on its Form 1041 that it made estimated tax payments based on treatment as a foreign trust. The Form 1041 must be filed with the Philadelphia Service Center (and not with the service center where the trust ordinarily would file its Form 1041).

(E) If a trust forms part of a qualified stock bonus, pension, or profit sharing plan, the election provided by this paragraph (f) must be made by attaching the statement to the plan's annual return required under section 6058 (information return) for the first plan year beginning after December 31, 1996, or to the plan's information return for the first plan year beginning after December 31, 1997. The statement must be attached to the plan's information return that is filed no later than the due date for filing the plan's information return for the first plan year beginning after December 31, 1997, plus extensions. The election will be effective for the first plan year beginning after December 31, 1996, and thereafter, until revoked or terminated.

(F) Any other type of trust that is not required to file a Form 1041 for the taxable year, but that is required to file an information return (for example, Form 5227) for the 1997 or 1998 taxable year must attach the statement to the trust's information return for the 1997 or 1998 taxable year. However, the statement must be attached to an information return that is filed no later than the due date for filing the trust's information return for the 1998 taxable year, plus extensions. The election will be effective for the 1997 taxable year, and thereafter, until revoked or terminated.

(G) A group trust described in Rev. Rul. 81–100 consisting of trusts that are parts of qualified retirement plans and individual retirement accounts (and any other trust that is not described above and that is not required to file a Form 1041 or an information return) need not attach the statement to any return and should file the statement with the Philadelphia Service Center.

The trust must make the election provided by this paragraph (f) by filing the statement by October 15, 1999. The election will be effective for the 1997 taxable year, and thereafter, until revoked or terminated.

(iii) *Failure to file the statement in the required manner and time.* If a trust fails to file the statement in the manner or time provided in paragraphs (f)(3)(i) and (ii) of this section, the trustee may provide a written statement to the district director having jurisdiction over the trust setting forth the reasons for failing to file the statement in the required manner or time. If the district director determines that the failure to file the statement in the required manner or time was due to reasonable cause, the district director may grant the trust an extension of time to file the statement. Whether an extension of time is granted shall be in the sole discretion of the district director. However, the relief provided by this paragraph (f)(3)(iii) is not ordinarily available if the statute of limitations for the trust's 1997 taxable year has expired. Additionally, if the district director grants an extension of time, it may contain 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.

(4) *Revocation or termination of the election*—(i) *Revocation of election.* The election provided by this paragraph (f) to be treated as a domestic trust may only be revoked with the consent of the Commissioner. See sections 684, 6048, and 6677 for the federal tax consequences and reporting requirements related to the change in trust residence.

(ii) *Termination of the election.* An election under this paragraph (f) to remain a domestic trust terminates if changes are made to the trust subsequent to the effective date of the election that result in the trust no longer having any reasonable basis (within the meaning of section 6662) for being treated as a domestic trust under section 7701(a)(30) prior to its amendment by the SBJP Act. The termination of the election will result in the trust changing its residency from a domestic trust to a foreign trust on the effective date of the termination of the election. See sections 684, 6048, and 6677 for the federal tax consequences and reporting requirements related to the change in trust residence.

(5) *Effective date.* This paragraph (f) is applicable beginning on February 2, 1999.

[T.D. 8813, 64 FR 4970, Feb. 2, 1999]

§ 301.7701–8 Military or naval forces and Armed Forces of the United States.

The term ''military or naval forces of the United States'' and the term ''Armed Forces of the United States'' each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force. The terms also include the Coast Guard. The members of such forces include commissioned officers and the personnel below the grade of commissioned officer in such forces.

§ 301.7701–9 Secretary or his delegate.

(a) The term *Secretary or his delegate* means the Secretary of the Treasury, or any officer, employee, or agency of the Treasury Department duly authorized by the Secretary (directly, or indirectly by one or more redelegations of authority) to perform the function mentioned or described in the context, and the term ''or his delegate'' when used in connection with any other official of the United States shall be similarly construed.

(b) In any case in which a function is vested by the Internal Revenue Code of 1954 or any other statute in the Secretary or his delegate, and Treasury regulations or Treasury decisions approved by the Secretary or his delegate provide that such function may be performed by the Commissioner, assistant commissioner, regional commissioner, assistant regional commissioner, district director, director of a regional service center, or by a designated officer or employee in the office of any such officer, such provision in the regulations or Treasury decision shall constitute a delegation by the Secretary of the authority to perform such function to the designated officer or employee.

If such authority is delegated to any officer or employee performing services under the supervision and control of the Commissioner, such provision in the regulations or Treasury decision shall constitute a delegation by the Secretary to the Commissioner of the authority to perform such function and a redelegation thereof by the Commissioner to the designated officer or employee.

(c) An officer or employee, including the Commissioner, authorized by regulations or Treasury decision to perform a function shall have authority to redelegate the performance of such function to any officer or employee performing services under his supervision and control, unless such power to so redelegate is prohibited or restricted by proper order or directive. The Commissioner may also redelegate authority to perform such function to other officers or employees under his supervision and control and, to the extent he deems proper, may authorize further redelegation of such authority.

(d) The Commissioner may prescribe such limitations as he deems proper on the extent to which any officer or employee under his supervision and control shall perform any such function, but, in the case of an officer or employee designated in regulations or Treasury decision as authorized to perform such function, such limitations shall not render invalid any performance by such officer or employee of the function which, except for such limitations, such officer or employee is authorized to perform by such regulations or Treasury decision in effect at the time the function is performed.

§ 301.7701–10 District director.

The term *district director* means the district director of internal revenue for an internal revenue district. The term also includes the Assistant Commissioner (International).

[32 FR 15241, Nov. 3, 1967, as amended by T.D. 8411, 57 FR 15241, Apr. 27, 1992]

§ 301.7701–11 Social security number.

For purposes of this chapter, the term *social security number* means the taxpayer identifying number of an individual or estate which is assigned pursuant to section 6011(b) or corresponding provisions of prior law, or pursuant to section 6109, and in which nine digits are separated by hyphens as follows: 000-00-0000. Such term does not include a number with a letter as a suffix which is used to identify an auxiliary beneficiary under the social security program. The terms ''account number'' and ''social security number'' refer to the same number.

[T.D. 7306, 39 FR 9947, Mar. 15, 1974]

§ 301.7701–12 Employer identification number.

For purposes of this chapter, the term *employer identification number* means the taxpayer identifying number of an individual or other person (whether or not an employer) which is assigned pursuant to section 6011 (b) or corresponding provisions of prior law, or pursuant to section 6109, and in which nine digits are separated by a hyphen, as follows: 00–0000000. The terms ''employer identification number'' and ''identification number'' (defined in §31.0–2(a)(11) of this chapter (Employment Tax Regulations)) refer to the same number.

[T.D. 7306, 39 FR 9947, Mar. 15, 1974]

§ 301.7701–13 Pre-1970 domestic building and loan association.

(a) *In general.* For taxable years beginning after October 16, 1962, and before July 12, 1969, the term ''domestic building and loan association'' means a domestic building and loan association, a domestic savings and loan association, a Federal savings and loan association, and any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law which meets supervisory test (described in paragraph (b) of this section), the business operations test (described in paragraph (c) of this section), and each of the various assets tests (described in paragraphs (d), (e), (f), and (h) of this section). For the definition of the term ''domestic building and loan association'', for taxable years beginning after July 11, 1969, see §301.7701–13A.

(b) *Supervisory test.* A domestic building and loan association must be either (1) an insured institution within the

meaning of section 401(a) of the National Housing Act (12 U.S.C. 1724 (a)) or (2) subject by law to supervision and examination by State or Federal authority having supervision over such associations. An ''insured institution'' is one the accounts of which are insured by the Federal Savings and Loan Insurance Corporation.

(c) *Business operations test*—(1) *In general.* An association must utilize its assets so that substantially all of its business consists of acquiring the savings of the public and investing in the loans described in subparagraphs (6) through (10) of paragraph (d) of this section. The requirement of this paragraph is referred to in this section as the business operations test. The business of acquiring the savings of the public and investing in the prescribed loans includes ancillary or incidental activities which are directly and primarily related to such acquisition and investment, such as advertising for savings, appraising property on which loans are to be made by the association, and inspecting the progress of construction in connection with construction loans. Even though an association meets the supervisory test in paragraph (b) and all the assets tests described in paragraphs (d) through (h) of this section, it will nevertheless not qualify as a domestic building and loan association if any substantial part of its business consists of activities which are not directly and primarily related to such acquisition and investment, such as brokering mortgage paper, selling insurance, or subdividing real estate. However, an association will meet the business operations test for a taxable year if it meets the requirements of both subparagraphs (2) and (3) of this paragraph (c), relating respectively to acquiring the savings of the public, and investing in loans.

(2) *Acquiring the savings of the public.* The requirement that substantially all of an association's business (other than investing in loans) must consist of acquiring the savings of the public ordinarily will be considered to be met if savings are acquired in all material respects in conformity with the rules and regulations of the Federal Home Loan Bank Board or substantially equivalent rules of a State law or supervisory authority. In addition, such requirement will be considered to be met if more than 85 percent of the dollar amount of the total deposits and withdrawable shares of the association are held during the taxable year by the general public as opposed to amounts deposited by family or related business groups or persons who are officers or directors of the association. The percentage specified in this subparagraph shall be computed as of the close of the taxable year, or at the option of the taxpayer, on the basis of the average of the amounts of deposits held during the year. Such average shall be determined by computing the percentage specified either as of the close of each month, as of the close of each quarter, or semiannually during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentages obtained.

(3) *Investing in loans*—(i) *In general.* The requirement that substantially all of an association's business (other than acquiring the savings of the public) must consist of investing in the loans described in subparagraphs (6) through (10) of paragraph (d) of this section ordinarily will be considered to be met for a taxable year if the association meets both the gross income test described in subdivision (ii) of this subparagraph, and the sales activity test described in subdivision (iii) of this subparagraph. However, if an association does not meet the requirements of both subdivisions (ii) and (iii) of this subparagraph, it will nevertheless meet the investing in loans requirement if it is able to demonstrate that substantially all its business (other than acquiring the savings of the public) consisted of investing in the prescribed loans. Transactions which are necessitated by exceptional circumstances and which are not undertaken as recurring business activities for profit will not be considered a substantial part of an association's business. Thus, for example, an association would meet the investing in loans requirement if it can establish that it failed to meet the gross income test because of receipt of a non-recurring item of income due to exceptional circumstances, or it failed to meet the sales activity test because

of sales made to achieve necessary liquidity to meet abnormal withdrawals from savings accounts. For the purposes of this subparagraph, however, the acquisition of loans in anticipation of their sale to other financial institutions does not constitute ''investing'' in loans, even though such acquisition and sale resulted from an excess of demand for loans over savings capital in the association's area.

(ii) *Gross income test.* The gross income test is met if more than 85 percent of the gross income of an association consists of:

(*a*) Interest or dividends on assets defined in subparagraph (2), (3), or (4) of paragraph (d) of this section,

(*b*) Interest on loans defined in subparagraphs (6) through (10) of paragraph (d) of this section,

(*c*) Income attributable to the portion of property used in the association's business as defined in paragraph (d)(5) of this section,

(*d*) Premiums, discounts, commissions, or fees (including late charges and penalties) on loans defined in subparagraphs (6) through (10) of paragraph (d) of this section which have at some time been held by the association, or for which firm commitments have been issued,

(*e*) Gain or loss on the sale of governmental obligations defined in paragraph (d)(3) of this section, or

(*f*) Income, gain, or loss attributable to foreclosed property (as defined in paragraph (j)(1) of this section), but not including such income, gain, or loss which, pursuant to section 595 and the regulations thereunder, is not included in gross income.

For the purposes of this subparagraph, gross income shall be computed without regard to gains or losses on the sale of the portion of property used in the association's business (described in paragraph (d)(5) of this section), without regard to gains or losses on the rented portion of property used as the principal or branch office of the association (described in such paragraph), and without regard to gains or losses on the sale of participations and loans (other than governmental obligations defined in paragraph (d)(3) of this section). Examples of types of income which would cause an association to fail to meet the gross income test, if in the aggregate they exceed 15 percent of gross income, are the excess of gains over losses on sale of real estate (other than foreclosed property); rental income (other than on foreclosed property and the portion of property used in the association's business); premiums, commissions, and fees (other than commitment fees) on loans which have never been held by the association; and insurance brokerage fees.

(iii) *Sales activity test: in general.* The sales activity test is met for a taxable year if the association meets both the sales of whole loans test described in subdivision (iv) of this subparagraph, and the sales of whole loans and participations test described in subdivision (v) of this subparagraph. For the purposes of this subdivision and subdivisions (iv), (v), and (vi) of this subparagraph:

(*a*) The term *loan* means loan as defined in paragraph (j)(1) of this section, other than foreclosed property defined in such paragraph and governmental obligations defined in paragraph (d)(3) of this section.

(*b*) The amount of a loan shall be determined in accordance with the rules contained in paragraph (l) (1) and (2)(ii) of this section.

(*c*) The term *loans acquired for investment during the taxable year* means the amount of loans outstanding as of the close of the taxable year, reduced (but not below zero) by the amount of loans outstanding as of the beginning of such year, and increased by the lesser of *(1)* the amount of repayments made on loans during the taxable year or *(2)* an amount equal to 20 percent of the amount of loans outstanding as of the beginning of the taxable year. For this purpose, repayments do not include repayments on loans to the extent such loans are refinanced by the association.

(*d*) The term *sales of participations* means sales by an association of interests in loans, which sales meet the requirements of the regulations of the Federal Home Loan Bank Board relating to sales of participations, or which meet substantially equivalent requirements of State law or regulations relating to sales of participations.

(*e*) The term *sales of whole loans* means sales of loans other than sales of

participations as defined in subdivision *(d)* of this subdivision, but in determining the amount of sales of whole loans, the following sales shall be disregarded: Sales of loans made to other financial institutions pursuant to an arrangement whereunder the association simultaneously enters in a bona fide agreement to repurchase such loans within a period of 18 months from the time of sale if such arrangement conforms to the rules and regulations of applicable supervisory authorities; sales made to the Federal Savings and Loan Insurance Corporation or to a corporation defined in paragraph (d)(4) of this section (relating to deposit insurance company securities); and sales made in the course of liquidation of the association pursuant to Federal or State law.

(iv) *Sales of whole loans test.* The sales of whole loans test is met for a taxable year if the amount of sales of whole loans during the taxable year does not exceed the greater of *(a)* 15 percent of the amount of loans acquired for investment during the taxable year, or *(b)* 20 percent of the amount of loans outstanding at the beginning of the taxable year. However, the 20 percent of beginning loans limitation specified in subdivision *(b)* of the previous sentence shall be reduced by the number of percentage points (rounded to the nearest one hundredth of a percentage point) which is equal to the sum of the 2 percentages obtained by dividing, for each of the 2 preceding taxable years, the amount of sales of whole loans during each such taxable year by the amount of loans outstanding at the beginning of such taxable year. For example, if the amounts of sales of whole loans made by a calendar year association in 1965 and 1966 were 3 percent and 4 percent, respectively, of loans outstanding at the beginning of each such year, the amount of sales of whole loans allowed under such subdivision *(b)* for 1967 would be an amount equal to 13 percent (20 percent minus 7 percentage points) of loans outstanding at the beginning of 1967. In computing the reduction to the 20 percent of beginning loans limitation specified in such subdivision *(b)*, sales of whole loans made before January 1, 1964, shall not be taken into account.

(v) *Sales of whole loans and participations test.* The sales of whole loans and participations test is met if the sum of the amount of sales of whole loans and the amount of sales of participations during the taxable year does not exceed 100 percent of the amount of loans acquired for investment during the taxable year.

(vi) *Sales activity tests: special rules—*(*a*) *Carryover of sales.* The amount specified in subdivision (iv)(a) of this subparagraph as the maximum amount of sales of whole loans shall be increased by the amount by which 15 percent of the amount of loans acquired for investment by the association during the 2 preceding taxable years exceeds the amount of sales of whole loans made during such preceding taxable years; and the amount specified in subdivision (v) of this subparagraph as the maximum amount of sales of whole loans and participations shall be increased by the amount by which the amount of loans acquired for investment by the association during the 2 preceding taxable years exceeds the sum of the amount of sales of whole loans and participations made during such preceding taxable years. For example, if 15 percent of the amount of loans acquired for investment in 1965 and 1966 exceeded the amount of sales of whole loans during such years by $250,000, the amount of sales of whole loans permitted in 1967 under subdivision (iv)*(a)* of this subparagraph would be increased by $250,000.

(*b*) *Use of preceding year's base.* If the amount of loans acquired for investment by the association during the preceding taxable year exceeds such amount for the current taxable year, the 15 percent limitation provided in subdivision (iv)*(a)* of this subparagraph and the 100 percent limitation provided in subdivision (v) of this subparagraph shall be based upon such preceding taxable year's amount. However, the maximum amount of sales of whole loans permitted under subdivision (iv)*(a)* and the maximum amount of sales of whole loans and participations permitted under subdivision (v) in any taxable year shall be reduced by the amount of the increase in such sales allowed for the preceding taxable year solely by

reason of the application of the provisions of the previous sentence. For example, assuming no carryover of sales under subdivision *(a)* of this subdivision, if the amount of loans acquired for investment by a calendar year association was $1,000,000 in 1965, under subdivision (iv)*(a)* of this subparagraph the association could make sales of whole loans in 1966 of $150,000 (15 percent of $1,000,000) even though the amount of its loans acquired for investment during 1966 was only $800,000. However, the amount of sales of whole loans permitted in 1967 under subdivision (iv)*(a)* of this subparagraph would be reduced to the extent that the amount of the sales of whole loans made by the association during 1966 exceeded $120,000 (15 percent of $800,000).

(vii) *Examples illustrating sales activity test.* The provisions of subdivisions (iii) through (vi) of this subparagraph may be illustrated by the following examples in each of which it is assumed that the association is a calendar year taxpayer which is operated in all material respects in conformity with applicable rules and regulations of Federal or State supervisory authorities.

Example 1. X Association made sales of whole loans in 1964 and 1965 which were 10 percent and 7 percent, respectively, of the amounts of loans outstanding at the beginning of each such year, and which were 25 percent and 17 percent, respectively, of the amounts of loans acquired for investment in each such year. The amount of X's loans outstanding at the beginning of 1966 was $1 million, and the amount of its loans acquired for investment for such year was $300,000. The maximum amount of sales of whole loans which X may make under the percentage of beginning loans limitation for 1966 is $30,000, which is 3 percent (20 percent reduced by the sum of 10 percent and 7 percent) of $1 million. The maximum amount of sales of whole loans permitted under the percentage of loans acquired for investment limitation for 1966 is $45,000 (15 percent of $300,000). X may therefore sell whole loans in an amount up to $45,000 in 1966 and meet the sales of whole loans test. It is assumed that the amount of loans acquired for investment in 1965 did not exceed $300,000, so that the preceding year's base cannot be used to increase the amount of sales permitted in 1966.

Example 2. Assume the same facts as in the previous example, except that the amount of loans acquired for investment in the preceding year (1965) was $320,000. Since such amount is greater than the $300,000 amount of loans acquired for investment in 1966, X may base its 15 percent limitation for 1966 on the $320,000 amount and sell whole loans in an amount up to $48,000 (15 percent of $320,000) and still meet the sales of whole loans test. However, to the extent that the amount of sales of whole loans exceeds $45,000 (15 percent of the $300,000 amount of loans acquired for investment in 1966), the maximum amount of sales computed under the percentage of loans acquired for investment limitation (but not the 20 percent of beginning loans limitation) for 1967 must be reduced.

Example 3. Y Association made no sales of whole loans in 1964 and 1965, and made sales of participations in the 2 years in amounts which, in the aggregate, were $50,000 less than the amounts of loans acquired for investment for such years. At the beginning of 1966 the amount of Y's loans outstanding was $1 million, and the amount of its loans acquired for investment in such year was $100,000. Although the maximum amount of sales of whole loans which Y could make under the sales of whole loans test is $200,000 (20 percent of $1 million), nevertheless, in order to meet the sales of whole loans and participations test, the sum of the amounts of sales of whole loans and sales of participations may not exceed $150,000 (100 percent of the $100,000 amount of loans acquired for investment in 1966 plus a carryover of sales from the previous two years of $50,000). It is assumed that the amount of loans acquired for investment in 1965 did not exceed $100,000, so that the preceding year's base cannot be used to increase the amount of sales permitted in 1966.

(viii) *Reporting requirements.* In the case of income tax returns for taxable years ending after October 31, 1964, there shall be filed with the return a statement showing the amount of gross income for the taxable year in each of the categories described in subdivision (ii) of this subparagraph; and, for the taxable year and the two preceding taxable years, the amount of loans (described in subdivision (iii) *(a)* of this subparagraph) outstanding at the beginning of the year and at the end of the year, the amount of repayments on loans (not including repayments on loans to the extent such loans are refinanced by the association), the amount of sales of whole loans, and the amount of sales of participations.

(4) *Effective date.* The provisions of subparagraphs (1) through (3) of this paragraph (c), are applicable to taxable years ending after October 31, 1964. However, at the option of the taxpayer,

for a taxable year beginning before November 1, 1964, and ending after October 31, 1964, the provisions of subparagraphs (1) through (3) of this paragraph (except the 20 percent of beginning loans limitation specified in subdivision (iv)*(b)* of subparagraph (3) of this paragraph (c)) shall apply only to the part year falling after October 31, 1964, as if such part year constituted a taxable year. In such case, the following rules shall apply:

(i) The amount of the ''loans acquired for investment'' for such part year shall be equal to the loans acquired for investment during the entire taxable year within which falls such part year, multiplied by a fraction the numerator of which is the number of days in such part year and the denominator of which is the number of days in such entire taxable year.

(ii) The increase in sales of whole loans and participations permitted by subdivision (vi) of subparagraph (3) of this paragraph (c), (relating to carryover of sales and use of preceding year's base) shall be the amount of such increase computed under such subdivision, multiplied by the fraction specified in subdivision (i) of this subparagraph.

If, treating the part year as a taxable year, the association meets all the requirements of this paragraph for such part year it will be considered to have met the business operations test for the entire taxable year, providing it operated in all material respects in conformity with applicable rules and regulations of Federal or State supervisory authorities for the entire taxable year. The 20 percent of beginning loans limitation specified in subdivision (iv)*(b)* of subparagraph (3) of this paragraph (c), shall be applied only on the basis of a taxable year and not the part year. For taxable years beginning after October 16, 1962, and ending before November 1, 1964, an association will be considered to have met the business operations test if it operated in all material respects in conformity with applicable rules and regulations of Federal or State supervisory authorities.

(d) *90 percent of assets test*—(1) *In general.* At least 90 percent of the amount of the total assets of a domestic building and loan association must consist of the assets defined in subparagraphs (2) through (10) of this paragraph (d). For purposes of this paragraph, it is immaterial whether the association originated the loans defined in subparagraphs (6) through (10) of this paragraph (d), or purchased or otherwise acquired them in whole or in part from another. See paragraph (j) of this section for definition of certain terms used in this paragraph, and paragraph (k) of this section for the determination of amount and character of loans.

(2) *Cash.* The term ''cash'' means cash on hand, and time or demand deposits with, or withdrawable accounts in, other financial institutions.

(3) *Governmental obligations.* The term ''governmental obligations'' means obligations of the United States, a State or political subdivision of a State, and stock or obligations of a corporation which is an instrumentality of the United States, a State, or political subdivision of a State.

(4) *Deposit insurance company securities.* The term ''deposit insurance company securities'' means certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations.

(5) *Property used in the association's business*—(i) *In general.* The term ''property used in the association's business'' means land, buildings, furniture, fixtures, equipment, leasehold interests, leasehold improvements, and other assets used by the association in the conduct of its business of acquiring the savings of the public and investing in the loans defined in subparagraphs (6) through (10) of this paragraph (d). Real property held for the purpose of being used primarily as the principal or branch office of the association constitutes property used in the association's business so long as it is reasonably anticipated that such property will be occupied for such use by the association, or that construction work preparatory to such occupancy will be commenced thereon, within 2 years after acquisition of the property. Stock of a wholly owned subsidiary corporation which has as its exclusive activity the ownership and management of

property more than 50 percent of the fair rental value of which is used as the principal or branch office of the association constitutes property used in such business. Real property held by an association for investment or sale, even for the purpose of obtaining mortgage loans thereon, does not constitute property used in the association's business.

(ii) *Property rented to others.* Except as provided in the second sentence of subdivision (i) of this subparagraph, property or a portion thereof rented by the association to others does not constitute property used in the association's business. However, if the fair rental value of the rented portion of a single piece of real property (including appurtenant parcels) used as the principal or branch office of the association constitutes less than 50 percent of the fair rental value of such piece of property, or if such property has an adjusted basis of not more than $150,000, the entire property shall be considered used in such business. If such rented portion constitutes 50 percent or more of the fair rental value of such piece of property, and such property has an adjusted basis of more than $150,000, an allocation of its adjusted basis is required. The portion of the total adjusted basis of such piece of property which is deemed to be property used in the association's business shall be equal to an amount which bears the same ratio to such total adjusted basis as the amount of the fair rental value of the portion used as the principal or branch office of the association bears to the total fair rental value of such property. In the case of all property other than real property used or to be used as the principal or branch office of the association, if the fair rental value of the rented portion thereof constitutes less than 15 percent of the fair rental value of such property, the entire property shall be considered used in the association's business. If such rented portion constitutes 15 percent or more of the fair rental value of such property, an allocation of its adjusted basis (in the same manner as required for real property used as the principal or branch office) is required.

(6) *Passbook loan.* The term ''passbook loan'' means a loan to the extent secured by a deposit, withdrawable share, or savings account in the association, or share of a member of the association, with respect to which a distribution is allowable as a deduction under section 591.

(7) *Home loan.* The term ''home loan'' means a loan secured by an interest in—

(i) Improved residential real property consisting of a structure or structures containing, in the aggregate, no more than 4 family units.

(ii) An individually owned family unit in a multiple-unit structure, the owner of which unit owns an undivided interest in the underlying real estate and the common elements of such structure (so-called condominium type).

Or a construction loan or improvement loan for such property. A construction loan made for the purpose of financing more than one structure (so-called tract financing) constitutes a home loan, providing no individual structure contains more than 4 family units and it is contemplated that, as soon as possible after completion of construction, the structures will become property described in subdivision (i) of this subparagraph. A construction loan secured by a structure containing more than 4 family units constitutes a home loan only if the structure has been committed to a plan of individual apartment ownership described in subdivision (ii) of this subparagraph and such plan is held out and advertised as such. A loan secured by a cooperative apartment building containing more than 4 family units does not constitute a home loan.

(8) *Church loan.* The term ''church loan'' means a loan secured by an interest in real property which is used primarily for church purposes, or a construction loan or improvement loan for such property. For the purposes of this subparagraph, the term ''church purposes'' means the ministration of sacerdotal functions, the conduct of religious worship and closely associated activities designed primarily to provide fellowship among members of the congregation, or the instruction of religion. Thus, a parish hall would normally qualify as property used primarily for church purposes, whereas a

building used primarily to furnish education, other than the instruction of religion, would not.

(9) *Multifamily loan.* The term ''multifamily loan'' means a loan, other than one defined in subparagraph (7) of this paragraph (d), (relating to a home loan), secured by an interest in improved residential real property or a construction loan or improvement loan for such property.

(10) *Nonresidential real property loan.* The term ''nonresidential real property loan'' means a loan, other than one defined in subparagraph (7), (8), or (9) of this paragraph (d), (relating respectively to a home loan, church loan, and multifamily loan) secured by an interest in real property, or a construction loan or improvement loan for such property.

(e) *18 percent of assets test.* Not more than 18 percent of the amount of the total assets of a domestic building and loan association may consist of assets other than those defined in subparagraphs (2) through (9) of paragraph (d) of this section. Thus, the sum of the amounts of the nonresidential real property loans and the assets other than those defined in paragraph (d) of this section may not exceed 18 percent of total assets.

(f) *36 or 41 percent of assets test*—(1) *36 percent test.* Unless subparagraph (2) of this paragraph (f), applies, not more than 36 percent of the amount of the total assets of a domestic building and loan association may consist of assets other than those defined in subparagraphs (2) through (8) of paragraph (d) of this section. Thus, unless subparagraph (2) of this paragraph (f), applies, the sum of the amounts of multifamily loans, nonresidential real property loans, and assets other than those defined in paragraph (d) of this section may not exceed 36 percent of total assets.

(2) *41 percent test.* If this subparagraph applies, not more than 41 percent of the amount of the total assets of a domestic building and loan association may consist of assets other than those defined in subparagraphs (2) through (8) of paragraph (d) of this section. Thus, if this subparagraph applies, the sum of the amounts of multifamily loans, nonresidential real property loans, and assets other than those defined in paragraph (d) of this section may not exceed 41 percent of total assets. See section 593(b)(5) and the regulations thereunder for the effect of application of this subparagraph on the allowable addition to the reserves for bad debts.

(g) *Taxable years for which 41 percent of assets test applies*—(1) *First taxable year.* For an association's first taxable year beginning after October 16, 1962, subparagraph (2) of paragraph (f) applies.

(2) *Second taxable year.* For an association's second taxable year beginning after October 16, 1962, subparagraph (2) of paragraph (f) applies if such association met all the requirements of paragraphs (b) through (e), (h), and either subparagraph (1) or (2) of paragraph (f) for its first taxable year.

(3) *Years other than first and second taxable years.* For any taxable year of an association beginning after October 16, 1962, other than its first and second taxable years beginning after such date, subparagraph (2) of paragraph (f) applies if such association met either—

(i) The requirements of paragraphs (b) through (e), (f)(1), and (h) of this section for the immediately preceding taxable year, or

(ii) The requirements of paragraphs (b) through (e), (f)(2), and (h) of this section for the immediately preceding taxable year, and the requirements of paragraphs (b) through (e), (f)(1), and (h) of this section for the second preceding taxable year.

Thus, in years other than its first and second taxable years beginning after October 16, 1962, an association may apply the 41 percent of assets test for 2 consecutive years, but only if it met the 36 percent test (and all other tests) for the year previous to the 2 consecutive years.

(4) *Examples.* The provisions of paragraph (f) and this paragraph may be illustrated by the following examples in each of which it is assumed that the association at all times meets all the requirements of paragraphs (b) through (e) and (h) of this section and files its returns on a calendar year basis.

Example 1. An association has 41 percent of its assets invested in assets other than those defined in subparagraphs (2) through (8) of paragraph (d) of this section as of the close

of 1963 and 1964. Because 1963 is its first taxable year beginning after October 16, 1962, the 41 percent of assets test applies, and the association therefore qualifies as a domestic building and loan association for 1963. Because 1964 is its second taxable year beginning after such date and the 41 percent of assets test applied for its first taxable year, the 41 percent of assets test applies for 1964 and it therefor qualifies for such year.

Example 2. An association has 36 percent of its assets invested in assets other than those defined in subparagraphs (2) through (8) of paragraph (d) of this section as of the close of 1964, and 41 percent as of the close of 1965, 1966, and 1967. The association qualifies in 1965 because, as a result of having met the 36 percent of assets test for the immediately preceding taxable year (1964), the 41 percent of assets test applies to 1965. It qualifies in 1966 because as a result of having met the 41 percent of assets test in the immediately preceding taxable year (1965) and the 36 percent of assets test in the second preceding taxable year (1964), the 41 percent of assets test applies to 1966. The association would not qualify in 1967, however, because, although it met the 41 percent of assets test for the immediately preceding taxable year (1966), it did not meet the 36 percent of assets test in the second preceding taxable year (1965), and therefore the 41 percent of assets test does not apply to 1967.

Example 3. An association has more than 41 percent of its assets invested in assets other than those defined in subparagraphs (2) through (8) of paragraph (d) of this section as of the close of 1963, and 41 percent invested in such assets as of the close of 1964. The association does not qualify in either year. It does not qualify in 1963 because it exceeded the 41 percent limitation, and it does not qualify in 1964 because the 41 percent of assets test does not apply to 1964 since the association did not meet either the 41 percent of assets test or the 36 percent of assets test in the prior year (1963).

(h) *3 percent of assets test.* Not more than 3 percent of the amount of the total assets of a domestic building and loan association may consist of stock of any corporation, unless such stock is property which is defined in paragraph (d) of this section. The stock which constitutes property defined in such paragraph (d) is:

(1) Stock representing a withdrawable account in another financial institution;

(2) Stock of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof;

(3) Stock which was security for a loan and which, by reason of having been bid in at foreclosure or otherwise having been reduced to ownership or possession of the association, is a loan within the definition of such term in paragraph (j)(1) of this section; and

(4) Stock of a wholly owned subsidiary corporation which has as its exclusive activity the ownership and management of property more than 50 percent of the fair rental value of which is used as the principal or branch office of the association.

(i) [Reserved]

(j) *Definition of certain terms.* For purposes of this section—

(1) *Loan.* The term ''loan'' means debt, as the term ''debt'' is used in section 166 and the regulations thereunder. The term ''loan'' also includes a redeemable ground rent (as defined in section 1055(c)) which is owned by the taxpayer, and any property (referred to in this section as ''foreclosed property'') which was security for the payment of any indebtedness and which has been bid in at foreclosure, or otherwise been reduced to ownership or possession of the association by agreement or process of law, whether or not such property was acquired subsequent to December 31, 1962.

(2) *Secured.* A loan will be considered as ''secured'' only if the loan is on the security of any instrument (such as a mortgage, deed of trust, or land contract) which makes the interest of the debtor in the property described therein specific security for the payment of the loan, provided that such instrument is of such a nature that, in the event of default, the interest of the debtor in such property could be subjected to the satisfaction of the loan with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated.

(3) *Interest.* The word ''interest'' means an interest in real property which, under the law of the jurisdiction in which such property is situated, constitutes either (i) an interest in fee in such property, (ii) a leasehold interest in such property extending or renewable automatically for a period of at least 30 years, or at least 10 years beyond the date scheduled for the final

payment on a loan secured by an interest in such property, (iii) a leasehold interest in property described in paragraph (d)(7)(i) of this section (relating to certain home loans) extending for a period of at least 2 years beyond the date scheduled for the final payment on a loan secured by an interest in such property or (iv) a leasehold interest in such property held subject to a redeemable ground rent defined in section 1055(c).

(4) *Real property.* The term ''real property'' means any property which, under the law of the jurisdiction in which such property is situated, constitutes real property.

(5) *Improved real property.* The term ''improved real property'' means—

(i) Land on which is located any building of a permanent nature (such as a house, apartment house, office building, hospital, shopping center, warehouse, garage, or other similar permanent structure), provided that the value of such building is substantial in relation to the value of such land;

(ii) Any building lot or site which, by reason of installations and improvements that have been completed in keeping with applicable governmental requirements and with general practice in the community, is a building lot or site ready for the construction of any building of a permanent nature within the meaning of subdivision (i) of this subparagraph; or

(iii) Real property which, because of its state of improvement, produces sufficient income to maintain such real property and retire the loan in accordance with the terms thereof.

(6) *Construction loan.* The term ''construction loan'' means a loan, the proceeds of which are to be disbursed to the borrower (either by the association or a third party) as construction work progresses on real property which is security for the loan, which property is, or from the proceeds of such loan will become, improved real property.

(7) *Improvement loan.* The term ''improvement loan'' means a loan which, by its terms and conditions, requires that the proceeds of the loan be used for altering, repairing, or improving real property. If more than 85 percent of the proceeds of a single loan are to be used for such purposes, the entire loan will qualify. If 85 percent or less of the proceeds of a loan are to be used for such purposes, an allocation of its adjusted basis is required. Examples of loans which constitute improvement loans are loans made for the purpose of painting a house, adding a new room to a house, remodeling the lobby of an apartment building, and purchasing and installing storm windows, storm doors, and awnings. Examples of loans which do not constitute improvement loans are loans made for the purpose of purchasing draperies, and removable appliances, such as refrigerators, ranges, and washing machines. It is not necessary that a loan be secured by the real property which is altered, repaired, or improved.

(8) *Residential real property.* The term ''residential real property'' means real property which consists of one or more family units. A family unit is a building or portion thereof which contains complete living facilities which are to be used on other than a transient basis by only one family consisting of one or more persons. Thus, an apartment which is to be used on other than a transient basis by one family, which contains complete facilities for living, sleeping, eating, cooking, and sanitation constitutes a family unit. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, sanitariums, rest homes, and parks and courts for mobile homes do not normally constitute residential real property.

(k) *Amount and character of loans*—(1) *Treatment at time of determination*—(i) *In general.* The amount of a loan, as of the time the determination required by subparagraph (3) of this paragraph (k), is made, shall be treated for the purposes of this section as being secured:

(*a*) First by the portion of property, if any, defined in subparagraph (6), (7), or (8) of paragraph (d) of this section to the extent of the loan value thereof;

(*b*) Next by the portion of property, if any, defined in subparagraph (9) of paragraph (d) of this section to the extent of the loan value thereof; and

(*c*) Next by the portion of property, if any, defined in subparagraph (10) of paragraph (d) of this section to the extent of the loan value thereof.

To the extent that the amount of a loan exceeds the amount treated as being secured by property defined in subparagraphs (6) through (10) of paragraph (d) of this section, such loan shall be treated as property not defined in paragraph (d) of this section. If the loan value of any one category of property defined in paragraph (d) of this section exceeds 85 percent of the amount of the loan for which it is security then the entire loan shall be treated as a loan secured by such property.

(ii) *Loans of $40,000 or less.* Notwithstanding the provisions of subdivision (i) of this subparagraph, in the case of loans amounting to $40,000 or less as of the time of a determination, made on the security of property which is a combination of two or more categories or property defined in subparagraph (6) through (10) of paragraph (d) of this section, all such loans for any taxable year may, at the option of the association, be treated for the purposes of this section as being secured by the category of property the loan value of which constitutes the largest percentage of the total loan value of the property except to the extent that the loan is treated as property not defined in paragraph (d) of this section.

(iii) *Home loans of $20,000 or less.* Notwithstanding the provisions of subdivisions (i) and (ii) of this subparagraph, if a loan amounting to $20,000 or less as of the time of a determination, is secured partly by property of a category described in subparagraph (7) of paragraph (d) of this section (relating to a home loan), the amount of the loan shall, for the purposes of this section, be treated as a loan described in such subparagraph except to the extent that the loan is treated as property not defined in paragraph (d) of this section.

(2) *Treatment subsequent to time of determination.* The amount of a loan outstanding as of any time subsequent to the time of a determination shall be treated, for the purposes of this section, as being secured by each of the categories of property in the same ratio that the amount which was treated as being secured by each category bore to the total amount of the loan at the time as of which the determination was last made with respect to such loan.

(3) *Time of determination*—(i) *In general.* The determination of the amount of a loan which is treated as being secured by each of the categories of property shall be made:

(*a*) As of the time a loan is made;

(*b*) As of the time a loan is increased;

(*c*) As of the time any portion of the property which was security for the loan is released; and

(*d*) As of any time required by applicable Federal or State regulatory authorities for reappraisal or reanalysis of such loans.

(ii) *Special rule.* In the case of loans outstanding with respect to which no event described in subdivision (i) of this subparagraph has occurred in a taxable year beginning on or after October 17, 1962, the determination of the amounts of such loans which are treated as being secured by each of the categories of property may be made, at the option of the association, as of the close of the first taxable year beginning on or after such date, providing the determinations with respect to all such loans are made as of such date.

(4) *Loan value.* The loan value of property which is security for a loan is the maximum amount at the time as of which the determination is made which the association is permitted to lend on such property under the rules and regulations of applicable Federal and State regulatory authorities. Such loan value shall not exceed the fair market value of such property at such time as determined under such rules and regulations. However, in the case of loans made incidentally with and as a part of a bona fide salvage operation, the loan value of the security property shall be considered to be the face amount of the loan where the loan can be shown by the association to have been made for the primary purpose of recovering the investment of the association, and where such salvage operation is in conformity with rules and regulations of applicable Federal or State regulatory authorities.

(5) *Examples.* The following examples, in each of which it is assumed that X Savings and Loan Association files its return on a calendar year basis, illustrate the application of the rules in this paragraph:

Example 1. On July 1, 1963, X makes a single loan of $1 million to M Corporation which loan is secured by real property which is a combination of homes, apartments, and stores. As of the time the loan is made X determines that the loan values of the categories of property are as follows:

Category of property	Loan value
Home	$400,000
Multifamily	420,000
Nonresidential real property	240,000
Total	1,060,000

As of the time the loan is made, therefore, the $1,000,000 loan is treated under subparagraph (1)(i) of this paragraph as being secured as follows:

Category of loan	Amount of loan	Percentage of total
Home loan	$400,000	40
Multifamily loan	420,000	42
Nonresidential real property loan	180,000	18
Total	1,000,000	100

Assuming that the $1 million loan to M was reduced to $900,000 as of the close of 1963, that there were no increases in the amount of the loan and no releases of property which was security for the loan, and that there was no regulatory requirement to reappraise or reanalyze the loan, such loan will be considered under subparagraph (2) of this paragraph to be secured, as of the close of 1963, as follows:

Category	Percentage as of last determination July 1, 1963	Amount as of Dec. 31, 1963	
Home	40	$360,000	(40%×$900,000)
Multifamily	42	378,000	(42%×$900,000)
Nonresidential real property	18	162,000	(18%×$900,000)
Total		900,000	

Example 2. X makes a loan of $40,000 secured by a building which contains a store on the first floor and four family units on the upper floors. The loan value of the part of the building used as a store is $21,000 and the loan value of the residential portion is $23,000. The loan will be treated under subdivision (i) of subparagraph (1) of this paragraph as a loan secured by residential real property containing four or fewer family units to the extent of $23,000, and by nonresidential property to the extent of $17,000, as of the time the loan is made. However, if X exercises the option to treat all loans of $40,000 or less in accordance with subdivision (ii) of subparagraph (1) of this paragraph, this loan would be treated as a home loan to the extent of the full $40,000 because the loan value of the residential portion is larger than the loan value of the nonresidential part.

(l) *Computation of percentages*—(1) *In general.* The percentages specified in paragraphs (d) through (h) of this section shall, except as provided in subparagraph (3) of this paragraph (l), be computed by comparing the amount of the assets described in each paragraph as of the close of the taxable year with the total amount of assets as of the close of the taxable year. The amount of the assets in any category and the total amount of assets shall be determined with reference to their adjusted basis under §1.1011–1, or by such other method as is in accordance with sound accounting principles, provided such method is used in valuing all the assets in a taxable year.

(2) *Treatment of certain assets and reserves.* For purposes of this paragraph (l):

(i) Reserves for bad debts established pursuant to section 593, or corresponding provisions of prior law, and the regulations thereunder shall not constitute a reduction of total assets, but shall be treated as a surplus or net worth item.

(ii) The adjusted basis of a ''loan in process'' does not include the unadvanced portion of such loan.

(iii) Advances made by the association for taxes, insurance, etc., on loans shall be treated as being in the same category as the loan with respect to which the advances are made (irrespective of whether the advances are secured by the property securing the loan).

(iv) Interest receivable included in gross income shall be treated as being in the same category as the loan or asset with respect to which it is earned.

(v) The unamortized portion of premiums paid on mortgage loans acquired by the association shall be considered part of the acquisition cost of such loans.

(vi) Prepaid Federal Savings and Loan Insurance Corporation premiums shall be treated as being governmental obligations defined in paragraph (d)(3) of this section.

(vii) Accounts receivable (other than accrued interest receivable), and prepaid expenses and deferred charges other than those referred to in subdivision (v) or (vi) of this subparagraph, shall be disregarded both as separate categories and in the computation of total assets.

(viii) Foreclosed property (as defined in paragraph (j)(1) of this section) shall be treated as having the same character as the loan for which it was given as security.

(3) *Alternative method.* At the option of the taxpayer, the percentages specified in paragraphs (d) through (h) of this section may be computed on the basis of the average assets outstanding during the taxable year. Such average shall be determined by making the computation provided in subparagraph (1) of this paragraph (l), either as of the close of each month, as of the close of each quarter, or semiannually during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentages obtained for each category. The method selected must be applied uniformly for the taxable year to all categories of assets, but the method may be changed from year to year.

(4) *Acquisition of certain assets.* For the purpose of the annual computation of percentages under subparagraph (1) of this paragraph (l)—

(i) Assets which, within a 60-day period beginning in one taxable year of the taxpayer and ending in the next year, are acquired directly or indirectly through borrowing and then repaid or disposed of within such period, shall be considered assets other than those defined in paragraph (d) of this section, unless both the acquisition and disposition are established to the satisfaction of the district director to have been for bona fide purposes; and

(ii) The amount of cash shall not include amounts received directly or indirectly from another financial institution (other than a Federal Home Loan Bank or a similar institution organized under State law) to the extent of the amount of cash which an association has on deposit or holds as a withdrawable account in such other financial institution.

(5) *Reporting requirements.* In the case of income tax returns for taxable years ending after October 31, 1964, there shall be filed with the return a statement showing the amount of assets as of the close of the taxable year in each of the categories defined in paragraph (d), and in the category described in paragraph (h) of this section, and a brief description and amount of all other assets. If the alternative method of computing percentages under subparagraph (3) of this paragraph (l) is selected, such statement shall show such information as of the end of each month, each quarter, or semiannually and the manner of calculating the averages. With respect to taxable years beginning after October 16, 1962, and ending before November 1, 1964, taxpayers shall maintain adequate records to establish to the satisfaction of the district director that it meets the various assets tests specified in this section.

(6) *Example.* The principles of this paragraph may be illustrated by the following example in which a description of the assets, the subparagraph of paragraph (d) in which the assets are defined, the amount of the assets, and the percentage of the total assets included in the calculation are set forth.

SAVINGS AND LOAN ASSOCIATION ASSETS AS OF DECEMBER 31, 1964

Item	Described in paragraph (d), subparagraph	Amount	Percentage
1. Cash	(2)	$1,000,000	1
2. Governmental obligations [1]	(3)	8,000,000	8
3. Deposit insurance company securities	(4)	1,000,000	1

SAVINGS AND LOAN ASSOCIATION ASSETS AS OF DECEMBER 31, 1964—Continued

Item	Described in paragraph (d), subparagraph	Amount	Percentage
Loans outstanding:[2]			
4. Home	(7)	59,000,000	59
5. Church	(8)	1,000,000	1
6. Multifamily	(9)	20,000,000	20
7. Nonresidential real property	(10)	5,000,000	5
8. Passbook	(6)	1,000,000	1
9. Other		2,000,000	2
Fixed assets (less depreciation reserves):			
10. Used in the association's business	(5)	1,000,000	1
11. Rented to others		500,000	.5
12. Land held for investment		500,000	.5
13. Total assets included for purposes of this paragraph		100,000,000	100.0%
14. Accounts receivable		100,000	(disregarded)
15. Prepaid expenses (other than prepaid FSLIC premiums)		1,000,000	(disregarded)
16. Deferred charges		1,000,000	(disregarded)
17. Total assets		102,100,000	

[1] Prepaid FSLIC premiums treated as governmental obligations.
[2] Not including unadvanced portion of loans in process, but including interest receivable and advances with respect to loans.

The computation of the percentages of assets in the various categories for the purpose of determining whether the percentage of assets tests in the paragraphs in this section are met as of the close of the year are as follows:

Test and paragraph	Items considered	Percentage
90 percent test (d)	the sum of items 1 through 8 and 10 item—13 (total included assets)	=97 percent
18 percent test (e)	the sum of items 7, 9, 11, and 12—item 13 (total included assets)	=8 percent
36 percent test (f)	the sum of items 6, 7, 9, 11, and 12—item 13 (total included assets)	=28 percent
3 percent test (h)	0—item 13 (total included assets)	=0 percent

At the option of the association, the computations listed above could have been made as of the close of each month, each quarter, or semiannually, and averaged for the entire year.

(m) *Taxable years beginning before October 17, 1962.* For taxable years beginning before October 17, 1962, the term ''domestic building and loan association'' means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association substantially all the business of which is confined to making loans to members.

[32 FR 15241, Nov. 3, 1967, as amended by T.D. 7622, 44 FR 28661, May 16, 1979]

§ 301.7701–13A Post-1969 domestic building and loan association.

(a) *In general.* For taxable years beginning after July 11, 1969, the term ''domestic building and loan association'' means a domestic building and loan association, a domestic savings and loan association, a Federal savings and loan association, and any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law which meets the supervisory test (described in paragraph (b) of this section), the business operations test (described in paragraph (c) of this section), and the assets test (described in paragraph (d) of this section). For the definition of the term ''domestic building and loan association'' for taxable years beginning after October 16, 1962, and before July 12, 1969, see § 301.7701–13.

(b) *Supervisory test.* A domestic building and loan association must be either (1) an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C. 1724(a)) or (2) subject by law to supervision and examination by State or Federal authority having supervision over such associations. An ''insured institution'' is one the accounts of which are insured by the Federal Savings and Loan Insurance Corporation.

(c) *Business operations test*—(1) *In general.* An association must utilize its assets so that its business consists principally of acquiring the savings of the

public and investing in loans. The requirement of this paragraph is referred to in this section as the business operations test. The business of acquiring the savings of the public and investing in loans includes ancillary or incidental activities which are directly and primarily related to such acquisition and investment, such as advertising for savings, appraising property on which loans are to be made by the association, and inspecting the progress of construction in connection with construction loans. Even though an association meets the supervisory test described in paragraph (b) of this section and the assets test described in paragraph (d) of this section, it will nevertheless not qualify as a domestic building and loan association if it does not meet the requirements of both paragraphs (2) and (3) of this paragraph (c), relating, respectively, to acquiring the savings of the public and investing in loans.

(2) *Acquiring the savings of the public.* The requirement that an association's business (other than investing in loans) must consist principally of acquiring the savings of the public ordinarily will be considered to be met if savings are acquired in all material respects in conformity with the rules and regulations of the Federal Home Loan Bank Board or substantially equivalent rules of a State law or supervisory authority. Alternatively, such requirement will be considered to be met if more than 75 percent of the dollar amount of the total deposits, withdrawable shares, and other obligations of the association are held during the taxable year by the general public, as opposed to amounts deposited or held by family or related business groups or persons who are officers or directors of the association. However, the preceding sentence shall not apply if the dollar amount of other obligations of the association outstanding during the taxable year exceeds 25 percent of the dollar amount of the total deposits, withdrawable shares, and other obligations of the association outstanding during such year. For purposes of this paragraph, the term ''other obligations'' means notes, bonds, debentures, or other obligations, or other securities (except capital stock), issued by an association in conformity with the rules and regulations of the Federal Home Loan Bank Board or substantially equivalent rules of a State law or supervisory authority. The term ''other obligations'' does not include an advance made by a Federal Home Loan Bank under the authority of section 10 or 10b of the Federal Home Loan Bank Act (12 U.S.C. 1430, 1430b) as amended and supplemented. Both percentages specified in this paragraph shall be computed either as of the close of the taxable year or, at the option of the taxpayer, on the basis of the average of the dollar amounts of the total deposits, withdrawable shares, and other obligations of the association held during the taxable year. Such averages shall be determined by computing each percentage specified either as of the close of each month, as of the close of each quarter, or semiannually during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentages obtained. The method selected must be applied uniformly for the taxable year to both percentages, but the method may be changed from year to year.

(3) *Investing in loans*—(i) *In general.* The requirement that an association's business (other than acquiring the savings of the public) must consist principally of investing in loans will be considered to be met for a taxable year only if more than 75 percent of the gross income of the association consists of—

(*a*) Interest or dividends on assets defined in paragraphs (1), (2), and (3) of paragraph (e) of this section,

(*b*) Interest on loans,

(*c*) Income attributable to the portion of property used in the association's business, as defined in paragraph (e)(11) of this section,

(*d*) So much of the amount of premiums, discounts, commissions, or fees (including late charges and penalties) on loans which have at some time been held by the association, or for which firm commitments have been issued, as is not in excess of 20 percent of the gross income of the association,

(*e*) Net gain from sales and exchanges of governmental obligations, as defined in paragraph (e)(2) of this section, or

(*f*) Income, gain or loss attributable to foreclosed property, as defined in paragraph (e)(9) of this section, but not including such income, gain or loss which, pursuant to section 595 and the regulations thereunder, is not included in gross income.

Examples of types of income which would cause an association to fail to meet the requirements of this paragraph if, in the aggregate, they equal or exceed 25 percent of gross income, are: The excess of gains over losses from sales of real property (other than foreclosed property); rental income (other than on foreclosed property and the portion of property used in the association's business); premiums, commissions, and fees (other than commitment fees) on loans which have never been held by the association; and insurance brokerage fees.

(ii) *Computation of gross income.* For purposes of this paragraph, gross income is computed without regard to—

(*a*) Gain or loss on the sale or exchange of the portion of property used in the association's business as defined in paragraph (e)(11) of this section.

(*b*) Gain or loss on the sale or exchange of the rented portion of property used as the principal or branch office of the association, as defined in paragraph (e)(11) of this section, and

(*c*) Gains or losses on sales of participations, and loans, other than governmental obligations defined in paragraph (e)(2) of this section.

For purposes of this paragraph, gross income is also computed without regard to items of income which an association establishes arise out of transactions which are necessitated by exceptional circumstances and which are not undertaken as recurring business activities for profit. Thus, for example, an association would meet the investing in loans requirement if it can establish that it would otherwise fail to meet that requirement solely because of the receipt of a nonrecurring item of income due to exceptional circumstances. For this purpose, transactions necessitated by an excess of demand for loans over savings capital in the association's area are not to be deemed to be necessitated by exceptional circumstances. For purposes of paragraph (c)(3)(ii)(*c*) of this section, the term ''sales of participations'' means sales by an association of interests in loans, which sales meet the requirements of the regulations of the Federal Home Loan Bank Board relating to sales of participations, or which meet substantially equivalent requirements of State law or regulations relating to sales of participations.

(iii) *Reporting requirement.* In the case of income tax returns for taxable years beginning after July 11, 1969, there is required to be filed with the return a statement showing the amount of gross income for the taxable year in each of the categories described in paragraph (c)(3)(i) of this section.

(d) *60 percent of assets test.* At least 60 percent of the amount of the total assets of a domestic building and loan association must consist of the assets defined in paragraph (e) of this section. The percentage specified in this paragraph is computed as of the close of the taxable year or, at the option of the taxpayer, may be computed on the basis of the average assets outstanding during the taxable year. Such average is determined by making the appropriate computation described in this section either as of the close of each month, as of the close of each quarter, or semiannually during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentage obtained for each category of assets defined in paragraph (e) of this section. The method selected must be applied uniformly for the taxable year to all categories of assets, but the method may be changed from year to year. For purposes of this paragraph, it is immaterial whether the association originated the loans defined in paragraphs (4) through (8) and (10) of paragraph (e) of this section or purchased or otherwise acquired them in whole or in part from another. See paragraph (f) of this section for definition of certain terms used in this paragraph and in paragraph (e) of this section, and for the determination of amount and character of loans.

(e) *Assets defined.* The assets defined in this paragraph are—

(1) *Cash.* The term ''cash'' means cash on hand, and time or demand deposits with, or withdrawable accounts in, other financial institutions.

(2) *Governmental obligations.* The term ''governmental obligations'' means—

(i) Obligations of the United States,

(ii) Obligations of a State or political subdivision of a State, and

(iii) Stock or obligations of a corporation which is an instrumentality of the United States, a State, or a political subdivision of a State,

other than obligations the interest on which is excludable from gross income under section 103 and the regulations thereunder.

(3) *Deposit insurance company securities.* The term ''deposit insurance company securities'' means certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations.

(4) *Passbook loan.* The term ''passbook loan'' means a loan to the extent secured by a deposit, withdrawable share, or savings account in the association, or share of a member of the association, with respect to which a distribution is allowable as a deduction under section 591.

(5) *Residential real property loan.* [Reserved]

(6) *Church loan.* [Reserved]

(7) *Urban renewal loan.* [Reserved]

(8) *Institutional loan.* [Reserved]

(9) *Foreclosed property.* [Reserved]

(10) *Educational loan.* [Reserved]

(11) *Property used in the association's business*—(i) *In general.* The term ''property used in the association's business'' means land, buildings, furniture, fixtures, equipment, leasehold interests, leasehold improvements, and other assests used by the association in the conduct of its business of acquiring the savings of the public and investing in loans. Real property held for the purpose of being used primarily as the principal or branch office of the association constitutes property used in the association's business so long as it is reasonably anticipated that such property will be occupied for such use by the association, or that construction work preparatory to such occupancy will be commenced thereon, within 2 years after acquisition of the property. Stock of a wholly owned subsidiary corporation which has as its exclusive activity the ownership and management of property more than 50 percent of the fair rental value of which is used as the principal or branch office of the association constitutes property used in such business. Real property held by an association for investment or sale, even for the purpose of obtaining mortgage loans thereon, does not constitute property used in the association's business.

(ii) *Property rented to others.* Except as provided in the second sentence of paragraph (11)(i) of this paragraph (e), property or a portion thereof rented by the association to others does not constitute property used in the association's business. However, if the fair rental value of the rented portion of a single piece of real property (including appurtenant parcels) used as the principal or branch office of the association constitutes less than 50 percent of the fair rental value of such piece of property, or if such property has an adjusted basis of not more than $150,000, the entire property shall be considered used in such business. If such rented portion constitutes 50 percent or more of the fair rental value of such piece of property, and such property has an adjusted basis of more than $150,000, an allocation of its adjusted basis is required. The portion of the total adjusted basis of such piece of property which is deemed to be property used in the association's business shall be equal to an amount which bears the same ratio to such total adjusted basis as the amount of the fair rental value of the portion used as the principal or branch office of the association bears to the total fair rental value of such property. In the case of all property other than real property used or to be used as the principal or branch office of the association, if the fair rental value of the rented portion thereof constitutes less than 15 percent of the fair rental value of such property, the entire property shall be considered used in the association's business. If such rented portion constitutes 15 percent or more of the fair rental value of such property, an allocation of its adjusted basis (in the same manner as required for real property used as the principal or branch office) is required.

(12) *Regular or residual interest in a REMIC*—(i) *In general.* If for any calendar quarter at least 95 percent of a REMIC's assets (as determined in accordance with §1.860F–4(e)(1)(ii) or §1.6049–7(f)(3) of this chapter) are assets defined in paragraph (e)(1) through (e)(11) of this section, then for that calendar quarter all the regular and residual interests in that REMIC are treated as assets defined in this paragraph (e). If less than 95 percent of a REMIC's assets are assets defined in paragraph (e)(1) through (e)(11) of this section, the percentage of each REMIC regular or residual interest treated as an asset defined in this paragraph (e) is equal to the percentage of the REMIC's assets that are assets defined in paragraph (e)(1) through (e)(11) of this section. See §§1.860F–4(e)(1)(ii)(B) and 1.6049–7(f)(3) of this chapter for information required to be provided to regular and residual interest holders if the 95 percent test is not met.

(ii) *Loans secured by manufactured housing.* For purposes of paragraph (e)(12)(i) of this section, a loan secured by manufactured housing treated as a single family residence under section 25(e)(10) is an asset defined in paragraph (e)(1) through (e)(11) of this section.

(f) *Special rules.* [Reserved]

[T.D. 7622, 44 FR 28661, May 16, 1979; 44 FR 29048, May 18, 1979, as amended by T.D. 8458, 57 FR 61313, Dec. 24, 1992]

§ 301.7701–14 Cooperative bank.

For taxable years beginning after October 16, 1962, the term ''cooperative bank'' means an institution without capital stock organized and operated for mutual purposes without profit which meets the supervisory test, the business operations test, and the various assets tests specified in paragraphs (d) through (h) of §301.7701–13, employing the rules and definitions of paragraphs (j) through (l) of that section. In applying paragraphs (b) through (l) of such section any references to an ''association'' or to a ''domestic building and loan association'' shall be deemed to be a reference to a cooperative bank.

§ 301.7701–15 Income tax return preparer.

(a) *In general.* An income tax return preparer is any person who prepares for compensation, or who employs (or engages) one or more persons to prepare for compensation, other than for the person, all or a substantial portion of any return of tax under subtitle A of the Internal Revenue Code of 1954 or of any claim for refund of tax under subtitle A of the Internal Revenue Code of 1954.

(1) A person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered an income tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund. See also paragraph (b) of this section.

(2) A person who only gives advice on specific issues of law shall not be considered an income tax return preparer, unless—

(i) The advice is given with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of contemplated actions; and

(ii) The advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund. For example, if a lawyer gives an opinion on a transaction which a corporation has consummated, solely to satisfy an accountant (not at the time a preparer of the corporation's return) who is attempting to determine whether the reserve for taxes set forth in the corporation's financial statement is reasonable, the lawyer shall not be considered a tax return preparer solely by reason of rendering such opinion.

(3) A person may be an income tax return preparer without regard to educational qualifications and professional status requirements.

(4) A person must prepare a return or claim for refund for compensation to be an income tax return preparer. A person who prepares a return or claim for refund for a taxpayer with no explicit or implicit agreement for compensation is not a preparer, even

though the person receives a gift or return service or favor.

(5) A person who prepares a return or claim for refund outside the United States is an income tax return preparer, regardless of his nationality, residence, or the locations of his places of business, if the person otherwise satisfies the definition of income tax return preparer. Notwithstanding the provisions of §301.6109–1(g), the person shall secure an employer identification number if he is an employer of another preparer, is a partnership in which one or more of the general partners is a preparer, or is an individual not employed (or engaged) by another preparer. The person shall comply with the provisions of section 1203 of the Tax Reform Act of 1976 and the regulations thereunder.

(6) An official or employee of the Internal Revenue Service performing his official duties is not an income tax return preparer.

(7) The following persons are not income tax return preparers:

(i) Any individual who provides tax assistance under a Volunteer Income Tax Assistance (VITA) program established by the Internal Revenue Service;

(ii) Any organization sponsoring or administering a Volunteer Income Tax Assistance (VITA) program established by the Internal Revenue Service, but only with respect to that sponsorship or administration;

(iii) Any individual who provides tax counseling for the elderly under a program established pursuant to section 163 of the Revenue Act of 1978; and

(iv) Any organization sponsoring or administering a program to provide tax counseling for the elderly established pursuant to section 163 of the Revenue Act of 1978, but only with respect to that sponsorship or administration.

(b) *Substantial preparation.* (1) Only a person (or persons acting in concert) who prepares all or a substantial portion of a return or claim for refund shall be considered to be a preparer (or preparers) of the return or claim for refund. A person who renders advice which is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund, will be regarded as having prepared that entry. Whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined by comparing the length and complexity of, and the tax liability or refund involved in, that portion to the length and complexity of, and tax liability or refund involved in, the return or claim for refund as a whole.

(2) For purposes of applying the rule of paragraph (b)(1) of this section, if the schedule, entry, or other portion of the return or claim for refund involves amounts of gross income, amounts of deductions, or amounts on the basis of which credits are determined which are—

(i) Less than $2,000; or

(ii) Less than $100,000, and also less than 20 percent of the gross income (or adjusted gross income if the taxpayer is an individual) as shown on the return or claim for refund,

then the schedule or other portion is not considered to be a substantial portion. If more than one schedule, entry or other portion is involved, they shall be aggregated in applying the rule of this paragraph (b)(2). Thus, if a person, for an individual taxpayer's return, prepares a schedule for dividend income which totals $1,500 and gives advice making him a preparer of a schedule of medical expenses which results in a deduction for medical expenses of $1,500, the person is not a preparer if the taxpayer's adjusted gross income shown on the return is more than $15,000. This paragraph shall not apply to a person who prepares all of a return or claim for refund.

(3) A preparer of a return is not considered to be a preparer of another return merely because an entry or entries reported on the return may affect an entry reported on the other return, unless the entry or entries reported on the prepared return are directly reflected on the other return and constitute a substantial portion of the other return. For example, the sole preparer of a partnership return of income or a small business corporation income tax return is considered a preparer of a partner's or a shareholder's return if the entry or entries on the partnership or small business corporation return reportable on the partner's or shareholder's return constitute a

substantial portion of the partner's or shareholder's return.

(c) *Return and claim for refund*—(1) *Return.* A return of tax under subtitle A is a return filed by or on behalf of a taxpayer reporting the liability of the taxpayer for tax under subtitle A. A return of tax under subtitle A also includes an information return filed by or on behalf of a person or entity that is not a taxable entity and which reports information which is or may be reported on the return of a taxpayer of tax under subtitle A.

(i) A return of tax under subtitle A includes an individual or corporation income tax return, a fiduciary income tax return (for a trust or estate), a regulated investment company undistributed capital gains tax return, a return of a charitable remainder trust, a return by a transferor of stock or securities to a foreign corporation, foreign trust, or foreign partnership, a partnership return of income, a small business corporation income tax return, and a DISC return.

(ii) A return of tax under subtitle A does not include an estate tax return, a gift tax return, any other return of excise taxes or income taxes collected at source on wages, an individual or corporation declaration of estimated tax, an application for an extension of time to file an individual or corporation income tax return, or an information statement on Form 990, any Form 1099, or similar form.

(2) *Claim for refund.* A claim for refund of tax under subtitle A includes a claim for credit against any tax under subtitle A.

(d) *Persons who are not preparers.* A person shall not be considered to be a preparer of a return or claim for refund if the person performs only one or more of the following services:

(1) Typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund.

(2) Preparation of a return or claim for refund of a person, or an officer, a general partner, or employee of a person, by whom the individual is regularly and continuously employed or in which the individual is a general partner.

(3) Preparation of a return or claim for refund for a trust or estate of which the person either is a fiduciary or is an officer, general partner, or employee of the fiduciary.

(4) Preparation of a claim for refund for a taxpayer in response to—

(i) A notice of deficiency issued to the taxpayer; or

(ii) A waiver of restriction after initiation of an audit of the taxpayer or another taxpayer if a determination in the audit of the other taxpayer affects, directly or indirectly, the liability of the taxpayer for tax under subtitle A.

For purposes of paragraph (d)(2) of this section, the employee of a corporation owning more than 50 percent of the voting power of another corporation, or the employee of a corporation more than 50 percent of the voting power of which is owned by another corporation, is considered the employee of the other corporation as well. For purposes of paragraph (d)(3) of this section, an estate, guardianship, conservatorship, committee, and any similar arrangement for a taxpayer under a legal disability (such as a minor, an incompetent, or an infirm individual) is considered a trust or estate.

[T.D. 7675, 45 FR 11468, Feb. 21, 1980]

§ 301.7701–16 Other terms.

For a definition of the term ''withholding agent'' see § 1.1441–7(a). Any other terms that are defined in section 7701 and that are not defined in §§ 301.7701–1 to 301.7701–15, inclusive, shall, when used in this chapter, have the meanings assigned to them in section 7701.

(Secs. 1441(c)(4) (80 Stat. 1553; 26 U.S.C. 1441(c)(4)), 3401(a)(6) (80 Stat. 1554; 26 U.S.C. 3401(a)(6)), and 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954)

[T.D. 7977, 49 FR 36836, Sept. 20, 1984]

§ 301.7701–17T Collective-bargaining plans and agreements (temporary).

Q–1: How did the Tax Reform Act of 1984 (TRA of 1984) change the laws with respect to plans that are maintained pursuant to collective bargaining agreements?

A–1: (a) Many of the requirements and rules applicable to deferred compensation and welfare benefit plans are different for plans maintained pursuant to a collective bargaining agreement.

Prior to the TRA of 1984, the Internal Revenue Code provided no clear definition of an employee representative or whether there is a collective bargaining agreement between such employee representative and one or more employers.

(b) Section 526(c) of the TRA of 1984 added a new condition under a new section 7701(a)(46) that must be satisfied in order for a plan to be considered to be a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers for purposes of the Code after March 31, 1984. If more than one-half of the membership of an organization is comprised of owners, officers, and executives of employers covered by the plan, then such organization is not an employee representative for purposes of determining whether a plan is to be treated as maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers. Whether an individual is an owner, officer or executive is to be determined separately with respect to each employer. Additionally, section 7701(a)(46) provides that the Internal Revenue Service shall make the determination for purposes of the Code as to whether there is a collective bargaining agreement between employee representatives and one or more employers.

Q–2: If an organization does not fail to be an employee representative under the 50 percent or less test of section 7701(a)(46), is a plan maintained pursuant to an agreement between such organization and one or more employers necessarily treated, under the Code, as a plan maintained pursuant to a collective bargaining agreement between an employee representative and one or more employers?

A–2: (a) No.

(b) Specific Code provisions generally require other conditions than that in section 7701(a)(46) to be satisfied in order for a plan to be considered to be collectively-bargained. For example, in order for a plan to be described in section 413(a), the Secretary of Labor must find that the plan is maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers.

(c) Even if (1) the finding in the example in the preceding paragraph (b) is made by the Secretary of Labor, (2) the union has been recognized as exempt under section 501(c)(5), and (3) the percentage condition in section 7701(a)(46) is satisfied, the Internal Revenue Service has the authority, pursuant to section 7701(a)(46), to determine whether there is a collective bargaining agreement under the Code.

[T.D. 8073, 51 FR 4337, Feb. 4, 1986]

§ 301.7701(b)–0 Outline of regulation provision for section 7701(b)–1 through (b)–9.

This section lists the paragraphs contained in §§ 301.7701(b)–1 through 301.7701(b)–9.

§ 301.7701(b)–1 Resident alien.

(a) Scope.
(b) Lawful permanent resident.
  (1) Green card test.
  (2) Rescission of resident status.
  (3) Administrative or judicial determination of abandonment of resident status.
(c) Substantial presence test.
  (1) In general.
  (2) Determination of presence.
  (i) Physical presence.
  (ii) United States.
  (3) Current year.
  (4) Thirty-one day minimum.
(d) Application of section 7701(b) to the possessions and territories.
  (1) Application to aliens.
  (2) Non-application to citizens.
(e) Examples.

§ 301.7701(b)–2 Closer connection exception.

(a) In general.
(b) Foreign country.
(c) Tax home.
  (1) Definition.
  (2) Duration and nature of tax home.
(d) Closer connection to a foreign country.
  (1) In general.
  (2) Permanent home.
(e) Special rule.
(f) Closer connection exception unavailable.
(g) Filing requirements.

§ 301.7701(b)–3 Days of presence in the United States that are excluded for purposes of section 7701(b).

(a) In general.
(b) Exempt individuals.
  (1) In general.
  (2) Foreign government-related individual.
  (i) In general.

[T.D. 8411, 57 FR 15241, Apr. 27, 1992; 58 FR 17516, Apr. 5, 1993; as amended by T.D. 8733, 62 FR 53386, Oct. 14, 1997]

§ 301.7701(b)–1 Resident alien.

(a) *Scope.* Section 301.7701(b)–1(b) provides rules for determining whether an

alien individual is a lawful permanent resident of the United States. Section 301.7701(b)–1(c) provides rules for determining if an alien individual satisfies the substantial presence test. Section 301.7701(b)–2 provides rules for determining when an alien individual will be considered to maintain a tax home in a foreign country and to have a closer connection to that foreign country. Section 301.7701(b)–3 provides rules for determining if an individual is an exempt individual because of his or her status as a foreign government-related individual, teacher, trainee, student, or professional athlete. Section 301.7701(b)–3 also provides rules for determining whether an individual may exclude days of presence in the United States because the individual was unable to leave the United States because of a medical condition. Section 301.7701(b)–4 provides rules for determining an individual's residency starting and termination dates. Section 301.7701(b)–5 provides rules for applying section 877 to a nonresident alien individual. Section 301.7701(b)–6 provides rules for determining the taxable year of an alien. Section 301.7701(b)–7 provides rules for determining the effect of these regulations on rules in tax conventions to which the United States is a party. Section 301.7701(b)–8 provides procedural rules for establishing that an individual is a nonresident alien. Section 301.7701(b)–9 provides the effective dates of section 7701(b) and the regulations under that section. Unless the context indicates otherwise, the regulations under §§ 301.7701(b)–1 through 301.7701(b)–9 apply for purposes of determining whether a United States citizen is also a resident of the United States. (This determination may be relevant, for example, to the application of section 861(a)(1) which treats income from interest-bearing obligations of residents as income from sources within the United States.) The regulations do not apply and §§ 1.871–2 and 1.871–5 of this chapter continue to apply for purposes of the bona fide residence test of section 911. See § 1.911–2(c) of this chapter. For purposes of determining whether an individual is a resident of the United States for estate and gift tax purposes, see § 20.0–1(b)(1) and (2) and § 25.2501–1(b) of this chapter, respectively.

(b) *Lawful permanent resident*—(1) *Green card test.* An alien is a resident alien with respect to a calendar year if the individual is a lawful permanent resident at any time during the calendar year. A lawful permanent resident is an individual who has been lawfully granted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws. Resident status is deemed to continue unless it is rescinded or administratively or judicially determined to have been abandoned.

(2) *Rescission of resident status.* Resident status is considered to be rescinded if a final administrative or judicial order of exclusion or deportation is issued regarding the alien individual. For purposes of this paragraph, the term ''final judicial order'' means an order that is no longer subject to appeal to a higher court of competent jurisdiction.

(3) *Administrative or judicial determination of abandonment of resident status.* An administrative or judicial determination of abandonment of resident status may be initiated by the alien individual, the Immigration and Naturalization Service (INS), or a consular officer. If the alien initiates this determination, resident status is considered to be abandoned when the individual's application for abandonment (INS Form I–407) or a letter stating the alien's intent to abandon his or her resident status, with the Alien Registration Receipt Card (INS Form I–151 or Form I–551) enclosed, is filed with the INS or a consular officer. If INS replaces any of the form numbers referred to in this paragraph or § 301.7701(b)–2(f), refer to the comparable INS replacement form number. For purposes of this paragraph, an alien individual shall be considered to have filed a letter stating the intent to abandon resident status with the INS or a consular office if such letter is sent by certified mail, return receipt requested (or a foreign country's equivalent thereof). A copy of the letter, along with proof that the letter was mailed and received, should be retained by the alien individual. If the INS or a

consular officer initiates this determination, resident status will be considered to be abandoned upon the issuance of a final administrative order of abandonment. If an individual is granted an appeal to a federal court of competent jurisdiction, a final judicial order is required.

(c) *Substantial presence test*—(1) *In general.* An alien individual is a resident alien if the individual meets the substantial presence test. An individual satisfies this test if he or she has been present in the United States on at least 183 days during a three year period that includes the current year. For purposes of this test, each day of presence in the current year is counted as a full day. Each day of presence in the first preceding year is counted as one-third of a day and each day of presence in the second preceding year is counted as one-sixth of a day. For purposes of this paragraph, any fractional days resulting from the above calculations will not be rounded to the nearest whole number. (See § 301.7701(b)–9(b)(2) for transitional rules for calendar years 1985 and 1986.)

(2) *Determination of presence*—(i) *Physical presence.* For purposes of the substantial presence test, an individual shall be treated as present in the United States on any day that he or she is physically present in the United States at any time during the day. (But see § 301.7701(b)–3 relating to days of presence that may be excluded.)

(ii) *United States.* For purposes of section 7701(b) and the regulations thereunder, the term *United States* when used in a geographical sense includes the states and the District of Columbia. It also includes the territorial waters of the United States and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. It does not include the possessions and territories of the United States or the air space over the United States.

(3) *Current year.* The term *current year* means any calendar year for which an alien individual is determining his or her resident status.

(4) *Thirty-one day minimum.* If an individual is not physically present for more than 30 days during the current year, the substantial presence test will not be applied for that year even if the three-year total is 183 or more days. For purposes of the substantial presence test, it is irrelevant that an individual was not present for more than 30 days in the first or second year preceding the current year.

(d) *Application of section 7701(b) to the possessions and territories*—(1) *Application to aliens.* Section 7701(b) provides the basis for determining whether an alien individual is a resident of a United States possession or territory that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term ''United States'' where appropriate) to those in force in the United States. If, after the application of section 7701(b) and the regulations thereunder, an alien individual is a resident of the United States and a resident of a United States possession or territory, the principles of § 301.7701(b)–2 (d) (relating to significant contacts maintained by an individual with a foreign country) shall be applied in order to establish that the individual is a resident alien of either the United States or a United States possession or territory, but not both. See § 1.933–1 (a) of this chapter for determining whether an individual (including a U.S. citizen or national) is a bona fide resident of Puerto Rico. See section 931 and the regulations thereunder for the determination of whether an individual (including a U.S. citizen or national) is a bona fide resident of American Samoa.

(2) *Non-application to citizens.* Section 7701(b) does not provide the basis for determining whether a United States citizen or national is a bona fide resident of a United States possession or territory. For example, a United States citizen who is present in a United States possession or territory for 183 days during a calendar year will not automatically be a ''bona fide resident'' of that possession or territory.

Whether a United States citizen or national is a bona fide resident of a possession or territory is determined under sections 931 through 933 and §1.935–1 to the extent it remains effective after December 31, 1984.

(e) *Examples.* This section may be illustrated by the following examples:

Example 1. B, an alien individual, is present in the United States for 122 days in the current year. He was present in the United States for 122 days in the first preceding calendar year and for 122 days in the second preceding calendar year. In determining his status for the current year, B counts all 122 days in the United States in the current year plus ⅓ of the 122 days in the United States in the first preceding calendar year (40⅔ days) and ⅙ of the 122 days in the United States during the second preceding calendar year (20⅓ days). The total of 122+40⅔+20⅓ equals 183 days. B meets the substantial presence test and is a resident alien for the current year.

Example 2. C, an alien individual, is present in the United States for 25 days during the current year. She was present in the United States for 365 days during the first preceding year and 365 days during the second preceding year. The substantial presence test does not apply because C is present in the United States for fewer than 31 days during the current year.

Example 3. D, an alien individual, is present in the United States for 170 days during the current year. He was present in the United States for 30 days during the first preceding year and 30 days during the second preceding year. In determining his status for the current year, D counts all 170 days in the United States in the current year plus ⅓ of the 30 days in the United States in the first preceding calendar year (10 days) and ⅙ of the 30 days in the United States during the second preceding calendar year (5 days). The total of 170+10+5 equals 185 days. D meets the substantial presence test and is a resident alien for the current year notwithstanding the fact that he was present in the United States for fewer than 31 days in each of the two preceding years.

[T.D. 8411, 57 FR 15242, Apr. 27, 1992; 57 FR 28612, June 26, 1992; 57 FR 37190, Aug. 18, 1992]

§ 301.7701(b)–2 Closer connection exception.

(a) *In general.* An alien individual who meets the substantial presence test may nevertheless be considered a nonresident alien for the current year if the following conditions are satisfied—

(1) The individual is present in the United States for fewer than 183 days in the current year;

(2) The individual maintains a tax home in a foreign country during the current year; and

(3) Except as provided in paragraph (e) of this section, the individual has a closer connection during the current year to a single foreign country in which he or she maintains a tax home than to the United States.

(b) *Foreign country.* For purposes of section 7701(b) and the regulations thereunder, the term ''foreign country'' when used in a geographical sense includes any territory under the sovereignty of the United Nations or a government other than that of the United States. It includes the territorial waters of the foreign country (determined in accordance with the laws of the United States), and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which the foreign country has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. It also includes the possessions and territories of the United States.

(c) *Tax home*—(1) *Definition.* For purposes of section 7701 (b) and the regulations under that section, the term ''tax home'' has the same meaning that it has for purposes of section 162(a)(2) (relating to travel expenses while away from home). Thus, an individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of the business, or because the individual is not engaged in carrying on any trade or business within the meaning of section 162(a), then the individual's tax home is the individual's regular place of abode in a real and substantial sense.

(2) *Duration and nature of tax home.* The tax home maintained by the alien individual must be in existence for the entire current year. The tax home must be located in the same foreign country for which the individual is claiming to have the closer connection

described in paragraph (d) of this section.

(d) *Closer connection to a foreign country*—(1) *In general.* For purposes of section 7701(b) and the regulations under that section, an alien individual will be considered to have a closer connection to a foreign country than the United States if the individual or the Commissioner establishes that the individual has maintained more significant contacts with the foreign country than with the United States. In determining whether an individual has maintained more significant contacts with a foreign country than the United States, the facts and circumstances to be considered include, but are not limited to, the following—

(i) The location of the individual's permanent home;

(ii) The location of the individual's family;

(iii) The location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and his or her family;

(iv) The location of social, political, cultural or religious organizations with which the individual has a current relationship;

(v) The location where the individual conducts his or her routine personal banking activities;

(vi) The location where the individual conducts business activities (other than those that constitute the individual's tax home);

(vii) The location of the jurisdiction in which the individual holds a driver's license;

(viii) The location of the jurisdiction in which the individual votes;

(ix) The country of residence designated by the individual on forms and documents; and

(x) The types of official forms and documents filed by the individual, such as Form 1078 (Certificate of Alien Claiming Residence in the United States), Form W–8 (Certificate of Foreign Status) or Form W–9 (Payer's Request for Taxpayer ldentification Number).

(2) *Permanent home.* For purposes of paragraph (d)(1)(i) of this section, it is immaterial whether a permanent home is a house, an apartment, or a furnished room. It is also immaterial whether the home is owned or rented by the alien individual. It is material, however, that the dwelling be available at all times, continuously, and not solely for stays of short duration.

(e) *Special Rule.* An alien individual may demonstrate in one year that he or she has a closer connection to two foreign countries (but no more than two) if he or she satisfies all of the following conditions—

(1) The individual maintains a tax home beginning on the first day of the current year in one foreign country;

(2) The individual changes his or her tax home during the current year to a second foreign country;

(3) The individual continues to maintain his or her tax home in the second foreign country for the remainder of the current year;

(4) The individual has a closer connection to each foreign country than to the United States for the period during which the individual maintains a tax home in that foreign country; and

(5) The individual is subject to taxation as a resident pursuant to the internal laws of either foreign country for the entire year or subject to taxation as a resident in both foreign countries for the period during which the individual maintains a tax home in each foreign country.

(f) *Closer connection exception unavailable.* An alien individual who has personally applied, or taken other affirmative steps, to change his or her status to that of a permanent resident during the current year or has an application pending for adjustment of status during the current year will not be eligible for the closer connection exception. Affirmative steps to change status to that of a permanent resident include, but are not limited to, the following—

(1) The filing of Immigration and Naturalization Form I–508 (Waiver of Immunities) by the alien;

(2) The filing of Immigration and Naturalization Form I–485 (Application for Status as Permanent Resident) by the alien;

(3) The filing of Immigration and Naturalization Form I–130 (Petition for Alien Relative) on behalf of the alien;

(4) The filing of Immigration and Naturalization Form I–140 (Petition for

Prospective Immigrant Employee) on behalf of the alien;

(5) The filing of Department of Labor Form ETA–750 (Application for Alien Employment Certification) on behalf of the alien; or

(6) The filing of Department of State Form OF–230 (Application for Immigrant Visa and Alien Registration) by the alien.

(g) *Filing requirements.* See §3O1.7701(b)–8 with regard to the statement that must be filed by an alien individual claiming the closer connection exception.

[T.D. 8411, 57 FR 15244, Apr. 27, 1992; 57 FR 28612, June 26, 1992; 57 FR 37190, Aug. 18, 1992; 58 FR 17516, Apr. 5, 1993]

§ 301.7701(b)–3 Days of presence in the United States that are excluded for purposes of section 7701(b).

(a) *In general.* In computing days of presence in the United States, an alien is considered to be present if the individual is physically present in the United States at any time during the day (see §301.7701(b)–1(c)(2)(i)). However, for purposes of section 7701(b) and the regulations under that section, the following days shall be excluded and will not count as days of presence in the United States—

(1) Any day that an individual is present in the United States as an exempt individual;

(2) Any day that an individual is prevented from leaving the United States because of a medical condition that arose while the individual was present in the United States;

(3) Any day that an individual is in transit between two points outside the United States; and

(4) Any day on which a regular commuter residing in Canada or Mexico commutes to and from employment in the United States.

(b) *Exempt individuals*—(1) *In general.* An exempt individual is an individual who is either a—

(i) Foreign government-related individual as defined in paragraph (b)(2) of this section;

(ii) Teacher or trainee as defined in paragraph (b)(3) of this section;

(iii) Student as defined in paragraph (b)(4) of this section; or

(iv) Professional athlete as defined in paragraph (b)(5) of this section.

(2) *Foreign government-related individual*—(i) *In general.* A foreign government-related individual is an individual (and that individual's immediate family) who is temporarily present in the United States—

(A) As a full-time employee of an international organization;

(B) By reason of diplomatic status; or

(C) By reason of a visa that the Secretary of the Treasury or his or her delegate (after consultation with the Secretary of State when appropriate) determines represents full-time diplomatic or consular status. An individual described in this paragraph shall be considered to be temporarily present in the United States if the individual is not a lawful permanent resident as described in §301.7701(b)–1(b)(1), regardless of the actual amount of time that the individual is present in the United States.

(ii) *Definition of international organization.* The term ''international organization'' means any public international organization that has been designated by the President by Executive Order as being entitled to enjoy the privileges, exemptions, and immunities provided for in the International Organizations Act (22 U.S.C. 288). An individual described in paragraph (b)(2)(i) of this section will be a full-time employee of an international organization if that individual's employment with the organization is consistent with an employment schedule of a person with a standard full-time work schedule with the organization.

(iii) *Full-time diplomatic or consular status.* An individual is considered to have full-time diplomatic or consular status if—

(A) The individual has been accredited by a foreign government recognized de jure or de facto by the United States;

(B) The individual intends to engage primarily in official activities for that foreign government while in the United States; and

(C) The individual has been recognized by the President, or by the Secretary of State, or by a consular officer acting on behalf of the Secretary of State, as being entitled to such status.

(3) *Teacher or trainee.* A teacher or trainee includes any individual (and that individual's immediate family), other than a student, who is admitted temporarily to the United States as a nonimmigrant under section 101(a)(15)(J) (relating to the admission of teachers and trainees into the United States) or section 101(a)(15)(Q) (relating to the admission of participants in international cultural exchange programs) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (J), (Q)) and who substantially complies with the requirements of being admitted.

(4) *Student.* A student is any individual (and that individual's immediate family) who is admitted temporarily to the United States as a nonimmigrant under section 101(a)(15)(F) or (M) (relating to the admission of students into the United States) or as a student under section 101(a)(15)(J) (relating to the admission of teachers and trainees into the United States) or section 101(a)(15)(Q) (relating to the admission of participants in international cultural exchange programs) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (F), (J), (M), (Q)) who substantially complies with the requirements of being admitted. For rules concerning taxation of certain nonresident students or trainees, see section 871(c) and §1.871–9(a) of this chapter.

(5) *Professional athlete.* A professional athlete is an individual who is temporarily present in the United States to compete in a charitable sports event described in section 274(l)(1)(B). For purposes of computing the days of presence in the United States, only days on which the athlete actually competes in a charitable sports event described in section 274(l)(1)(B) shall be excluded. Thus, days on which the individual is present to practice for the event, to perform promotional or other activities related to the event, or to travel between events shall be included for purposes of the substantial presence test.

(6) *Substantial compliance.* An individual described in paragraph (b) (3) or (4) of this section will be deemed to comply substantially with the visa requirements relevant to residence for tax purposes if the individual has not engaged in activities that are prohibited by the Immigration and Nationality Act and the regulations thereunder and could result in the loss of F, J or M visa status. An individual will not be deemed to comply substantially with the visa requirements relevant to residence for tax purposes merely by showing that the individual's visa has not been revoked. An independent determination of substantial compliance may be made by the Internal Revenue Service for any individual claiming to be an exempt individual under paragraph (b) (3) or (4) of this section. For example, if an individual with an F visa (student visa) is found to have accepted unauthorized employment or to have maintained a course of study that is not considered by the Internal Revenue Service to be full-time, the individual will not be considered to comply substantially with the individual's visa requirements regardless of whether the individual's visa has been revoked.

(7) *Limitation on teacher or trainee and student exemptions*—(i) *Teacher or trainee limitation in general.* Except as otherwise provided, an individual shall not exclude days of presence as a teacher or trainee if the individual has been exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years.

(ii) *Special teacher or trainee limitation for section 872(b)(3) compensation.* If—

(A) A teacher or trainee receives compensation in the current year and all of that compensation is described in section 872(b)(3);

(B) That individual was present in the United States as a teacher or trainee in any prior year within the last 6 years; and

(C) During each prior year (within the 6 year period) in which the individual was present as a teacher or trainee, the individual received compensation all of which was described in section 872(b)(3);

Then that individual shall include days of presence as a teacher or trainee in the current year only if the individual has been exempt as a teacher, trainee, or student for any part of four of the six preceding calendar years.

(iii) *Limitation on student exemption.* An individual will not be able to exclude days of presence as a student if

the individual has been exempt as a teacher, trainee, or student for any part of more than five calendar years, unless it is established to the satisfaction of the district director that the individual does not intend to reside permanently in the United States and has substantially complied with the requirements of the student visa providing for the individual's temporary presence in the United States. For purposes of this paragraph (b)(7), the facts and circumstances to be considered in determining if an individual has demonstrated an intent to reside permanently in the United States include (but are not limited to)—

(A) Whether the individual has maintained a closer connection with a foreign country as described in § 301.7701(b)–2; and

(B) Whether the individual has taken affirmative steps within the meaning of paragraph (f) of § 301.7701(b)–2 to adjust the individual's status from nonimmigrant to lawful permanent resident.

(iv) *Transition rule.* The rules in this paragraph (b)(7) relating to stated periods of exempt status apply only for those stated periods that occur after 1984. Thus, for example, an alien who is present as a student during the calendar years 1982–1990 will not be subject to the five year rule for students until 1990.

(v) *Examples.* The following examples illustrate the application of paragraphs (b)(7) (i) and (ii) of this section:

Example 1. B is temporarily present in the United States during the current year as a teacher, within the meaning of section 101(a)(15)(J) of the Immigration and Nationality Act. B does not receive compensation described in section 872(b)(3) in the current year. B has been treated as an exempt student for the past three years. Although this is the first year that B is seeking to be exempt as a teacher, he will not be considered an exempt individual for the year because he has been exempt as a student for at least two of the past six years.

Example 2. C is temporarily present in the United States during the current year as a teacher and receives compensation described in section 872(b)(3) in the current year. C has been treated as an exempt teacher for the past two years but C's compensation for those years was not described in section 872(b)(3). C will not be considered an exempt individual for the current year because she has been exempt as a teacher for at least two of the past six years.

Example 3. The facts are the same as in *Example 2*, except that all of C's compensation for the two preceding years was described in section 872(b)(3). C will be considered to be an exempt individual for the current year because she has not been exempt as a student, teacher or trainee for four of the six preceding calendar years.

Example 4. D is temporarily present in the United States during the current year as a teacher, within the meaning of section 101(a)(15)(J) of the Immigration and Nationality Act. D does not receive compensation described in section 872(b)(3) in the current year. D entered the United States in December of the second preceding year and intends to remain in the United States until June of the current year. D will not be considered an exempt individual for the current year because he has been exempt as a teacher for at least two of the past six years.

(8) *Immediate family.* The immediate family of an exempt individual includes the individual's spouse and unmarried children (whether by blood or adoption) but only if the spouse's or unmarried children's visa status are derived from and dependent on the visa classification of the exempt individual. For the purposes of this paragraph, the term *unmarried children* means those children who are under 21 years of age, who reside regularly in the household of the exempt individual, and who are not members of some other household. The immediate family of an exempt individual does not include the attendants, servants, and personal employees of that individual.

(c) *Medical condition*—(1) *In general.* An individual will not be considered present on any day that the individual intends to leave and is unable to leave the United States because of a medical condition or medical problem that arose while the individual was present in the United States. A day of presence will not be excluded if the individual, who was initially prevented from leaving, is subsequently able to leave the United States and then remains in the United States beyond a reasonable period for making arrangements to leave the United States. A day will also not be excluded if the medical condition arose during a prior stay in the United States (whether or not days of presence during the prior stay were excluded) and the alien returns to the United

States for treatment of the medical condition or medical problem that arose during the prior stay.

(2) *Intent to leave the United States.* For purposes of paragraph (c)(1) of this section, whether an individual intends to leave the United States on a particular day will be determined based on all the facts and circumstances. Thus, if at the time an individual's medical condition or medical problem arose, the individual was present in the United States for a definite purpose which by its nature could be accomplished within the United States during a period of time that would not cause the individual to be a resident under the substantial presence test, the individual may be able to establish that he or she intended to leave the United States. However, if the individual's purpose is of such a nature that an extended period of time would be required for its accomplishment (sufficient to cause the individual to be a resident under the substanial presence test), the individual would not be able to establish the requisite intent to leave the United States. If the individual is present in the United States for no particular purpose or a purpose by its nature that does not require a specific period of time to accomplish, the determination of whether the individual has the requisite intent to leave the United States will depend on all the surrounding facts and circumstances. In the case of an individual adjudicated mentally incompetent, proof of intent to leave the United States may be determined by analyzing the incompetent's pattern of behavior prior to the adjudication of incompetence. Generally, an individual will be presumed to have intended to leave during a period of illness if the individual leaves the United States within a reasonable period of time (time to make arrangements to leave) after becoming physically able to leave.

(3) *Pre-existing medical condition.* A medical condition or problem will not be considered to arise while the individual is present in the United States, if the condition or problem existed prior to the individual's arrival in the United States, and the individual was aware of the condition or problem, regardless of whether the individual required treatment for the condition or problem when the individual entered the United States.

(4) *Examples.* The following examples illustrate the application of this paragraph (c):

Example 1. B is in a serious automobile accident in the United States on March 25. B intended to leave the United States on March 31 (as evidenced by an airline ticket), but was unable to leave on that date as a result of the injuries suffered in the accident. B recovered from the injuries and was able to leave and did leave the United States on May 31. B's presence in the United States during the period from April 1 through May 31 will not be counted as days of presence in the United States.

Example 2. The facts are the same as in *Example 1,* except that B's return flight (as evidenced by an airline ticket) was scheduled for May 31. Because B did not intend to leave the United States until May 31, B may not exclude any days of presence in the United States.

(d) *Days in transit.* An alien individual may exclude days of presence in the United States if the individual is in transit between two foreign points, and is physically present in the United States for fewer than 24 hours. For purposes of this paragraph, an individual will be considered to be in transit if the individual pursues activities that are substantially related to completing his or her travel to a foreign point of destination. For example, an alien who travels between airports in the United States in order to change planes en route to the individual's destination will be considered to be in transit. However, if the individual attends a business meeting while he or she is present in the United States, whether or not that meeting is within the confines of the airport, the individual will not be considered to be in transit. For purposes of this paragraph, the term ''foreign point'' means any areas that are not included within the definition of the term ''United States'' provided in § 301.7701(b)–1(c)(2)(ii).

(e) *Regular commuters from Mexico or Canada*—(1) *General rule.* An alien individual will not be considered to be present in the United States on days that the individual commutes to the United States from the individual's residence in Mexico or Canada if the

individual regularly commutes from Mexico or Canada. An alien individual will be considered to commute regularly if the individual commutes to the individual's location of employment or self-employment in the United States from his or her residence in Mexico or Canada on more than 75% of the workdays during the working period.

(2) *Definitions.* (i) The term *commutes* means to travel to employment or self-employment and to return to one's residence within a 24-hour period.

(ii) The term *workdays* means days on which the individual works in the United States or Canada or Mexico.

(iii) The term *working period* means the period beginning with the first day in the current year on which the individual is physically present in the United States for purposes of engaging in employment or self-employment and ending on the last day in the current year on which the individual is physically present in the United States for purposes of engaging in that employment or self-employment. If the nature of the employment or self-employment is such that it requires the individual to be present in the United States only on a seasonal or cyclical basis, the working period will begin with the first day of the season or cycle on which the individual is present in the United States for purposes of engaging in that employment or self-employment and end on the last day of the season or cycle on which the individual is present in the United States for the purpose of engaging in that employment or self-employment. Thus, there may be more than one working period in a calendar year and a working period may begin in one calendar year and end in the following calendar year.

(3) *Examples.* The following examples illustrate the operation of this paragraph (e):

Example 1. B lives in Mexico and is employed by Corporation X in its office in Mexico. B was temporarily assigned to X's office in the United States. B's employment in the United States office began on February 1, 1988, and continued through June 1, 1988. On June 2, B resumed his employment in Mexico. On 59 days in the period beginning on February 1, 1988, and ending on June 1, 1988, B travelled each morning from his residence in Mexico to X Corporation's United States office for the purpose of engaging in his employment with X Corporation. B returned to his residence in Mexico on each of those evenings. On seven days in the period from February 1, 1988, through June 1, 1988, B worked in X's Mexico office. B is not considered to have been present in the United States on any of the days that he travelled to X's United States office for the purpose of engaging in employment with Corporation X because he commuted to his place of employment within the United States on more than 75% of the workdays during the working period (59 workdays in the United States/66 workdays in the working period=89.4%).

Example 2. C, who lives in Canada, contracted with a resort located in the United States to provide snow-skiing instructions for the resort's customers for two skiing seasons, the first beginning on November 15, 1987, and ending on March 15, 1988, and the second beginning on November 15, 1988, and ending on March 15, 1989. On 90 days in each of the two skiing seasons, C travelled in the morning from Canada to the resort to provide skiing instructions pursuant to the contract. C returned to Canada on each of those evenings. On 20 days during each of the two skiing seasons, C worked in Canada. C is not considered to have been present in the United States on any of the days that she travelled to the United States to provide ski instructions in either the first working period beginning on November 15, 1987, and ending on March 15, 1988, or the second working period beginning on November 15, 1988, and ending on March 15, 1989, because she commuted to her employment within the United States on more than 75% of the workdays during each of the working periods (90 workdays in the United States/110 workdays in the working period=81.8%).

Example 3. D, who lives in Canada, is the sole proprietor of a wholesale lumber business with offices in both the United States and Canada. Beginning on January 4, 1988, and ending on February 12, 1988, D commuted to work in his United States office on 30 days. Beginning on February 15, 1988, and ending on March 25, 1988, D commuted to work in his Canadian office on 30 days. Beginning on March 28, 1988, and ending on May 27, 1988, D commuted to work in his United States office on 45 days. Subsequent to May 27, D did not commute to the United States on any other days in 1988. D is considered to have been present in the United States on each day that he travelled to his office in the United States because D did not commute to the United States office on more than 75% of the workdays during the working period beginning on January 4, 1988, and ending on May 27, 1988 (75 workdays in the United States/105 workdays in the working period=71.4%).

(f) *Determination of excluded days applies beyond year of determination.* If a

day of presence is excluded under this section, then that day shall not be taken into account in the current year or the first or second preceding year.

[T.D. 8411, 57 FR 15245, Apr. 27, 1992; 57 FR 28612, June 26, 1992; 57 FR 37190, Aug. 18, 1992; as amended by T.D. 8733, 62 FR 53386, Oct. 14, 1997]

§ 301.7701(b)–4 Residency time periods.

(a) *First year of residency*. An alien individual who was not a United States resident during the preceding calendar year and who is a United States resident for the current year will begin to be a resident for tax purposes on the alien's residency starting date. The residency starting date for an alien who meets the substantial presence test is the first day during the calendar year on which the individual is present in the United States. The residency starting date for an alien who meets the lawful permanent resident test (green card test), described in paragraph (b)(1) of § 301.7701(b)–1, is the first day during the calendar year in which the individual is physically present in the United States as a lawful permanent resident. The residency starting date for an alien who satisfies both the substantial presence test and the green card test will be the earlier of the first day the individual is physically present in the United States as a lawful permanent resident of the United States or the first day during the year that the individual is present for purposes of the substantial presence test. (See § 301.7701(b)–9(b)(1) for the transitional rule relating to the residency starting date of an alien individual who was a lawful permanent resident in 1984. See also § 301.7701(b)–3 for days that may be excluded.)

(b) *Last year of residency*—(1) *General rule.* An alien individual who is a United States resident during the current year but who is not a United States resident at any time during the following calendar year will cease to be a resident for tax purposes on the individual's residency termination date. Generally, the residency termination date will be the last day of the calendar year.

(2) *Exceptions.* Notwithstanding paragraph (b)(1) of this section, the residency termination date for an alien individual who meets the substantial presence test is the last day during the calendar year that the individual is physically present in the United States if the individual establishes that, for the remainder of the calendar year, the individual's tax home was in a foreign country and he or she maintained a closer connection (within the meaning of § 301.7701(b)–2(d)) to that foreign country than to the United States. Similarly, the residency termination date for an alien who meets the green card test is the first day during the calendar year that the alien is no longer a lawful permanent resident if the individual establishes that, for the remainder of the calendar year, his or her tax home was in a foreign country and he or she maintained a closer connection to that foreign country than to the United States. The residency termination date for an alien who satisfies both the substantial presence test and the green card test for the current year, will be the later of the first day the individual is no longer a lawful permanent resident of the United States or the last day the individual was physically present in the United States if the alien establishes that, for the remainder of the calendar year, his or her tax home was in a foreign country and he or she maintained a closer connection to that foreign country than to the United States. It is immaterial whether the individual's tax home was in the United States, or that the individual had a closer connection to the United States than to the foreign country, prior to the date of his or her departure from the United States or the date on which the individual was no longer a lawful permanent resident, whichever is applicable.

(c) *Rules relating to residency starting date and residency termination date*—(1) *De minimis presence.* An alien individual may be present in the United States for up to 10 days without triggering the residency starting date (for purposes of the substantial presence test) or extending the residency termination date (for purposes of the substantial presence test) if the individual is able to establish that, during that period, the individual's tax home was in a foreign country and he or she maintained a

closer connection to that foreign country than to the United States. Days from more than one period of presence may be disregarded for purposes of determining an individual's residency starting date or termination date so long as the total is not more than 10 days. However, an individual may not disregard any days that occur in a period of consecutive days of presence, if all the days that occur during that period cannot be excluded. An individual must include days of presence for purposes of determining whether the individual meets the substantial presence test even though the days may be disregarded for purposes of determining the individual's residency starting date or residency termination date.

(2) *Proration.* If an individual's residency starting date does not fall on the first day of the tax year, or the individual's residency termination date does not fall on the last day of the tax year, the individual's income tax liability should be calculated in accordance with §1.871–13 of this chapter dealing with the taxation of individuals who change residence status during the taxable year.

(3) *Residency starting date for certain individuals*—(i) *In general.* If an alien individual (who otherwise does not meet the substantial presence test or the green card test for the current year) is physically present in the United States for at least 31 consecutive days during the current year, and also for a period of continuous presence beginning with the first day of that thirty-one day period (see paragraph (c)(3)(iii) of this section), then the individual may elect to be treated as a resident during the current year. The individual's residency starting date shall be the first day of that thirty-one day period, if—

(A) The individual was not a resident of the United States under the substantial presence test or the green card test in the year preceding the current year; and

(B) The individual is a resident of the United States in the subsequent year under the substantial presence test (whether or not the individual is also a resident of the United States under the green card test).

(ii) *Determination of presence.* Except as otherwise provided in paragraph (c)(3)(iii) of this section, an individual shall be treated as present in the United States on any day that the individual is physically present in the United States at any time during the day.

(iii) *Thirty-one day period.* For purposes of this paragraph (c)(3), the term *thirty-one day period* means any period of 31 consecutive days during which an individual is physically present in the United States during each day of the period.

(iv) *Period of continuous presence.* For purposes of this paragraph (c)(3), the term *continuous presence* means a period of presence in the United States that includes 75 percent of the days in the current year beginning with (and including) the first day of the individual's thirty-one day period of presence. Only for purposes of the continuous presence requirement, an individual will be deemed to be present in the United States for up to 5 days on which the individual is absent from the United States. These days will not be deemed to be days of presence for purposes of the thirty-one day period of presence requirement. If an individual is present for more than one thirty-one day period of presence and satisfies the continuous presence requirement with regard to each period, the individual's residency starting date shall be the first day of the first thirty-one day period of presence. If an individual is present for more than one thirty-one day period of presence but satisfies the continuous presence requirement only for a later thirty-one day period, the individual's residency starting date shall be the first day of the later thirty-one day period of presence. For purposes of this paragraph (c)(3), days of presence that are otherwise excluded under section 7701(b)(3)(D)(i) and §301.7701(b)–3(a)(1) (exempt individual), (a)(2) (medical condition), (a)(3) (in transit between two foreign points), and (a)(4) (regular commuter) shall not be counted as days of presence for purposes of either the thirty-one day period or continuous presence requirement.

(v) *Election procedure*—(A) *Filing requirements.* An alien individual shall

make an election to be treated as a resident under paragraph (c)(3) of this section by attaching a statement (described in paragraph (c)(3)(v)(C) of this section) to the individual's income tax return (Form 1040) for the taxable year for which the election is to be in effect (the election year). The alien individual may not make this election until such time as he has satisfied the substantial presence test for the year following the election year. If an alien individual has not satisfied the substantial presence test for the year following the election year as of the due date (not including extensions) of the tax return for the election year, the alien individual may request an extension of time for filing the return until a reasonable period after he or she has satisfied such test, provided that the individual pays with his or her extension application the amount of tax he or she expects to owe for the election year computed as if he or she were a nonresident alien throughout the election year. An election made under paragraph (c)(3) of this section may not be revoked without the approval of the Commissioner or his delegate.

(B) *Election on behalf of a dependent child.* An individual may make an election on behalf of a dependent child (as defined in paragraphs (1) and (2) of section 152(a), without regard to section 152(b)(3)) if the individual is qualified to make an election on his or her own behalf, the child qualifies to make an election under this paragraph (c)(3), and the child is not required by section 6012 to file a United States income tax return for the year for which the election is to be effective.

(C) *Statement.* The statement required by paragraph (c)(3)(v)(A) of this section shall include the name and address of the alien individual and contain a signed declaration that the election is being made. If the individual is also making an election on behalf of any dependent children, then the statement must include the required information with respect to those children. The statement must specify—

(*1*) That the alien individual was not a resident in the year immediately preceding the election year;

(*2*) That the alien individual is a resident under the substantial presence test in the year following the election year;

(*3*) The individual's number of days of presence in the United States during the year following the election year;

(*4*) The date or dates of the alien individual's thirty-one day period of presence and period of continuous presence in the United States during the election year; and

(*5*) The date or dates of absence from the United States during the election year that are deemed to be days of presence.

(vi) *Penalty for failure to comply with filing requirements*—(A) *General rule.* If an individual fails to comply with the election procedure of paragraph (c)(3)(v) of this section, the individual must file his or her income tax return for the current year as a nonresident alien.

(B) *Exception.* The penalty described in paragraph (c)(3)(vi)(A) of this section shall not apply if the individual can show by clear and convincing evidence that he or she took reasonable actions to become aware of the filing requirements and significant affirmative steps to comply with the requirements. An individual who requests an extension of time to file his or her income tax return pursuant to paragraph (c)(3)(v) of this section will be considered to have taken significant affirmative steps to comply with the requirement that the individual pay his or her tax determined as if the individual were a nonresident alien if the individual paid with his or her extension application at least 90 percent of the amount of the tax the individual actually owed for the election year computed as if he or she were a nonresident alien throughout the election year.

(d) *Examples.* The following examples illustrate the operation of this section:

Example 1. B, a citizen of foreign country X, is an alien who has never before been a United States resident for tax purposes. B comes to the United States on January 6, 1985, to attend a business meeting and returns to country X on January 10, 1985. B is able to establish a closer connection to country X for the period January 6–10. On March 1, 1985, B moves to the United States and resides here until August 20, 1985, when he returns to country X. On December 12, 1985, B comes to the United States for pleasure and stays here until December 16, 1985 when he

returns to country X. B is able to establish a closer connection to country X for the period December 12–16. B is not a United States resident for tax purposes during the following year and can establish a closer connection to country X for the remainder of calendar year 1985. B is a resident of the United States under the substantial presence test because B is present in the United States for 183 days (5 days in January plus 173 days for the period March 1–August 20 plus 5 days in December). B's residency starting date is March 1, 1985, and his residency termination date is August 20, 1985.

Example 2. The facts are the same as in *Example 1,* except that B remains in the United States until December 17, 1985, and is able to establish a closer connection to country X for the period December 18 through 31. B's residency termination date is December 17, 1985.

Example 3. C, a citizen of foreign country Y, is an alien who has never before been a United States resident for tax purposes. C comes to the United States for the first time on February 10, 1985, and attends a business conference until February 24, 1985, when she returns to country Y. On April 20, 1985, C enters the United States as a lawful permanent resident. On November 10, 1985, C ceases to be a lawful permanent resident but stays on in the United States until November 20, 1985 when she returns to country Y. On December 8, 1985, C comes to the United States and stays here until December 17, 1985 when she returns to country Y. She can establish a closer connection to country Y for that period. C is not a resident of the United States during the following calendar year and can establish a closer connection to country Y for the remainder of calendar year 1985. C qualifies as a United States resident under both the green card test and the substantial presence test. C's residency starting date under the green card test is April 20, 1985. Under the substantial presence test, C's residency starting date is February 10, 1985, because she is present for more than ten days in February and cannot take advantage of the de minimis presence rule. Therefore, C's residency starting date is February 10, 1985. C's residency termination date under the green card test is November 10, 1985. Her residency termination date under the substantial presence test is November 20, because B can disregard ten days of presence in December. Thus, her residency termination date is November 20, 1985, the later of her residency termination date under the substantial presence test or the green card test.

Example 4. The facts are the same as in *Example 3,* except that C is initially present in the United States on business from February 5 to February 9, 1985. C is able to establish a closer connection to country Y for that period. C may take advantage of only ten days of de minimis presence and may exclude days from a continuous period of presence only if she can exclude all the days that occur during that period. Thus, C may choose either of the following periods of residency: residency starting date February 5, 1985, and residency termination date November 20, 1985, or residency starting date April 20, 1985, and residency termination date December 17, 1985.

Example 5. D, a citizen of foreign country Z, is an alien who has never before been a United States resident for tax purposes. D comes to the United States on November 1, 1985 and is present in the United States on 31 consecutive days (from November 1 through December 1, 1985). D returns to country Z on December 1 and does not come back to the United States until December 17, 1985. He remains in the United States for the rest of the year. During 1986, D is a resident of the United States under the substantial presence test. D may elect to be treated as a resident of the United States for 1985 because he was present in the United States in 1985 for a 31 consecutive day period of presence (November 1 through December 1, 1985) and for at least 75 percent of the days following (and including) the first day of D's 31 consecutive day period of presence (46 total days of presence in the United States/61 days in the period from November 1 through December 31=75.4%). If D makes the election to be treated as a resident, his residency starting date will be November 1, 1985.

Example 6. The facts are the same as in *Example 5,* except that D is absent from the United States on December 24, 25, 29, 30 and 31. D may make the election to be treated as a resident for 1985 because up to five days of absence will be deemed to be days of presence for purposes of the continuous presence requirement.

Example 7. F, a citizen of foreign country M, is an alien individual who has never before been a United States resident for tax purposes. F comes to the United States on January 1, 1985 and remains in the United States through January 31, 1985, when she returns to country M. F comes back to the United States on October 1, 1985 and is present in the United States through November 1, 1985. From November 1, 1985 through December 31, 1985, F is present in the United States for 38 days. Although F satisfies two 31 consecutive day periods of presence, (January 1 through January 31 and October 1 through November 1), she satisfies the continuous presence requirement only with regard to the later period of presence (69 total days of presence/92 days in the period from October 1 through December 31=75%). Thus, if F makes the election to be treated as a resident, his residency starting date is October 1, 1985.

(e) *No lapse*—(1) *Residency in prior year.* An alien individual who was a United States resident during any part

of the preceding calendar year and who is a United States resident for any part of the current year will be considered to be taxable as a resident at the beginning of the current year. For purposes of this paragraph (e)(1), it is immaterial whether an individual is considered to be a resident under the substantial presence test or the green card test.

(2) *Residency in following year.* An alien individual who is a United States resident for any part of the current year and who is also a United States resident for any part of the following year (regardless of whether the individual has a closer connection to a foreign country than the United States during the current year) will be taxable as a resident through the end of the current year. For purposes of this paragraph (e)(2), it is immaterial whether an individual is considered to be a resident under the substantial presence test or the green card test.

(3) *Special rule.* If an individual meets the green card test for the current year but is not physically present in the United States during the current year, then the individual's residency starting date shall be the first day of the following year.

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

Example. B, an alien individual who is a citizen of foreign country M, comes to the United States for the first time on May 1, 1985, and remains in the United States until November 5, 1985, when he returns to country M. B comes back to the United States on March 5, 1986 as a lawful permanent resident and remains in the United States until September 10, 1986, when he ceases to be a lawful permanent resident and returns to country M. B is not a resident in calendar year 1987. B's United States residency in calendar year 1985 continues through December 31, 1985, because he is a United States resident in the following calendar year. In calendar year 1986, B's United States residency is deemed to begin on January 1, 1986 because B qualified as a resident in the preceding calendar year. Thus, B's residency period in the United States begins on May 1, 1985, and ends on September 10, 1986.

[T.D. 8411, 57 FR 15247, Apr. 27, 1992; 57 FR 28612, June 26, 1992]

§ 301.7701(b)–5 Coordination with section 877.

(a) *General rule.* An alien individual will be subject to United States income tax in the manner provided by section 877, regardless of whether the individual has a tax avoidance motive, if—

(1) The alien individual is a resident alien of the United States for at least three consecutive calendar years (the initial residency period) beginning after December 31, 1984;

(2) The period of residence for each of the three consecutive calendar years includes at least 183 days;

(3) The alien is once again taxed as a nonresident (including an individual taxed as a nonresident) under § 301.7701(b)–7(a)(1); and

(4) The alien then becomes a resident of the United States before the close of the third calendar year beginning after the individual's residency termination date in the initial residency period.

(b) *Tax imposed.* The tax provided for under paragraph (a) of this section will be imposed for the intervening period of nonresidency only if the amount of tax would exceed the amount of tax that would be imposed under section 871, relating to the taxation of nonresident aliens.

(c) *Example.* The following example illustrates the application of this section.

Example. B, a citizen of foreign country F, enters the United States on April 1, 1985, as a lawful permanent resident. On August 1, 1987, B ceases to be a lawful permanent resident and returns to country F. B meets the initial residency period requirement because he is a resident of the United States for at least 183 days in each of three consecutive years (1985, 1986 and 1987). B returns to the United States on October 5, 1990, as a lawful permanent resident. Because B became a resident of the United States before the close of the third calendar year (1990) beginning after the close of the initial residency period (August 1, 1987), he is subject to tax under section 877(b) for the intervening period of nonresidency, August 2, 1987 through October 4, 1990, if the amount of the tax imposed under section 877 is more than the tax imposed under section 871.

[T.D. 8411, 57 FR 15250, Apr. 27, 1992]

§ 301.7701(b)–6 Taxable year.

(a) *In general.* An alien individual who has not established a fiscal year as

his or her taxable year prior to the period that the individual is subject to United States income tax as a resident or a nonresident shall adopt the calendar year as his or her taxable year. An alien who has established a fiscal year in a foreign country prior to the period that the individual is subject to United States income tax may adopt the calendar year as his or her taxable year for United States income tax purposes without requesting a change in accounting period. An individual will be considered to have established a fiscal year (whether in the United States or a foreign country) if the annual accounting period on which the individual computes his or her income is a fiscal year, the individual keeps his or her books in accordance with that fiscal year, and the requirements of section 441 and §1.441–1(e) of this chapter are otherwise satisfied. An alien who has established a fiscal year and is a resident alien during the calendar year will be treated as a resident alien with respect to any portion of his or her taxable year (beginning with the individual's residency starting date and ending with the individual's residency termination date) that falls within such calendar year. Once the individual has established either a fiscal or calendar year taxable year for any period for which the individual is subject to United States income tax, the individual may not change that taxable year without the approval of the Secretary. See section 442.

(b) *Examples.* The following examples illustrate the operation of this section:

Example 1. B, a citizen and resident of foreign country F, was engaged in a United States business during 1982 and filed a return on a fiscal year basis. B's fiscal year runs from October 1 to September 30. B comes to the United States on March 8, 1985 and remains in the United States until October 10, 1985, when he returns to country F. B maintains a closer connection to and his tax home in Country F for the remainder of calendar year 1985. B, who is not a United States resident at any time in 1986, is a United States resident for the period that begins on March 8, 1985, and ends on October 10, 1985. B has adopted a fiscal year taxable year for purposes of computing his United States income tax liability. For his fiscal year that ends on September 30, 1985, B will be taxed as a United States resident for the period that begins on March 8, 1985 and ends on September 30, 1985. For his fiscal year that ends on September 30, 1986, B will only be taxed as a United States resident for the period that begins on October 1, 1985 and ends on October 10, 1985.

Example 2. The facts are the same as in *Example 1*, except that B's 1982 business was a country F business established on a fiscal year basis and at no time prior to 1985 was B subject to United States income tax. B may adopt a calendar year as his taxable year for United States income tax purposes without requesting a change of accounting period. B continues to use a fiscal year as his taxable year. For his fiscal year that ends on September 30, 1985, B will be taxed as a United States resident for the period that begins on March 8, 1985 and ends September 30, 1985. For his fiscal year that ends on September 30, 1986, B will be taxed as a United States resident for the period that begins on October 1, 1985 and ends on October 10, 1985.

Example 3. The facts are the same as in *Example 1*, except that B's 1982 business was a country F business established on a fiscal year basis and at no time prior to 1985 was B subject to United States income tax. B may adopt a calendar year as his taxable year for United States income tax purposes without requesting a change of accounting period. B adopts a calendar year as his taxable year for 1985. For his calendar year taxable year ending on December 31, 1985, B will be taxed as a United States resident for the period that begins on March 8, 1985, and ends on October 10, 1985.

[T.D. 8411, 57 FR 15250, Apr. 27, 1992; 57 FR 28612, June 26, 1992]

§ 301.7701(b)–7 Coordination with income tax treaties.

(a) *Consistency requirement*—(1) *Application.* The application of this section shall be limited to an alien individual who is a dual resident taxpayer pursuant to a provision of a treaty that provides for resolution of conflicting claims of residence by the United States and its treaty partner. A ''dual resident taxpayer'' is an individual who is considered a resident of the United States pursuant to the internal laws of the United States and also a resident of a treaty country pursuant to the treaty partner's internal laws. If the alien individual determines that he or she is a resident of the foreign country for treaty purposes, and the alien individual claims a treaty benefit (as a nonresident of the United States) so as to reduce the individual's United States income tax liability with respect to any item of income covered by

an applicable tax convention during a taxable year in which the individual was considered a dual resident taxpayer, then that individual shall be treated as a nonresident alien of the United States for purposes of computing that individual's United States income tax liability under the provisions of the Internal Revenue Code and the regulations thereunder (including the withholding provisions of section 1441 and the regulations under that section in cases in which the dual resident taxpayer is the recipient of income subject to withholding) with respect to that portion of the taxable year the individual was considered a dual resident taxpayer.

(2) *Computation of tax liability.* If an alien individual is a dual resident taxpayer, then the rules on residency provided in the convention shall apply for purposes of determining the individual's residence for all purposes of that treaty.

(3) *Other Code purposes.* Generally, for purposes of the Internal Revenue Code other than the computation of the individual's United States income tax liability, the individual shall be treated as a United States resident. Therefore, for example, the individual shall be treated as a United States resident for purposes of determining whether a foreign corporation is a controlled foreign corporation under section 957 or whether a foreign corporation is a foreign personal holding company under section 552. In addition, the application of paragraph (a)(2) of this section does not affect the determination of the individual's residency time periods under § 301.7701(b)–4.

(4) *Special rules for S corporations.* [Reserved]

(b) *Filing requirements.* An alien individual described in paragraph (a) of this section who determines his or her U.S. tax liability as if he or she were a nonresident alien shall make a return on Form 1040NR on or before the date prescribed by law (including extensions) for making an income tax return as a nonresident. The individual shall prepare a return and compute his or her tax liability as a nonresident alien. The individual shall attach a statement (in the form required in paragraph (c) of this section) to the Form 1040NR. The Form 1040NR and the attached statement, shall be filed with the Internal Revenue Service Center, Philadelphia, PA 19255. The filing of a Form 1040NR by an individual described in paragraph (a) of this section may affect the determination by the Immigration and Naturalization Service as to whether the individual qualifies to maintain a residency permit.

(c) *Contents of statement*—(1) *In general*—(i) *Returns due after December 15, 1997.* The statement filed by an individual described in paragraph (a)(1) of this section, for a return relating to a taxable year for which the due date (without extensions) is after December 15, 1997, must be in the form of a fully completed Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) or appropriate successor form. See section 6114 and § 301.6114–1 for rules relating to other treaty-based return positions taken by the same taxpayer.

(ii) *Earlier returns.* For returns relating to taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997, the statement filed by the individual described in paragraph (a)(1) of this section must contain the information in accordance with paragraph (c)(1) of this section in effect prior to December 15, 1997 (see § 301.7701(b)–7(c)(1) as contained in 26 CFR part 301, revised April 1, 1997).

(2) *Controlled foreign corporation shareholders.* If the taxpayer who claims a treaty benefit as a nonresident of the United States is a United States shareholder in a controlled foreign corporation (CFC), as defined in section 957 or section 953(c), and there are no other United States shareholders in that CFC, then for purposes of paragraph (c)(1) of this section, the approximate amount of subpart F income (as defined in section 952) that would have been included in the taxpayer's income may be determined based on the audited foreign financial statements of the CFC.

(3) *S corporation shareholders.* [Reserved]

(d) *Relationship to section 6114(a) treaty-based return positions.* The statement required by paragraph (b) of this section will be considered disclosure for

purposes of section 6114 and § 301.6114–1(a), but only if the statement is in the form required by paragraph (c) of this section. If the taxpayer fails to file the statement required by paragraph (b) of this section on or before the date prescribed in paragraph (b) of this section, the taxpayer will be subject to the penalties imposed by section 6712. See section 6712 and § 301.6712–1.

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

Example 1. B, an alien individual, is a resident of foreign country X, under X's internal law. Country X is a party to an income tax convention with the United States. B is also a resident of the United States under the Internal Revenue Code. B is considered to be a resident of country X under the convention. The convention does not specifically deal with characterization of foreign corporations as controlled foreign corporations or the taxability of United States shareholders on inclusions of subpart F income, but it provides, in an ''Other Income'' article similar to Article 21 of the 1981 draft of the United States Model Income Tax Convention (U.S. Model), that items of income of a resident of country X that are not specifically dealt with in the convention shall be taxable only in country X. B owns 80% of the one class of stock of foreign corporation R. The remaining 20% is owned by C, a United States citizen who is unrelated to B. In 1985, corporation R's only income is interest that is foreign personal holding company income under § 1.954A–2 of this chapter. Because the United States-X income tax convention does not deal with characterization of foreign corporations as controlled foreign corporations, United States internal income tax law applies. Therefore, B and C are United States shareholders within the meaning of § 1.951–1(g) of this chapter, corporation R is a controlled foreign corporation within the meaning of § 1.957–1 of this chapter, and corporation R's income is included in C's income as subpart F income under § 1.951–1 of this chapter. B may avoid current taxation on his share of the subpart F inclusion by filing as a nonresident (*i.e.*, by following the procedure in § 301.7701(b)–7(b)).

Example 2. The facts are the same as in *Example 1*, except that B also earns United States source dividend income. The United States-X income tax convention provides that the rate of United States tax on United States source dividends paid to residents of country X shall not exceed 15 percent of the gross amount of the dividends. B's United States tax liability with respect to the dividends would be smaller if he were treated as a resident alien, subject to tax on a net basis (*i.e.*, after the allowance of deductions) than if he were treated as a nonresident alien. If, however, B chooses to file as a nonresident in order to claim treaty benefits with respect to his share of R's subpart F income, his overall United States tax liability, including the portion attributable to the dividends, must be determined as if he were a nonresident alien.

Example 3. C, a married alien individual with three children, is a resident of foreign country Y, under Y's internal law. Country Y is a party to an income tax convention with the United States. C is also a resident of the United States under the Internal Revenue Code. C is considered to be a resident of country Y under the convention. The convention specifically covers, among other items of income, personal services income, dividends and interest. C is sent by her country Y employer to work in the United States from January 1, 1985 until December 31, 1985. During 1985, C also earns United States source dividends and interest and incurs mortgage interest expenses on her personal residence. The United States-Y treaty provides that remuneration for personal services performed in the United States by a country Y resident is exempt from United States tax if, among other things, the individual performing such services is present in the United States for a period that is not in excess of 183 days. The treaty provides that the rate of United States tax on United States source dividends paid to residents of Y shall not exceed 15 percent of the gross amount of the dividends and it exempts residents of Y from United States tax on United States source interest. In filing her 1985 tax return, C may choose to file either as a resident alien without claiming any treaty benefits or as a nonresident alien if she desires to claim any treaty benefit. C files as a nonresident (*i.e.* by following the procedure described in § 301.7701(b)–7(b)). Because C does not satisfy the requirements of the United States-Y treaty with regard to exempting personal services income from United States tax, C will be taxed on her personal services income at graduated rates under section 1 of the Code pursuant to section 871(b) of the Code. She will not be entitled to deduct her mortgage interest expenses or to claim more than one personal exemption because she is taxed as a nonresident alien under the Code by virtue of her decision to claim treaty benefits, and section 873 of the Code denies nonresidents the deduction for personal residence mortgage interest expense and generally limits them to only one personal exemption. C will be subject to a tax of 15 percent of the gross amount of her dividend income under section 871(a) of the Code as modified by the treaty, and she will be exempt from tax on her interest income. C is not entitled to file a joint return with her

spouse even if he is a resident alien under the Code for 1985.

Example 4. The facts are the same as in *Example 3,* except that C does not choose to claim treaty benefits with respect to any items of income covered by the treaty (*i.e.,* she files as a resident). Therefore, she is taxed as a resident under the Code and pays tax at graduated rates on her personal services income, dividends, and interest. In addition, she is entitled to deduct her mortgage interest expenses and to take personal exemptions for her spouse and three children. C will be entitled to file a joint return with her spouse if he is a resident alien for 1985 or, if he is a nonresident alien, C and her spouse may elect to file a joint return pursuant to section 6013.

[T.D. 8411, 57 FR 15251, Apr. 27, 1992; 57 FR 28612, June 26, 1992, as amended by T.D. 8733, 62 FR 53387, Oct. 14, 1997]

§ 301.7701(b)–8 Procedural rules.

(a) *Who must file*—(1) *Closer connection exception.* An alien individual who otherwise meets the substantial presence test must file a statement to explain the basis of the individual's claim that he or she is able to satisfy the closer connection exception described in § 301.7701(b)–2.

(2) *Exempt individuals and individuals with a medical condition.* An alien individual must file a statement to explain the basis of the individual's claim that he or she is able to exclude days of presence in the United States because the individual—

(i) Is an exempt individual as described in § 301.7701(b)–3(b)(3) (teacher/trainee) or (b)(4) (student);

(ii) Is an exempt individual described in § 301.7701 (b)–3(b)(5) (professional athlete); or

(iii) Has a medical condition or problem as described in § 301.7701(b)–3(c).

(3) *De minimis presence and residency starting and termination dates.* A statement must be filed by an individual who is seeking to establish—

(i) That a period of de minimis presence of ten or fewer days should be disregarded for purposes of the individual's residency starting or termination date; or

(ii) A residency termination date.

(b) *Contents of statement*—(1) *Closer connection exception*—(i) *Returns due after December 15, 1997.* The statement filed by an individual described in paragraph (a)(1) of this section, for a return relating to a taxable year for which the due date (without extensions) is after December 15, 1997, must be in the form of a fully completed Form 8840 (Closer Connection Exception Statement) or appropriate successor form.

(ii) *Earlier returns.* For returns relating to taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997, the statement filed by the individual described in paragraph (a)(1) of this section must contain the information in accordance with paragraph (b)(1) of this section in effect prior to December 15, 1997 (see § 301.7701(b)–8(b)(1) as contained in 26 CFR part 301, revised April 1, 1997).

(2) *Exempt individuals and individuals with a medical condition*—(i) *Returns due after December 15, 1997.* The statement filed by an individual described in paragraph (a)(2) of this section, for a return relating to a taxable year for which the due date (without extensions) is after December 15, 1997, must be in the form of a fully completed Form 8843 (Statement for Exempt Individuals and Individuals with a Medical Condition) or appropriate successor form.

(ii) *Earlier returns.* For returns relating to taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997, the statement filed by the individual described in paragraph (a)(2) of this section must contain the information in accordance with paragraph (b)(2) of this section in effect prior to December 15, 1997 (see § 301.7701(b)–8(b)(2) as contained in 26 CFR part 301, revised April 1, 1997).

(3) *De minimis presence and residency starting and termination dates.* The statement filed by an individual described in paragraph (a)(3) of this section shall be dated, signed by the individual seeking to exclude de minimis presence for purposes of the individual's residency starting or termination date or to establish a residency termination date, and verified by a declaration that the statement is made under the penalty of perjury. The statement shall contain the information described in paragraphs (b)(1) (i), (ii) and (iii) of

this section and the following information (as applicable)—

(i) The first day that the individual was present in the United States during the current year;

(ii) The last day that the individual was present in the United States during the current year;

(iii) Dates of de minimis presence that the individual is seeking to exclude from his or her residency starting or termination dates;

(iv) Sufficient facts to establish that the individual has maintained his or her tax home in and a closer connection to a foreign country during a period of de minimis presence;

(v) Sufficient facts to establish that the individual has maintained his or her tax home in and a closer connection to a foreign country following the individual's last day of presence in the United States during the current year or following the abandonment or rescission of the individual's status as a lawful permanent resident during the current year;

(vi) Date that the individual's status as a lawful permanent resident was abandoned or rescinded; and

(vii) Sufficient facts (including copies of relevant documents) to establish that the individual's status as lawful permanent resident has been abandoned or rescinded.

(c) *How to file.* Individuals described in paragraph (a) of this section who are required to make a return on Form 1040 or 1040NR pursuant to paragraph (a) or (b) of §1.6012–1 of this chapter must attach the statement described in paragraph (b) of this section to their return for the taxable year for which the statement is relevant. An individual who is not required to file either Form 1040 or l040NR must file the statement with the Internal Revenue Service Center, Philadelphia, PA 19255 on or before the date prescribed by law (including extensions) for making an income tax return as a nonresident for the calendar year for which the statement applies. The statement may be signed and filed for the taxpayer by the taxpayer's agent in accordance with §1.6061–1 of this chapter.

(d) *Penalty for failure to file statement*—(1) *General rule.* If an individual is required to file a statement pursuant to paragraph (a)(1), (a)(2)(ii), (a)(2)(iii) or (a)(3) of this section and fails to file such statement on or before the date prescribed by paragraph (c) of this section, the individual will not be eligible for the closer connection exception described in §301.7701(b)–2 and will be required to include all days of presence in the United States (calculated without the benefit of §§301.7701(b)–3(b)(5), 301.7701(b)–3(c), and 301.7701(b)–4(c)(1)) for purposes of the substantial presence test and for determining the individual's residency starting and termination dates. If an individual is considered to be a resident because of this paragraph and the individual is also a resident of a country with which the United States has an income tax convention pursuant to that convention, the individual shall be treated in the manner provided in §301.7701(b)–7 (a) (relating to the treatment of individuals who are dual residents).

(2) *Exception.* The penalty described in paragraph (d)(1) of this section shall not apply if the individual can show by clear and convincing evidence that he or she took reasonable actions to become aware of the filing requirements and significant affirmative steps to comply with those requirements.

(e) *Filing requirement disregarded.* Notwithstanding paragraph (d) of this section, the Secretary or his or her delegate may in their sole discretion, when it is in the best interest of the government to do so and based on all of the facts and circumstances, disregard the individual's failure to file timely the statement described in paragraph (a) of this section in determining the individual's days of presence in the United States.

[T.D. 8411, 57 FR 15252, Apr. 27, 1992; 57 FR 28612, June 26, 1992; 57 FR 37190, Aug. 18, 1992; as amended by T.D. 8733, 62 FR 53387, Oct. 14, 1997]

§ 301.7701(b)–9 Effective dates of §§ 301.7701(b)–1 through 301.7701(b)–7.

(a) *In general.* Except as indicated in paragraph (b) of this section, §§301.7701(b)–1 through 301.7701(b)–7 apply to taxable years beginning after December 31, 1984. For the rules applicable to earlier taxable years, see

§§ 1.871–2 through 1.871–5 of this chapter.

(b) *Special rules*—(1) *Green card test-residency starting date.* If an alien was a lawful permanent resident throughout 1984 (regardless of whether the individual was physically present in the United States), or was physically present in the United States at any time during 1984 while a lawful permanent resident, the individual will be considered to have been a resident of the United States during 1984 for purposes of applying the provisions of section 7701(b)(2)(A) and § 301.7701(b)–4 such that the individual will, if he meets the substantial presence or green card test in 1985, be considered a resident of the United States as of January 1, 1985, regardless of when the individual was first present in the United States in 1985.

(2) *Substantial presence test-years included.* For purposes of applying the substantial presence test for calendar years 1985 and 1986, days of presence in 1984 will only be counted for aliens who had been residents under prior law (§§ 1.871–2 through 1.871–5 of this chapter) at the end of calendar year 1984. Days of presence in 1983 will only be counted for aliens who had been residents under prior law at the end of both calendar year 1983 and 1984.

(3) *Professional athletes.* For purposes of applying the substantial presence test, only days of presence in the United States after October 22, 1986, shall be excluded for individuals described in § 301.7701(b)–3(b)(5) (professional athletes).

(4) *Procedural rules and filing requirements.* The procedural rules and filing requirements described in §§ 301.7701(b)–7(b) and 301.7701(b)–8 shall apply to taxable years beginning after December 31, 1991.

[T.D. 8411, 57 FR 15253, Apr. 27, 1992]

§ 301.7701(i)–0 Outline of taxable mortgage pool provisions.

This section lists the major paragraphs contained in §§ 301.7701(i)–1 through 301.7701(i)–4.

§ 301.7701(i)–1 Definition of a taxable mortgage pool.

(a) Purpose.
(b) In general.
(c) Asset composition tests.
(1) Determination of amount of assets.
(2) Substantially all.
(i) In general.
(ii) Safe harbor.
(3) Equity interests in pass-through arrangements.
(4) Treatment of certain credit enhancement contracts.
(i) In general.
(ii) Credit enhancement contract defined.
(5) Certain assets not treated as debt obligations.
(i) In general.
(ii) Safe harbor.
(A) In general.
(B) Payments with respect to a mortgage defined.
(C) Entity treated as not anticipating payments.
(d) Real estate mortgages or interests therein defined.
(1) In general.
(2) Interests in real property and real property defined.
(i) In general.
(ii) Manufactured housing.
(3) Principally secured by an interest in real property.
(i) Tests for determining whether an obligation is principally secured.
(A) The 80 percent test.
(B) Alternative test.
(ii) Obligations secured by real estate mortgages (or interests therein), or by combinations of real estate mortgages (or interests therein) and other assets.
(A) In general.
(B) Example.
(e) Two or more maturities.
(1) In general.
(2) Obligations that are allocated credit risk unequally.
(3) Examples.
(f) Relationship test.
(1) In general.
(2) Payments on asset obligations defined.
(3) Safe harbor for entities formed to liquidate assets.
(g) Anti-avoidance rules.
(1) In general.
(2) Certain investment trusts.
(3) Examples.

§ 301.7701(i)–2 Special rules for portions of entities.

(a) Portion defined.
(b) Certain assets and rights to assets disregarded.
(1) Credit enhancement assets.
(2) Assets unlikely to service obligations.
(3) Recourse.
(c) Portion as obligor.
(1) In general.
(2) Example.

[T.D. 8610, 60 FR 40088, Aug. 7, 1995]

§ 301.7701(i)–1 Definition of a taxable mortgage pool.

(a) *Purpose.* This section provides rules for applying section 7701(i), which defines taxable mortgage pools. The purpose of section 7701(i) is to prevent income generated by a pool of real estate mortgages from escaping Federal income taxation when the pool is used to issue multiple class mortgage-backed securities. The regulations in this section and in §§ 301.7701(i)–2 through 301.7701(i)–4 are to be applied in accordance with this purpose. The taxable mortgage pool provisions apply to entities or portions of entities that qualify for REMIC status but do not elect to be taxed as REMICs as well as to certain entities or portions of entities that do not qualify for REMIC status.

(b) *In general.* (1) A taxable mortgage pool is any entity or portion of an entity (as defined in § 301.7701(i)–2) that satisfies the requirements of section 7701(i)(2)(A) and this section as of any testing day (as defined in § 301.7701(i)–3(c)(2)). An entity or portion of an entity satisfies the requirements of section 7701(i)(2)(A) and this section if substantially all of its assets are debt obligations, more than 50 percent of those debt obligations are real estate mortgages, the entity is the obligor under debt obligations with two or more maturities, and payments on the debt obligations under which the entity is obligor bear a relationship to payments on the debt obligations that the entity holds as assets.

(2) Paragraph (c) of this section provides the tests for determining whether substantially all of an entity's assets are debt obligations and for determining whether more than 50 percent of its debt obligations are real estate mortgages. Paragraph (d) of this section defines real estate mortgages for purposes of the 50 percent test. Paragraph (e) of this section defines two or more maturities and paragraph (f) of this section provides rules for determining whether debt obligations bear a relationship to the assets held by an entity. Paragraph (g) of this section provides anti-avoidance rules. Section 301.7701(i)–2 provides rules for applying section 7701(i) to portions of entities and § 301.7701(i)–3 provides effective dates. Section 301.7701(i)–4 provides special rules for certain entities. For purposes of the regulations under section 7701(i), the term entity includes a portion of an entity (within the meaning of section 7701(i)(2)(B)), unless the context clearly indicates otherwise.

(c) *Asset composition tests*—(1) *Determination of amount of assets.* An entity must use the Federal income tax basis of an asset for purposes of determining whether substantially all of its assets consist of debt obligations (or interests therein) and whether more than 50 percent of those debt obligations (or interests) consist of real estate mortgages (or interests therein). For purposes of this paragraph, an entity determines the basis of an asset with the assumption that the entity is not a taxable mortgage pool.

(2) *Substantially all*—(i) *In general.* Whether substantially all of the assets of an entity consist of debt obligations (or interests therein) is based on all the facts and circumstances.

(ii) *Safe harbor.* Notwithstanding paragraph (c)(2)(i) of this section, if less than 80 percent of the assets of an entity consist of debt obligations (or interests therein), then less than substantially all of the assets of the entity consist of debt obligations (or interests therein).

(3) *Equity interests in pass-through arrangements.* The equity interest of an entity in a partnership, S corporation, trust, REIT, or other pass-through arrangement is deemed to have the same composition as the entity's share of the assets of the pass-through arrangement. For example, if an entity's stock interest in a REIT has an adjusted basis of $20,000, and the assets of the REIT consist of equal portions of real estate mortgages and other real estate assets, then the entity is treated as holding $10,000 of real estate mortgages and $10,000 of other real estate assets.

(4) *Treatment of certain credit enhancement contracts*—(i) *In general.* A credit enhancement contract (as defined in paragraph (c)(4)(ii) of this section) is not treated as a separate asset of an entity for purposes of the asset composition tests set forth in section 7701(i)(2)(A)(i), but instead is treated as part of the asset to which it relates. Furthermore, any collateral supporting a credit enhancement contract is not treated as an asset of an entity solely because it supports the guarantee represented by that contract.

(ii) *Credit enhancement contract defined.* For purposes of this section, a credit enhancement contract is any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a debt obligation (or interest therein) or on a pool of such obligations (or interests), or full or partial payment on one or more classes of debt obligations under which an entity is the obligor, in the event of defaults or delinquencies on debt obligations, unanticipated losses or expenses incurred by the entity, or lower than expected returns on investments. Types of credit enhancement contracts may include, but are not limited to, pool insurance contracts, certificate guarantee insurance contracts, letters of credit, guarantees, or agreements whereby an entity, a mortgage servicer, or other third party agrees to make advances (regardless of whether, under the terms of the agreement, the payor is obligated, or merely permitted, to make those advances). An agreement by a debt servicer to advance to an entity out of its own funds an amount to make up for delinquent payments on debt obligations is a credit enhancement contract. An agreement by a debt servicer to pay taxes and hazard insurance premiums on property securing a debt obligation, or other expenses incurred to protect an entity's security interests in the collateral in the event that the debtor fails to pay such taxes, insurance premiums, or other expenses, is a credit enhancement contract.

(5) *Certain assets not treated as debt obligations*—(i) *In general.* For purposes of section 7701(i)(2)(A), real estate mortgages that are seriously impaired are not treated as debt obligations. Whether a mortgage is seriously impaired is based on all the facts and circumstances including, but not limited to: the number of days delinquent, the loan-to-value ratio, the debt service coverage (based upon the operating income from the property), and the debtor's financial position and stake in the property. However, except as provided in paragraph (c)(5)(ii) of this section, no single factor in and of itself is determinative of whether a loan is seriously impaired.

(ii) *Safe harbor*—(A) *In general.* Unless an entity is receiving or anticipates receiving payments with respect to a mortgage, a single family residential real estate mortgage is seriously impaired if payments on the mortgage are more than 89 days delinquent, and a multi-family residential or commercial real estate mortgage is seriously impaired if payments on the mortgage are more than 59 days delinquent. Whether an entity anticipates receiving payments with respect to a mortgage is based on all the facts and circumstances.

(B) *Payments with respect to a mortgage defined.* For purposes of paragraph (c)(5)(ii)(A) of this section, payments with respect to a mortgage mean any payments on the mortgage as defined in paragraph (f)(2)(i) of this section if those payments are substantial and relatively certain as to amount and any payments on the mortgage as defined in paragraph (f)(2) (ii) or (iii) of this section.

(C) *Entity treated as not anticipating payments.* With respect to any testing day (as defined in § 301.7701(i)–3(c)(2)), an entity is treated as not having anticipated receiving payments on the

mortgage as defined in paragraph (f)(2)(i) of this section if 180 days after the testing day, and despite making reasonable efforts to resolve the mortgage, the entity is not receiving such payments and has not entered into any agreement to receive such payments.

(d) *Real estate mortgages or interests therein defined*—(1) *In general.* For purposes of section 7701(i)(2)(A)(i), the term real estate mortgages (or interests therein) includes all—

(i) Obligations (including participations or certificates of beneficial ownership therein) that are principally secured by an interest in real property (as defined in paragraph (d)(3) of this section);

(ii) Regular and residual interests in a REMIC; and

(iii) Stripped bonds and stripped coupons (as defined in section 1286(e) (2) and (3)) if the bonds (as defined in section 1286(e)(1)) from which such stripped bonds or stripped coupons arose would have qualified as real estate mortgages or interests therein.

(2) *Interests in real property and real property defined*—(i) *In general.* The definition of interests in real property set forth in §1.856–3(c) of this chapter and the definition of real property set forth in §1.856–3(d) of this chapter apply to define those terms for purposes of paragraph (d) of this section.

(ii) *Manufactured housing.* For purposes of this section, the definition of real property includes manufactured housing, provided the properties qualify as single family residences under section 25(e)(10) and without regard to the treatment of the properties under state law.

(3) *Principally secured by an interest in real property*—(i) *Tests for determining whether an obligation is principally secured.* For purposes of paragraph (d)(1) of this section, an obligation is principally secured by an interest in real property only if it satisfies either the test set out in paragraph (d)(3)(i)(A) of this section or the test set out in paragraph (d)(3)(i)(B) of this section.

(A) *The 80 percent test.* An obligation is principally secured by an interest in real property if the fair market value of the interest in real property (as defined in paragraph (d)(2) of this section) securing the obligation was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (that is, the issue date). For purposes of this test, the fair market value of the real property interest is first reduced by the amount of any lien on the real property interest that is senior to the obligation being tested, and is reduced further by a proportionate amount of any lien that is in parity with the obligation being tested.

(B) *Alternative test.* An obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire, improve, or protect an interest in real property that, at the origination date, is the only security for the obligation. For purposes of this test, loan guarantees made by Federal, state, local governments or agencies, or other third party credit enhancement, are not viewed as additional security for a loan. An obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation.

(ii) *Obligations secured by real estate mortgages (or interests therein), or by combinations of real estate mortgages (or interests therein) and other assets*—(A) *In general.* An obligation secured only by real estate mortgages (or interests therein), as defined in paragraph (d)(1) of this section, is treated as an obligation secured by an interest in real property to the extent of the value of the real estate mortgages (or interests therein). An obligation secured by both real estate mortgages (or interests therein) and other assets is treated as an obligation secured by an interest in real property to the extent of both the value of the real estate mortgages (or interests therein) and the value of so much of the other assets that constitute real property. Thus, under this paragraph, a collateralized mortgage obligation may be an obligation principally secured by an interest in real property. This section is applicable only to obligations issued after December 31, 1991.

(B) *Example.* The following example illustrates the principles of this paragraph (d)(3)(ii):

Example. At the time it is originated, an obligation has an adjusted issue price of $300,000 and is secured by a $70,000 loan principally secured by an interest in a single family home, a fifty percent co-ownership interest in a $400,000 parcel of land, and $80,000 of stock. Under paragraph (d)(3)(ii)(A) of this section, the obligation is treated as secured by interests in real property and under paragraph (d)(3)(i)(A) of this section, the obligation is treated as principally secured by interests in real property.

(e) *Two or more maturities*—(1) *In general.* For purposes of section 7701(i)(2)(A)(ii), debt obligations have two or more maturities if they have different stated maturities or if the holders of the obligations possess different rights concerning the acceleration of or delay in the maturities of the obligations.

(2) *Obligations that are allocated credit risk unequally.* Debt obligations that are allocated credit risk unequally do not have, by that reason alone, two or more maturities. Credit risk is the risk that payments of principal or interest will be reduced or delayed because of a default on an asset that supports the debt obligations.

(3) *Examples.* The following examples illustrate the principles of this paragraph (e):

Example 1. (i) Corporation M transfers a pool of real estate mortgages to a trustee in exchange for Class A bonds and a certificate representing the residual beneficial ownership of the pool. All Class A bonds have a stated maturity of March 1, 2002, but if cash flows from the real estate mortgages and investments are sufficient, the trustee may select one or more bonds at random and redeem them earlier.

(ii) The Class A bonds do not have different maturities. Each outstanding Class A bond has an equal chance of being redeemed because the selection process is random. The holders of the Class A bonds, therefore, have identical rights concerning the maturities of their obligations.

Example 2. (i) Corporation N transfers a pool of real estate mortgages to a trustee in exchange for Class C bonds, Class D bonds, and a certificate representing the residual beneficial ownership of the pool. The Class D bonds are subordinate to the Class C bonds so that cash flow shortfalls due to defaults or delinquencies on the real estate mortgages are borne first by the Class D bond holders. The terms of the bonds are otherwise identical in all relevant aspects except that the Class D bonds carry a higher coupon rate because of the subordination feature.

(ii) The Class C bonds and the Class D bonds share credit risk unequally because of the subordination feature. However, neither this difference, nor the difference in interest rates, causes the bonds to have different maturities. The result is the same if, in addition to the other terms described in paragraph (i) of this *Example 2*, the Class C bonds are accelerated as a result of the issuer becoming unable to make payments on the Class C bonds as they become due.

(f) *Relationship test*—(1) *In general.* For purposes of section 7701(i)(2)(A)(iii), payments on debt obligations under which an entity is the obligor (liability obligations) bear a relationship to payments (as defined in paragraph (f)(2) of this section) on debt obligations an entity holds as assets (asset obligations) if under the terms of the liability obligations (or underlying arrangement) the timing and amount of payments on the liability obligations are in large part determined by the timing and amount of payments or projected payments on the asset obligations. For purposes of the relationship test, any payment arrangement, including a swap or other hedge, that achieves a substantially similar result is treated as satisfying the test. For example, any arrangement where the timing and amount of payments on liability obligations are determined by reference to a group of assets (or an index or other type of model) that has an expected payment experience similar to that of the asset obligations is treated as satisfying the relationship test.

(2) *Payments on asset obligations defined.* For purposes of section 7701(i)(2)(A)(iii) and this section, payments on asset obligations include—

(i) A payment of principal or interest on an asset obligation, including a prepayment of principal, a payment under a credit enhancement contract (as defined in paragraph (c)(4)(ii) of this section) and a payment from a settlement at a discount (other than a substantial discount);

(ii) A payment from a settlement at a substantial discount, but only if the settlement is arranged, whether in writing or otherwise, prior to the issuance of the liability obligations; and

(iii) A payment from the foreclosure on or sale of an asset obligation, but

only if the foreclosure or sale is arranged, whether in writing or otherwise, prior to the issuance of the liability obligations.

(3) *Safe harbor for entities formed to liquidate assets.* Payments on liability obligations of an entity do not bear a relationship to payments on asset obligations of the entity if—

(i) The entity's organizational documents manifest clearly that the entity is formed for the primary purpose of liquidating its assets and distributing proceeds of liquidation;

(ii) The entity's activities are all reasonably necessary to and consistent with the accomplishment of liquidating assets;

(iii) The entity plans to satisfy at least 50 percent of the total issue price of each of its liability obligations having a different maturity with proceeds from liquidation and not with scheduled payments on its asset obligations; and

(iv) The terms of the entity's liability obligations (or underlying arrangement) provide that within three years of the time it first acquires assets to be liquidated the entity either—

(A) Liquidates; or

(B) Begins to pass through without delay all payments it receives on its asset obligations (less reasonable allowances for expenses) as principal payments on its liability obligations in proportion to the adjusted issue prices of the liability obligations.

(g) *Anti-avoidance rules*—(1) *In general.* For purposes of determining whether an entity meets the definition of a taxable mortgage pool, the Commissioner can disregard or make other adjustments to a transaction (or series of transactions) if the transaction (or series) is entered into with a view to achieving the same economic effect as that of an arrangement subject to section 7701(i) while avoiding the application of that section. The Commissioner's authority includes treating equity interests issued by a non-REMIC as debt if the entity issues equity interests that correspond to maturity classes of debt.

(2) *Certain investment trusts.* Notwithstanding paragraph (g)(1) of this section, an ownership interest in an entity that is classified as a trust under §301.7701–4(c) will not be treated as a debt obligation of the trust.

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

Example 1. (i) Partnership P, in addition to its other investments, owns $10,000,000 of mortgage pass-through certificates guaranteed by FNMA (FNMA Certificates). On May 15, 1997, Partnership P transfers the FNMA Certificates to Trust 1 in exchange for 100 Class A bonds and Certificate 1. The Class A bonds, under which Trust 1 is the obligor, have a stated principal amount of $5,000,000 and bear a relationship to the FNMA Certificates (within the meaning of §301.7701(i)–1(f)). Certificate 1 represents the residual beneficial ownership of the FNMA Certificates.

(ii) On July 5, 1997, with a view to avoiding the application of section 7701(i), Partnership P transfers Certificate 1 to Trust 2 in exchange for 100 Class B bonds and Certificate 2. The Class B bonds, under which Trust 2 is the obligor, have a stated principal amount of $5,000,000, bear a relationship to the FNMA Certificates (within the meaning of §301.7701(i)-1(f)), and have a different maturity than the Class A bonds (within the meaning of §301.7701(i)-1(e)). Certificate 2 represents the residual beneficial ownership of Certificate 1.

(iii) For purposes of determining whether Trust 1 is classified as a taxable mortgage pool, the Commissioner can disregard the separate existence of Trust 2 and treat Trust 1 and Trust 2 as a single trust.

Example 2. (i) Corporation Q files a consolidated return with its two wholly-owned subsidiaries, Corporation R and Corporation S. Corporation R is in the business of building and selling single family homes. Corporation S is in the business of financing sales of those homes.

(ii) On August 10, 1998, Corporation S transfers a pool of its real estate mortgages to Trust 3, taking back Certificate 3 which represents beneficial ownership of the pool. On September 25, 1998, with a view to avoiding the application of section 7701(i), Corporation R issues bonds that have different maturities (within the meaning of §301.7701(i)–1(e)) and that bear a relationship (within the meaning of §301.7701(i)-1(f)) to the real estate mortgages in Trust 3. The holders of the bonds have an interest in a credit enhancement contract that is written by Corporation S and collateralized with Certificate 3.

(iii) For purposes of determining whether Trust 3 is classified as a taxable mortgage pool, the Commissioner can treat Trust 3 as the obligor of the bonds issued by Corporation R.

Example 3. (i) Corporation X, in addition to its other assets, owns $110,000,000 in Treasury

securities. From time to time, Corporation X acquires pools of real estate mortgages, which it immediately uses to issue multiple-class debt obligations.

(ii) On October 1, 1996, Corporation X transfers $20,000,000 in Treasury securities to Trust 4 in exchange for Class C bonds, Class D bonds, Class E bonds, and Certificate 4. Trust 4 is the obligor of the bonds. The different classes of bonds have the same stated maturity date, but if cash flows from the Trust 4 assets exceed the amounts needed to make interest payments, the trustee uses the excess to retire the classes of bonds in alphabetical order. Certificate 4 represents the residual beneficial ownership of the Treasury securities.

(iii) With a view to avoiding the application of section 7701(i), Corporation X reserves the right to replace any Trust 4 asset with real estate mortgages or guaranteed mortgage pass-through certificates. In the event the right is exercised, cash flows on the real estate mortgages and guaranteed pass-through certificates will be used in the same manner as cash flows on the Treasury securities. Corporation X exercises this right of replacement on February 1, 1997.

(iv) For purposes of determining whether Trust 4 is classified as a taxable mortgage pool, the Commissioner can treat February 1, 1997, as a testing day (within the meaning of § 301.7701(i)-3(c)(2)). The result is the same if Corporation X has an obligation, rather than a right, to replace the Trust 4 assets with real estate mortgages and guaranteed pass-through certificates.

Example 4. (i) Corporation Y, in addition to its other assets, owns $1,900,000 in obligations secured by personal property. On November 1, 1995, Corporation Y begins negotiating a $2,000,000 loan to individual A. As security for the loan, A offers a first deed of trust on land worth $1,700,000.

(ii) With a view to avoiding the application of section 7701(i), Corporation Y induces A to place the land in a partnership in which A will have a 95 percent interest and agrees to accept the partnership interest as security for the $2,000,000 loan. Thereafter, the loan to A, together with the $1,900,000 in obligations secured by personal property, are transferred to Trust 5 and used to issue bonds that have different maturities (within the meaning of § 301.7701(i)-1(e)) and that bear a relationship (within the meaning of § 301.7701(i)-1(f)) to the $1,900,000 in obligations secured by personal property and the loan to A.

(iii) For purposes of determining whether Trust 5 is a taxable mortgage pool, the Commissioner can treat the loan to A as an obligation secured by an interest in real property rather than as an obligation secured by an interest in a partnership.

Example 5. (i) Corporation Z, in addition to its other assets, owns $3,000,000 in notes secured by interests in retail shopping centers. Partnership L, in addition to its other assets, owns $20,000,000 in notes that are principally secured by interests in single family homes and $3,500,000 in notes that are principally secured by interests in personal property.

(ii) On December 1, 1995, Partnership L asks Corporation Z for two separate loans, one in the amount of $9,375,000 and another in the amount of $625,000. Partnership L offers to collateralize the $9,375,000 loan with $10,312,500 of notes secured by interests in single family homes and the $625,000 loan with $750,000 of notes secured by interests in personal property. Corporation Z has made similar loans to Partnership L in the past.

(iii) With a view to avoiding the application of section 7701(i), Corporation Z induces Partnership L to accept a single $10,000,000 loan and to post as collateral $7,500,000 of the notes secured by interests in single family homes and all $3,500,000 of the notes secured by interests in personal property. Ordinarily, Corporation Z would not make a loan on these terms. Thereafter, the loan to Partnership L, together with the $3,000,000 in notes secured by interests in retail shopping centers, are transferred to Trust 6 and used to issue bonds that have different maturities (within the meaning of § 301.7701(i)–1(e)) and that bear a relationship (within the meaning of § 301.7701(i)–1(f)) to the loans secured by interests in retail shopping centers and the loan to Partnership L.

(iv) For purposes of determining whether Trust 6 is a taxable mortgage pool, the Commissioner can treat the $10,000,000 loan to Partnership L as consisting of a $9,375,000 obligation secured by interests in real property and a $625,000 obligation secured by interests in personal property. Under § 301.7701(i)–1(d)(3)(ii)(A), the notes secured by single family homes are treated as $7,500,000 of interests in real property. Under § 301.7701(i)–1(d)(3)(i)(A), $7,500,000 of interests in real property are sufficient to treat a $9,375,000 obligation as principally secured by an interest in real property ($7,500,000 equals 80 percent of $9,375,000).

[T.D. 8610, 60 FR 40088, Aug. 7, 1995; 60 FR 49754, Sept. 27, 1995]

§ 301.7701(i)–2 Special rules for portions of entities.

(a) *Portion defined.* Except as provided in paragraph (b) of this section and § 301.7701(i)–1, a portion of an entity includes all assets that support one or more of the same issues of debt obligations. For this purpose, an asset supports a debt obligation if, under the terms of the debt obligation (or underlying arrangement), the timing and

amount of payments on the debt obligation are in large part determined, either directly or indirectly, by the timing and amount of payments or projected payments on the asset or a group of assets that includes the asset. Indirect payment arrangements include, for example, a swap or other hedge, or arrangements where the timing and amount of payments on the debt obligations are determined by reference to a group of assets (or an index or other type of model) that has an expected payment experience similar to that of the assets. For purposes of this paragraph, the term payments includes all proceeds and receipts from an asset.

(b) *Certain assets and rights to assets disregarded*—(1) *Credit enhancement assets.* An asset that qualifies as a credit enhancement contract (as defined in §301.7701(i)–1(c)(4)(ii)) is not included in a portion as a separate asset, but is treated as part of the assets in the portion to which it relates under §301.7701(i)–1(c)(4)(i). An asset that does not qualify as a credit enhancement contract (as defined in §301.7701(i)–1(c)(4)(ii)), but that nevertheless serves the same function as a credit enhancement contract, is not included in a portion as a separate asset or otherwise.

(2) *Assets unlikely to service obligations.* A portion does not include assets that are unlikely to produce any significant cash flows for the holders of the debt obligations. This paragraph applies even if the holders of the debt obligations are legally entitled to cash flows from the assets. Thus, for example, even if the sale of a building would cause a series of debt obligations to be redeemed, the building is not included in a portion if it is not likely to be sold.

(3) *Recourse.* An asset is not included in a portion solely because the holders of the debt obligations have recourse to the holder of that asset.

(c) *Portion as obligor*—(1) *In general.* For purposes of section 7701(i)(2)(A)(ii), a portion of an entity is treated as the obligor of all debt obligations supported by the assets in that portion.

(2) *Example.* The following example illustrates the principles of this section:

Example. (i) Corporation Z owns $1,000,000,000 in assets including an office complex and $90,000,000 of real estate mortgages.

(ii) On November 30, 1998, Corporation Z issues eight classes of bonds, Class A through Class H. Each class is secured by a separate letter of credit and by a lien on the office complex. One group of the real estate mortgages supports Class A through Class D, another group supports Class E through Class G, and a third group supports Class H. It is anticipated that the cash flows from each group of mortgages will service its related bonds.

(iii) Each of the following constitutes a separate portion of Corporation Z: the group of mortgages supporting Class A through Class D; the group of mortgages supporting Class E through Class G; and the group of mortgages supporting Class H. No other asset is included in any of the three portions notwithstanding the lien of the bonds on the office complex and the fact that Corporation Z is the issuer of the bonds. The letters of credit are treated as incidents of the mortgages to which they relate.

(iv) For purposes of section 7701(i)(2)(A)(ii), each portion described above is treated as the obligor of the bonds of that portion, notwithstanding the fact that Corporation Z is the legal obligor with respect to the bonds.

[T.D. 8610, 60 FR 40091, Aug. 7, 1995]

§301.7701(i)–3 Effective dates and duration of taxable mortgage pool classification.

(a) *Effective dates.* Except as otherwise provided, the regulations under section 7701(i) are effective and applicable September 6, 1995.

(b) *Entities in existence on December 31, 1991*—(1) *In general.* For transitional rules concerning the application of section 7701(i) to entities in existence on December 31, 1991, see section 675(c) of the Tax Reform Act of 1986.

(2) *Special rule for certain transfers.* A transfer made to an entity on or after September 6, 1995, is a substantial transfer for purposes of section 675(c)(2) of the Tax Reform Act of 1986 only if—

(i) The transfer is significant in amount; and

(ii) The transfer is connected to the entity's issuance of related debt obligations (as defined in paragraph (b)(3) of this section) that have different maturities (within the meaning of §301.7701–1(e)).

(3) *Related debt obligation.* A related debt obligation is a debt obligation whose payments bear a relationship (within the meaning of §301.7701–1(f)) to

payments on debt obligations that the entity holds as assets.

(4) *Example.* The following example illustrates the principles of this paragraph (b):

Example. On December 31, 1991, Partnership Q holds a pool of real estate mortgages that it acquired through retail sales of single family homes. Partnership Q raises $10,000,000 on October 25, 1996, by using this pool to issue related debt obligations with multiple maturities. The transfer of the $10,000,000 to Partnership Q is a substantial transfer (within the meaning of § 301.7701(i)–3(b)(2)).

(c) *Duration of taxable mortgage pool classification*—(1) *Commencement and duration.* An entity is classified as a taxable mortgage pool on the first testing day that it meets the definition of a taxable mortgage pool. Once an entity is classified as a taxable mortgage pool, that classification continues through the day the entity retires its last related debt obligation.

(2) *Testing day defined.* A testing day is any day on or after September 6, 1995, on which an entity issues a related debt obligation (as defined in paragraph (b)(3) of this section) that is significant in amount.

[T.D. 8610, 60 FR 40092, Aug. 7, 1995]

§ 301.7701(i)–4 Special rules for certain entities.

(a) *States and municipalities*—(1) *In general.* Regardless of whether an entity satisfies any of the requirements of section 7701(i)(2)(A), an entity is not classified as a taxable mortgage pool if—

(i) The entity is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (within the meaning of § 1.103–1(b) of this chapter), or is empowered to issue obligations on behalf of one of the foregoing;

(ii) The entity issues the debt obligations in the performance of a governmental purpose; and

(iii) The entity holds the remaining interests in all assets that support those debt obligations until the debt obligations issued by the entity are retired.

(2) *Governmental purpose.* The term governmental purpose means an essential governmental function within the meaning of section 115. A governmental purpose does not include the mere packaging of debt obligations for resale on the secondary market even if any profits from the sale are used in the performance of an essential governmental function.

(3) *Determinations by the Commissioner.* If an entity is not described in paragraph (a)(1) of this section, but has a similar purpose, then the Commissioner may determine that the entity is not classified as a taxable mortgage pool.

(b) *REITs.* [Reserved]

(c) *Subchapter S corporations*—(1) *In general.* An entity that is classified as a taxable mortgage pool may not elect to be an S corporation under section 1362(a) or maintain S corporation status.

(2) *Portion of an S corporation treated as a separate corporation.* An S corporation is not treated as a member of an affiliated group under section 1361(b)(2)(A) solely because a portion of the S corporation is treated as a separate corporation under section 7701(i).

[T.D. 8610, 60 FR 40092, Aug. 7, 1995]

§ 301.7704–2 Transition provisions.

See the regulations under section 7704 contained in part 1 of this chapter for a definition of the ''substantial new line of business'' that an ''existing'' publicly traded partnership cannot enter without forfeiting its partnership status under the transition provisions applicable to section 7704.

[T.D. 8450, 57 FR 58710, Dec. 11, 1992]

General Rules

APPLICATION OF INTERNAL REVENUE LAWS

§ 301.7803–1 Security bonds covering personnel of the Internal Revenue Service.

For regulations relating to the procurement of security bonds covering designated personnel of the Internal Revenue Service between January 1,