

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8853]

RIN 1545-AV07

Recharacterizing Financing Arrangements Involving Fast-pay Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that recharacterize, for tax purposes, financing arrangements involving fast-pay stock. The regulations are necessary to prevent taxpayers from using fast-pay stock to achieve inappropriate tax avoidance. The regulations affect corporations that issue fast-pay stock, holders of fast-pay stock, and other shareholders that may claim tax benefits purported to result from arrangements involving fast-pay stock.

DATES: Effective Date: February 27, 1997.

Applicability Dates: For dates of applicability, see §§ 1.1441-10(e) and 1.7701(l)-3(g) of these regulations.

FOR FURTHER INFORMATION CONTACT: Jonathan Zelnik, (202) 622-3920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction

Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1642. Responses to this collection of information are mandatory.

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

The estimated average annual burden hours per respondent/recordkeeper: 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

On February 27, 1997, the IRS issued Notice 97-21, 1997-1 C.B. 407, which relates to financing arrangements involving fast-pay stock. Among other things, the notice informed the public that the IRS and Treasury Department expected to issue regulations recharacterizing these arrangements to prevent tax

avoidance. No comments were received in response to Notice 97-21.

On January 6, 1999, the IRS published in the **Federal Register** a notice of proposed rulemaking (64 FR 805) providing rules for the recharacterization of certain fast-pay arrangements under section 7701(1) of the Internal Revenue Code. Because no one requested to speak at the public hearing, the hearing was canceled. Four written comments responding to the notice of proposed rulemaking were received. The comments addressed neither (1) the accuracy of the estimate of the collection of information burden nor (2) the accuracy of the IRS's understanding that the total number of entities engaging in transactions affected by these regulations is not substantial and most are not small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. chapter 6). After considering the comments, the proposed regulations are adopted as final regulations with some changes.

The preamble to the proposed regulations (64 FR 805) provides a detailed discussion of fast-pay arrangements and the proposed regulations.

SUMMARY OF COMMENTS AND CHANGES

In General

Two commentators were generally favorable to the proposed regulations. One considered them a reasonable attempt to address abusive transactions. The other viewed them as consistent with section 7701(1), but preferred, as a matter of tax policy, a legislative solution. One of these commentators also recommended

narrowing the scope of the proposed regulations, asserting they might penalize shareholders who do not benefit from the fast-pay arrangement. Significantly, neither of these commentators recommended that the final regulations adopt a different approach, such as the one taken in Notice 97-21.

A third commentator criticized the proposed regulations as inconsistent with section 7701(1). This commentator viewed them as addressing not a conduit financing issue, but a tax accounting issue, namely, that the amount of dividend income under tax principles can exceed the economic income from the stock. Additionally, this commentator believed that regulations under section 7701(1) cannot operate if there is no back-to-back structure or if the corporation subject to recharacterization holds bona fide assets such as third-party debt. Finally, the commentator questioned whether the grant of regulatory authority under section 7701(1) permits recharacterizing transactions subject to other, comprehensive statutory rules such as the rules governing the transactions of RICs and REITs.

The IRS and Treasury Department have concluded that section 7701(1) authorizes recharacterization of any multiple-party financing transaction, including a fast-pay arrangement. The IRS and Treasury Department have also concluded (as did the other two commentators) that recharacterizing a fast-pay arrangement as an arrangement directly between the fast-pay shareholders and the benefited shareholders is consistent with the legislative mandate of section 7701(1). Thus, the final regulations retain the

approach of the proposed regulations while making some changes to address other comments.

Definition of Fast-pay Stock

Under the proposed regulations, stock is fast-pay stock if it is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). To determine if it is fast-pay stock, stock is examined when issued, and, for stock that is not fast-pay stock when issued, when there is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances.

Two commentators expressed concern about the interaction of section 302 with the definition of fast-pay stock and the duty to retest stock. In particular, the commentators asked whether stock that is not fast-pay stock when issued can become fast-pay stock solely because a redemption of the stock is treated as a dividend under section 302. This conversion is possible because section 302 treats certain redemptions as distributions of property to which section 301 applies rather than as distributions in exchange for stock.

The commentators gave different reasons why stock should not become fast-pay stock solely because a redemption is treated as a dividend. One reason was that section 302 and the provisions referring to it (for example, section 1059(e)) already

recharacterize certain redemptions of stock, which indicates Congress has determined the appropriate tax treatment of these transactions. Another reason was that applying the fast-pay regulations to arrangements involving redemptions may have a chilling effect on common, non-abusive transactions. Finally, it was suggested that any changes affecting the application of section 302 should be accomplished by issuing new regulations under that statute.

The IRS and Treasury Department agree it is inappropriate to treat as a fast-pay arrangement every arrangement in which a redemption of stock produces dividend income under section 302. The IRS and Treasury Department, however, conclude that eliminating all such arrangements from the scope of the regulations would render the regulations meaningless. Little difference exists between a fast-pay arrangement resulting from redemptions structured to be dividends and a fast-pay arrangement resulting from dividends structured to be a return of the holder's investment.

To balance the concerns of the commentators and the concerns of the IRS and Treasury Department, the final regulations add a new rule clarifying the effect of section 302 on the determination of whether stock is fast-pay stock. Under this rule, stock is not fast-pay stock solely because a redemption is treated as a dividend by section 302 unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. In this way, only those arrangements in which

redemptions are designed to return a shareholder's economic investment as dividends are recharacterized. Because the problem of stock redemptions may be common to many different fast-pay arrangements, regardless of how they are structured, the rule addressing such problem is placed within the regulations under section 7701(1) rather than under a different section.

Characterization of the Financing Instruments

Under the proposed regulations, the fast-pay shareholders are treated as holding financing instruments issued by the benefited shareholders rather than as holding the fast-pay stock. The character of financing instruments (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances.

All three commentators were concerned by the failure of the proposed regulations to classify the financing instruments as debt. If the financing instruments are classified as stock, the benefited shareholders are subject to substantially greater tax liabilities: they must include in income all dividends paid by the corporation that issues the fast-pay stock, but cannot deduct amounts deemed paid with respect to the financing instruments. According to the commentators, this result distorts the benefited shareholders' economic income. Therefore, the regulations should classify the financing instruments as debt in all cases.

After careful consideration of the comments, the IRS and Treasury Department have decided against characterizing the financing instruments in the final regulations. Although debt

characterization may be appropriate in some cases, in other cases it will be more appropriate to characterize the financing instruments as equity or something else. Thus, the rule in the proposed regulations is retained. (As explained below, however, the final regulations permit taxpayers, for a limited period, to determine their taxable income attributable to a recharacterized fast-pay arrangement by treating the financing instruments as debt.)

Election to Limit Taxable Income Attributable to a Recharacterized Fast-pay Arrangement for Periods Before April 1, 2000

Because the regulations are effective February 27, 1997 (the date Notice 97-21 was issued to the public), the proposed regulations permit a shareholder of a recharacterized fast-pay arrangement to limit, for certain taxable years, its income from the arrangement. Specifically, a shareholder may limit its taxable income attributable to a recharacterized fast-pay arrangement to the taxable income that results if the fast-pay arrangement is recharacterized under Notice 97-21. This limit is available under the proposed regulations for taxable years ending after the effective date of the regulations and before the regulations are finalized. Any amount excluded under this limit must be included as an adjustment to taxable income in the shareholder's first taxable year that includes the date the regulations are finalized. Thus, the sole benefit of limiting taxable income under the proposed regulations is a timing

benefit. The preamble to the proposed regulations found this appropriate on the assumption that over the life of a fast-pay arrangement a shareholder has the same amount of taxable income whether the fast-pay arrangement is recharacterized under Notice 97-21 or under the regulations.

One commentator criticized this assumption, and, therefore, the limit and later adjustment. In particular, the commentator pointed out that if the financing instruments are treated as equity under the regulations, a benefited shareholder would have had less taxable income over the life of the fast-pay arrangement under the recharacterization of Notice 97-21 (that is, a shareholder would have a permanent reduction to taxable income). Thus, the limit is without any substantive effect because any non-timing reduction in taxable income due to the limit is included in the year the regulations are finalized. To rectify this problem, the commentator asked that, if the final regulations do not classify the financing instruments as debt in all cases, they should at least classify the financing instruments as debt for the period starting after the effective date of the final regulations and ending before the final regulations are published.

To address these concerns, the final regulations adopt a different rule from the one in the proposed regulations. As with the proposed regulations, a shareholder may limit its taxable income to either the amount determined under Notice 97-21 or the amount determined under the regulations. For purposes of this

limit, a shareholder may assume the financing instruments are debt under the final regulations. A shareholder may also make this assumption to determine the amount of any later adjustment to income because of the limit. Thus, the later adjustment will not include any permanent reduction to taxable income a shareholder realizes by limiting its taxable income to the amount determined under Notice 97-21.

The final regulations also adopt a longer period during which shareholders may limit their taxable income. Under the proposed regulation, a shareholder may limit its taxable income for taxable years ending after February 26, 1997, and before the date these regulations are published as final regulations in the Federal Register. The final regulations permit a shareholder to limit its taxable income for all periods before April 1, 2000. Thus, for all taxable years ending after February 26, 1997 and before April 1, 2000, and for that part of a shareholder's taxable year before April 1, 2000, a shareholder may limit its taxable income attributable to the fast-pay arrangement.

In permitting shareholders to determine their taxable income under the regulations by assuming that the financing instruments are debt for periods before April 1, 2000, the IRS and Treasury Department intend no implication regarding the proper characterization of the financing instruments under general tax principles. Rather, the rule regarding the financing instruments is intended solely for the purpose of giving shareholders the

benefit of the recharacterization described in Notice 97-21 for periods before April 1, 2000.

Use of Derivatives to Avoid the Regulations

One commentator recommended adding an explicit rule to prevent parties from using derivative contracts to create a fast-pay arrangement that escapes either the regulations or the effect of the recharacterization rules. To illustrate this point, the commentator posited a simplified transaction in which a corporation issues fast-pay stock to one tax-exempt entity and benefited stock to another tax-exempt entity. The tax-exempt entity holding the benefited stock enters into a prepaid forward contract with a taxable person. Under the prepaid forward contract, the taxable person must buy the benefited stock in the future for an amount substantially below its expected value. According to the commentator, unless the taxable person is treated as owning the benefited stock, the parties have created a fast-pay arrangement in which the recharacterization of the regulations fails to prevent tax avoidance. Without making a recommendation, the commentator offered a number of rules to correct this situation. (The commentator did not discuss whether the benefited holder would be subject to the "debt-financing" rules in section 514).

The IRS and Treasury Department have concluded that there is no present need to modify the regulations to address this problem. First, the tax treatment of derivatives in general is outside of the scope of these regulations. Therefore, a rule

specific to these regulations would only increase the complexity regarding the tax treatment of derivatives. Second, and more importantly, the IRS and Treasury Department have concluded that under existing law the party entitled to purchase the benefited stock under a prepaid forward contract such as the one described above is the owner of the benefited stock for federal income tax purposes. See Rev. Rul. 82-150, 1982-2 C.B. 110 (concluding that the holder of a deep-in-the-money option is the owner of the reference property). Finally, the regulations state they are to be interpreted in a manner consistent with preventing the avoidance of tax. Mechanically applying the regulations in a manner that does not prevent tax avoidance is clearly inconsistent with the purpose of the regulations and the Congressional mandate of section 7701(1).

Fast-pay Arrangement Defined

The proposed regulations define a fast-pay arrangement as any arrangement in which a corporation has outstanding for any part of its taxable year two or more classes of stock, at least one of which is fast-pay stock. Some taxpayers assert that the regulations can be avoided by creating a fast-pay arrangement in which a corporation issues what is nominally a single class of shares, notwithstanding that some of the shares are subject to a related agreement. These taxpayers apparently rely on the formal meaning of "class" under state corporate law and ignore the direction in the proposed regulations to determine whether stock is fast-pay stock based on all the facts and circumstances.

To remove any doubt that the regulations cover fast-pay arrangements no matter how contrived, the IRS and Treasury Department have simplified the definition of "fast-pay arrangement" in the final regulations. Under this definition, a fast-pay arrangement is any arrangement in which a corporation has fast-pay stock outstanding for any part of its taxable year. The regulations illustrate this point with an example.

Effective Date

These regulations apply to taxable years ending after February 26, 1997.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the understanding of the IRS and Treasury Department that the total number of fast-pay arrangements is fewer than 100, that the number of entities engaging in transactions affected by these regulations is not substantial and, of those entities, few or none are small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of

the Small Business Administration for comments on its impact on small businesses.

Drafting Information

The principal authors of these regulations are Jonathan Zelnik and Marshall Feiring of the Office of the Assistant Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

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

PART 1--INCOME TAXES

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

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

Section 1.7701(1)-3 also issued under 26 U.S.C. 7701(1).

* * *

Par. 2. Section 1.1441-10, is added to read as follows:

§1.1441-10 Withholding agents with respect to fast-pay arrangements.

(a) In general. A corporation that issues fast-pay stock in a fast-pay arrangement described in §1.7701(1)-3(b)(1) is a

withholding agent with respect to payments made on the fast-pay stock and payments deemed made under the recharacterization rules of §1.7701(1)-3. Except as provided in this paragraph (a) or in paragraph (b) of this section, the withholding tax rules under section 1441 and section 1442 apply with respect to a fast-pay arrangement described in §1.7701(1)-3(c)(1)(i) in accordance with the recharacterization rules provided in §1.7701(1)-3(c). In all cases, notwithstanding paragraph (b) of this section, if at any time the withholding agent knows or has reason to know that the Commissioner has exercised the discretion under either §1.7701(1)-3(c)(1)(ii) to apply the recharacterization rules of §1.7701(1)-3(c), or §1.7701(1)-3(d) to depart from the recharacterization rules of §1.7701(1)-3(c) for a taxpayer, the withholding agent must withhold on payments made (or deemed made) to that taxpayer in accordance with the characterization of the fast-pay arrangement imposed by the Commissioner under §1.7701(1)-3.

(b) Exception. If at any time the withholding agent knows or has reason to know that any taxpayer entered into a fast-pay arrangement with a principal purpose of applying the recharacterization rules of §1.7701(1)-3(c) to avoid tax under section 871(a) or section 881, then for each payment made or deemed made to such taxpayer under the arrangement, the withholding agent must withhold, under section 1441 or section 1442, the higher of--

(1) The amount of withholding that would apply to such payment determined under the form of the arrangement; or

(2) The amount of withholding that would apply to deemed payments determined under the recharacterization rules of §1.7701(l)-3(c).

(c) Liability. Any person required to deduct and withhold tax under this section is made liable for that tax by section 1461, and is also liable for applicable penalties and interest for failing to comply with section 1461.

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

Example 1. REIT W issues shares of fast-pay stock to foreign individual A, a resident of Country C. United States source dividends paid to residents of C are subject to a 30 percent withholding tax. W issues all shares of benefited stock to foreign individuals who are residents of Country D. D's income tax convention with the United States reduces the United States withholding tax on dividends to 15 percent. Under §1.7701(l)-3(c), the dividends paid by W to A are deemed to be paid by W to the benefited shareholders. W has reason to know that A entered into the fast-pay arrangement with a principal purpose of using the recharacterization rules of §1.7701(l)-3(c) to reduce United States withholding tax. W must withhold at the 30 percent rate because the amount of withholding that applies to the payments determined under the form of the arrangement is higher than the amount of withholding that applies to the payments determined under §1.7701(l)-3(c).

Example 2. The facts are the same as in Example 1 of this paragraph (d) except that W does not know, or have reason to know, that A entered into the arrangement with a principal purpose of using the recharacterization rules of §1.7701(l)-3(c) to reduce United States withholding tax. Further, the Commissioner has not exercised the discretion under §1.7701(l)-3(d) to depart from the recharacterization rules of §1.7701(l)-3(c). Accordingly, W must withhold tax at a 15 percent rate on the dividends deemed paid to the benefited shareholders.

(e) Effective date. This section applies to payments made (or deemed made) on or after January 6, 1999.

Par. 3. Section 1.7701(1)-0 is added to read as follows:

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This section lists captions that appear in §§1.7701(1)-1 and 1.7701(1)-3:

§1.7701(1)-1 Conduit financing arrangements.

§1.7701(1)-3 Recharacterizing financing arrangements involving fast-pay stock.

- (a) Purpose and scope.
- (b) Definitions.
 - (1) Fast-pay arrangement.
 - (2) Fast-pay stock.
 - (i) Defined.
 - (ii) Determination.
 - (3) Benefited stock.
- (c) Recharacterization of certain fast-pay arrangements.
 - (1) Scope.
 - (2) Recharacterization.
 - (i) Relationship between benefited shareholders and fast-pay shareholders.
 - (ii) Relationship between benefited shareholders and corporation.
 - (iii) Relationship between fast-pay shareholders and corporation.
 - (3) Other rules.
 - (i) Character of the financing instruments.
 - (ii) Multiple types of benefited stock.
 - (iii) Transactions affecting benefited stock.
 - (A) Sale of benefited stock.
 - (B) Transactions other than sales.
 - (iv) Adjustment to basis for amounts accrued or paid in taxable years ending before February 27, 1997.
- (d) Prohibition against affirmative use of recharacterization by taxpayers.
- (e) Examples.
- (f) Reporting requirement.
 - (1) Filing requirements.
 - (i) In general.
 - (ii) Controlled foreign corporation.
 - (iii) Foreign personal holding company.
 - (iv) Passive foreign investment company.
 - (2) Statement.
- (g) Effective date.
 - (1) In general.
 - (2) Election to limit taxable income attributable to a recharacterized fast-pay arrangement for periods before April 1, 2000.
 - (i) Limit.
 - (ii) Adjustment and statement.

- (iii) Examples.
- (3) Rule to comply with this section.
- (4) Reporting requirements.

Par. 4. Section 1.7701(l)-3 is added to read as follows:

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

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

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

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

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

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

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

(3) Benefited stock. With respect to any fast-pay stock, all other stock in the corporation (including other fast-pay

stock having any significantly different characteristics) is benefited stock.

(c) Recharacterization of certain fast-pay arrangements--

(1) Scope. This paragraph (c) applies to any fast-pay arrangement--

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

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

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

(i) Relationship between benefited shareholders and fast-pay shareholders. The benefited shareholders issue financial instruments (the financing instruments) directly to the fast-pay shareholders in exchange for cash equal to the fair market value of the fast-pay stock at the time of issuance (taking into account any related agreements). The financing instruments have

the same terms (other than issuer) as the fast-pay stock. Thus, for example, the timing and amount of the payments made with respect to the financing instruments always match the timing and amount of the distributions made with respect to the fast-pay stock.

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

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

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

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

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

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

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

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

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

(A) Its income attributable to the benefited stock (reduced by deductions attributable to the financing instruments) for

taxable years ending before February 27, 1997, computed by recharacterizing the fast-pay arrangement under this paragraph (c) and by treating the financing instruments as debt; exceeds

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

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

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

Example 1. Decline in dividend rate--(i) Facts. Corporation X issues 100 shares of A Stock and 100 shares of B Stock for \$1,000 per share. By its terms, a share of B Stock is reasonably expected to pay a \$110 dividend in years 1 through 10

and a \$30 dividend each year thereafter. If X liquidates, the holder of a share of B Stock is entitled to a preference equal to the share's issue price. Otherwise, the B Stock cannot be redeemed at either X's or the shareholder's option.

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

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

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

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

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

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

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

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

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

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

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

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

Example 5. Transfer of benefited stock illustrated--
(i) Facts. The facts are the same as in Example 4 of this paragraph (e). Near the end of year 5, a person holding one share of C Stock sells it for \$1,300. The buyer is unrelated to REIT Y or to any of the D Stock shareholders. At the time of the

sale, the amount needed to terminate the seller's position in the financing instruments at fair market value is \$747.

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

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

Example 6. Fast-pay arrangement involving amounts accrued or paid in a taxable year ending before February 27, 1997--

(i) Facts. Y is a calendar year taxpayer. In June 1996, Y acquires shares of REIT T benefited stock for \$15,000. In December 1996, Y receives dividends of \$100. Under the recharacterization rules of paragraph (c)(2) of this section, Y's 1996 income attributable to the benefited stock is \$1,200, Y's 1996 deduction attributable to the financing instruments is \$500, and Y's basis in the benefited stock is \$25,000.

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

(f) Reporting requirement--(1) Filing requirements--(i) In general. A corporation that has fast-pay stock outstanding at any time during the taxable year must attach the statement described in paragraph (f)(2) of this section to its federal

income tax return for such taxable year. This paragraph (f)(1)(i) does not apply to a corporation described in paragraphs (f)(1)(ii), (iii), or (iv) of this section.

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

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

(iv) Passive foreign investment company. In the case of a passive foreign investment company (PFIC), as defined in section

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

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

(g) Effective date--(1) In general. Except as provided in paragraph (g)(4) of this section (relating to reporting requirements), this section applies to taxable years ending after

February 26, 1997. Thus, all amounts accrued or paid during the first taxable year ending after February 26, 1997, are subject to this section.

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

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

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

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

for which an adjustment must be made and providing the amount of the adjustment for each such fast-pay arrangement.

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

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

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

(C) On the day Y is formed, it acquires a five-year mortgage note (the note) issued by an unrelated third party for \$200,000. The note provides for annual interest payments on December 31 of \$18,000 (a coupon interest rate of 9.00 percent, compounded annually), and one payment of principal at the end of 5 years. The note can be prepaid, in whole or in part, at any time.

(ii) Recharacterization under Notice 97-21--(A) In general. One way to recharacterize the fast-pay arrangement under Notice 97-21 is to treat the fast-pay shareholders and the benefited shareholders as if they jointly purchased the note from the issuer with the understanding that over the five-year term of the note the benefited shareholders would use their share of the interest to buy (on a dollar-for-dollar basis) the fast-pay shareholders' portion of the note. The benefited shareholders' and the fast-pay shareholders' yearly taxable income under Notice 97-21 can then be calculated after determining their initial portions of the note and whether those initial portions are purchased at a discount or premium.

(B) Determining initial portions of the debt instrument. The fast-pay shareholders' and the benefited shareholders' initial portions of the note can be determined by comparing the

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

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

| <u>Taxable Period</u> | <u>Interest Income</u> | <u>Amortizable Premium</u> | <u>Taxable Income</u> |
|-----------------------|------------------------|----------------------------|-----------------------|
| 1/1/97 - 12/31/97 | \$ 8,876 | (\$302) | \$ 8,574 |
| 1/1/98 - 12/31/98 | \$ 8,145 | (\$293) | \$ 7,852 |
| 1/1/99 - 12/31/99 | <u>\$ 7,348</u> | <u>(\$281)</u> | <u>\$ 7,067</u> |
| | \$24,369 | (\$876) | \$23,493 |

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

| <u>Taxable Period</u> | <u>Interest Income</u> | <u>Accrued Discount</u> | <u>Taxable Income</u> |
|-----------------------|------------------------|-------------------------|-----------------------|
| 1/1/97 - 12/31/97 | \$ 9,124 | \$229 | \$ 9,353 |
| 1/1/98 - 12/31/98 | \$ 9,855 | \$251 | \$10,106 |
| 1/1/99 - 12/31/99 | <u>\$10,652</u> | <u>\$274</u> | <u>\$10,926</u> |
| | \$29,631 | \$754 | \$30,385 |

(iii) Taxable income under the recharacterization of this section--(A) Fast-pay shareholders. Under paragraphs (c) and (g)(2)(i)(B) of this section, the fast-pay shareholders' taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, is the interest deemed paid on the financing instruments. For purposes of paragraph (g)(2)(i)(B) of this section, the fast-pay shareholders' taxable income as a group is as follows:

| <u>Taxable Period</u> | <u>Taxable Income</u> |
|-----------------------|-----------------------|
| 1/1/97 - 12/31/97 | \$ 8,574 |
| 1/1/98 - 12/31/98 | \$ 7,852 |
| 1/1/99 - 12/31/99 | <u>\$ 7,067</u> |
| | \$23,493 |

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

| <u>Taxable Period</u> | <u>Dividends Paid On Benefited Stock</u> | <u>Interest Paid On Financing Instruments</u> | <u>Taxable Income</u> |
|-----------------------|--|---|-----------------------|
| 1/1/97 - 12/31/97 | \$18,000 | (\$ 8,574) | \$ 9,426 |
| 1/1/98 - 12/31/98 | \$18,000 | (\$ 7,852) | \$10,148 |
| 1/1/99 - 12/31/99 | <u>\$18,000</u> | <u>(\$ 7,067)</u> | <u>\$10,933</u> |
| | \$54,000 | (\$23,493) | \$30,507 |

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

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

attributable to the fast-pay arrangement for periods before January 1, 2000, to either \$30,385 (as a group) or \$30,507 (as a group).

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

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

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

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

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

(C) Issuer's interest expense under Notice 97-21. Under Notice 97-21, Z's interest expense attributable to the fast-pay arrangement for periods before January 1, 2000, equals the interest accrued on the debt instrument held by the fast-pay shareholders, plus the interest accrued on the debt instrument

held by the benefited shareholders other than Z. For purposes of paragraph (g)(2)(i)(A) of this section, Z's interest expense is as follows:

| <u>Taxable Period</u> | Accrued Interest Fast-pay Shareholders | Accrued Interest Other Benefited Shareholders | Total Interest Expense |
|-----------------------|---|--|------------------------------|
| 1/1/97 - 12/31/97 | (\$ 8,574) | (\$1,861) | (\$10,435) |
| 1/1/98 - 12/31/98 | (\$ 7,852) | (\$2,015) | (\$ 9,867) |
| 1/1/99 - 12/31/99 | <u>(\$ 7,067)</u> | <u>(\$2,184)</u> | <u>(\$ 9,251)</u> |
| | (\$23,493) | (\$6,060) | (\$29,553) |

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

| <u>Taxable Period</u> | Dividends Benefited Stock | Accrued Interest On Debt Held By Y | Accrued Interest Financing Instruments | Taxable Expense |
|-----------------------|---------------------------------|---|---|--------------------|
| 1/1/97 - 12/31/97 | \$14,400 | (\$18,000) | (\$ 6,859) | (\$10,459) |
| 1/1/98 - 12/31/98 | \$14,400 | (\$18,000) | (\$ 6,281) | (\$ 9,881) |
| 1/1/99 - 12/31/99 | <u>\$14,400</u> | <u>(\$18,000)</u> | <u>(\$ 5,654)</u> | <u>(\$ 9,254)</u> |
| | \$43,200 | (\$54,000) | (\$18,794) | (\$29,594) |

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

(3) Rule to comply with this section. To comply with this section for each taxable year in which it failed to do so, a taxpayer should file an amended return. For taxable years ending before January 10, 2000, a taxpayer that has complied with Notice

97-21, 1997-1 C.B. 407 (see §601.601(d)(2) of this chapter), for all such taxable years is considered to have complied with this section and limited its taxable income under paragraph (g)(2)(i)(A) of this section.

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

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

Par. 6. Section 602.101(b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

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(b) * * *

| CFR part or section where identified and described | Current OMB control No. |
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| * * * * * | |
| 1.7701(1)-3 | 1545-1642 |
| * * * * * | |

/s/ Bob Wenzel

Deputy Commissioner of Internal Revenue

Approved:

/s/ Jonathan Talisman

Acting Assistant Secretary of the Treasury