application to your supervisory bank. The supervisory bank may provide comments on your national charter application to the Farm Credit Administration within a reasonable period of time.

(3) The Farm Credit Administration will notify you of its approval or disapproval of the amendment request.

(d) *Criteria for issuing national charters.* (1) You may apply for a national charter if you are in compliance with:

(i) Capital adequacy requirements in subpart H of part 615 of this chapter;

(ii) Loan underwriting requirements in subpart D of part 614 of this chapter;

(iii) Loan servicing requirements in subpart N of part 614 of this chapter;

(iv) Internal control requirements in subpart J of part 618 of this chapter;

(v) All applicable laws and regulations pertaining to nondiscrimination in lending requirements in part 626 of this chapter, and other Federal statutes and regulations governing consumer protection, equal credit opportunity, and fair lending practices.

(2) The Farm Credit Administration will grant national charters only to direct lender associations that it determines are operating safely and soundly in accordance with capital, assets, management, earnings, liquidity, interest rate sensitivity, and other safety and soundness standards.

(3) If you apply for a national charter, you must demonstrate to the Farm Credit Administration that you have implemented a program that serves young, beginning, and small farmers in your local service area, and that you have complied with § 614.4165 of this chapter and other Agency guidance.

(4) After you receive a national charter, you must continue to comply with all the requirements in paragraphs (d)(1), (d)(2) and (d)(3) of this section.

(e) *LSA requirement.* If you receive a national charter, you will have a LSA. Once you receive your national charter, you must extend credit and offer related services to all eligible and creditworthy customers in your LSA, consistent with safe and sound lending practices.

PART 618—GENERAL PROVISIONS

6. The authority citation for part 618 continues to read as follows:

Authority: Secs. 1.5, 1.11, 1.12, 2.2, 2.4, 2.5, 2.12, 3.1, 3.7, 4.12, 4.13A, 4.25, 4.29, 5.9, 5.10, 5.17 of the Farm Credit Act (12 U.S.C. 2013, 2019, 2020, 2073, 2075, 2076, 2093, 2122, 2128, 2183, 2200, 2211, 2218, 2243, 2244, 2252).

Subpart J—Internal Controls

7. Revise § 618.8440 to read as follows:

§ 618.8440 Planning.

(a) No later than 30 days after the commencement of each calendar year, the board of directors of each Farm Credit System institution must adopt an operational and strategic business plan for at least the succeeding 3 years.

(b) The business plan must include, at a minimum, the following:

(1) A mission statement;

(2) A review of the internal and external factors that are likely to affect the institution during the planning period;

(3) Quantifiable goals and objectives;

(4) Pro forma financial statements for each year of the plan;

(5) A detailed operating budget for the first year of the plan; and

(6) The capital adequacy plan adopted pursuant to §§ 615.5200(b), 615.5330(c), and 615.5335(b) of this chapter.

(c)(1) The business plan for each Farm Credit System association that has received a national charter, as defined in § 611.1126 of this chapter, must include a Local Service Area (LSA) Plan.

(2) A LSA Plan is a plan that addresses how the Farm Credit System association will serve its LSA under § 611.1126(d) of this chapter. At a minimum, a LSA Plan must:

(i) Describe all segments of the existing market of the Farm Credit System association (including both existing and potential customers);

(ii) Evaluate how well the Farm Credit System association is currently serving each segment of its existing market (including both existing and potential customers);

(iii) Assess underserved segments in the Farm Credit System association's existing market;

(iv) Assess the Farm Credit System association's capacity to serve all segments of its existing markets (including both existing and potential customers) and any constraints on this capacity; and

(v) Describe the strategies the Farm Credit System association will pursue to ensure that it provides full service within its LSA.

PART 620—DISCLOSURE TO SHAREHOLDERS

8. The authority citation for part 620 continues to read as follows:

Authority: Secs. 5.17, 5.19, 8.11 of the Farm Credit Act (12 U.S.C. 2252, 2254, 2279aa–11); sec. 424 of Pub. L. 100–233, 101 Stat. 1568, 1656.

Subpart B—Annual Report to Shareholders

9. Amend § 620.5(a)(3) as follows:

a. Remove the '';'' at the end of the third sentence and add a ''.''; and

b. Add two new sentences to the end of this paragraph to read as follows:

§ 620.5 Contents of the annual report to shareholders.

* * * * *

(a) *Description of business.* * * *

* * * * *

(3) * * * For any association that has a national charter, it must identify the percentage and the total dollar amount of loans, leases, and related services that it extends to eligible customers. An association with a national charter must separately report the total loans, leases, and related services that is made both inside and outside its local service area;

* * * * *

Dated: February 12, 2001.

Kelly Mikel Williams,

Secretary, Farm Credit Administration Board.

[FR Doc. 01–3942 Filed 2–15–01; 8:45 am]

BILLING CODE 6705–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–105946–00]

RIN 1545–AY31

Mid-contract Change in Taxpayer

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations concerning a mid-contract change in taxpayer of a contract that has been accounted for under a long-term contract method of accounting. A taxpayer that is a party to such a contract will be affected by these proposed regulations. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by May 17, 2001. Outlines of oral comments to be presented at the public hearing scheduled for June 13, 2001, at 10 a.m. must be received by May 30, 2001.

ADDRESSES: Send submissions to CC:M&SP:RU (REG–105946–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–105946–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at *http://www.irs.gov/prod/tax_regs/regslist.html.* The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John Aramburu or Leo F. Nolan II at (202) 622–4960; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor of the Regulations Unit at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent 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, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224. Comments on the collections of information should be received by April 17, 2001. Comments are specifically requested concerning:

- Whether the proposed collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;
- The accuracy of the estimated burden associated with the proposed collections of information (see below);
- How the quality, utility, and clarity of the information to be collected may be enhanced;
- How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and
- Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in § 1.460–6(g)(3)(ii)(C). The information collected in § 1.460–6(g)(3)(ii)(C) is required to provide certain recipients of long-term contracts with the information needed to make look-back calculations. This collection of information is mandatory. The likely respondents are for-profit entities.

Estimated total reporting burden: 10,000 hours.

Estimated average burden per respondent: 2 hours.

Estimated number of respondents: 5000.

Estimated annual frequency of responses: On occasion.

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.

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

Background

Section 460 of the Internal Revenue Code was enacted by section 804 of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085, 2358–2361). Section 460 was amended by section 10203 of the Omnibus Budget Reconciliation Act of 1987, Public Law 100–203 (101 Stat. 1330, 1330–394); by sections 1008(c) and 5041 of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100–647 (102 Stat. 3342, 3438–3439 and 3673–3676); by sections 7621 and 7811(e) of the Omnibus Budget Reconciliation Act of 1989, Public Law 101–239 (103 Stat. 2106, 2375–2377 and 2408–2409); by section 11812 of the Omnibus Budget Reconciliation Act of 1990, Public Law 101–508 (104 Stat. 1388, 1388–534 to 1388–536); by sections 1702(h)(15) and 1704(t)(28) of the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755, 1874, 1888); and by section 1211 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 998–1000).

Section 460(h) directs the Secretary to prescribe regulations to the extent necessary or appropriate to carry out the purpose of section 460, including regulations to prevent a taxpayer from avoiding section 460 by using related parties, pass-through entities, intermediaries, options, and other similar arrangements.

Explanation of Provisions

Overview

Generally, manufacturing and construction contracts not completed within the taxable year they are entered into are long-term contracts. A manufacturing contract, however, is not a long-term contract unless it requires the manufacture of a unique item or an item normally requiring more than 12 months to complete. Section 460 generally requires that long-term contracts be accounted for under the percentage-of-completion method (PCM) and that taxpayers make a look-back computation of interest to compensate the government (or the taxpayer) for any underestimation (overestimation) of income from the contract. However, home construction contracts and certain contracts of smaller construction contractors are exempt from these requirements. Moreover, residential builders are entitled to use the 70/30 percentage-of-completion/ capitalized cost method (PCCM), and certain shipbuilders are entitled to use the 40/60 PCCM. A long-term contract or a portion of a long-term contract that is exempt from the PCM may be accounted for under any permissible method, including the completed contract method (CCM) or the exempt percentage-of-completion method (EPCM). These long-term contract methods of accounting (i.e., the PCM, PCCM, CCM and EPCM) are described in proposed § 1.460–4. These proposed regulations address the Federal income tax treatment of a change in taxpayer prior to completion of a long-term contract accounted for under a long-term contract method of accounting.

Existing Guidance on Transfers of Long-term Contracts

In the case of transactions not governed by section 381, such as those occurring prior to its effective date, numerous cases have required a taxpayer to take into income items that under its method of accounting would be deferred past the date of the transaction. These cases have involved both taxable and nontaxable transactions, e.g., liquidations and reorganizations. For example, in the case of a disposition of a long-term contract accounted for under the CCM, the transferor was required to recognize income earned on the contract prior to its transfer, with the amount earned determined under some variant of the PCM. These cases generally relied on section 446(b), section 482 and/or the assignment of income doctrine to allocate income to the transferor. See e.g., *Jud Plumbing and Heating, Inc.* v. *Commissioner,* 153 F.2d 681 (5th Cir. 1946); *Standard Paving Co.* v. *Commissioner,* 190 F.2d 330 (10th Cir.), *cert. denied,* 342 U.S. 860 (1951); *Central Cuba Sugar Co.* v. *Commissioner,* 198 F.2d 214 (2nd Cir.), *cert. denied,* 344 U.S. 874 (1952); *Dillard-Waltermire, Inc.* v. *Campbell,* 255 F.2d 433 (5th Cir. 1958); and *Midland-Ross Corp.* v. *United States,* 485 F.2d 110 (6th Cir. 1973). In addition, § 1.451–5(f) of the regulations has been cited as support for taxing a transferor who has deferred advance payments under its long-term contract method of accounting. See *Rotolo* v. *Commissioner,* 88 T.C. 1500 (1987).

Under section 381(c)(4), in the case of a section 381 transaction, an acquiring corporation generally must use the method of accounting used by the transferor. Further, regulations under § 1.381(c)(4)–1 require the acquiring corporation to take into account the transferor's items of income or deduction which, because of its method of accounting, were not required or permitted to be included or deducted by the transferor in computing taxable income prior to the date of the transfer. Consistent with section 381, the IRS has held that section 381 generally requires a transferee to account for a long-term contract transferred pursuant to a section 381 transaction using the CCM used by the transferor and, thus, to report the entire gain or loss from the contract. Accordingly, the decisions in the *Standard Paving* line of cases are generally not applicable to transactions to which section 381 applies. Rev. Rul. 70–83 (1970–1 C.B. 85). In addition, section 351 generally has been interpreted to prevent recognition of gain or loss by a transferor from a section 351 transfer of partially completed long-term contracts accounted for by the transferor using the CCM. See GCM 39258 (July 13, 1984) applying Rev. Rul. 80–198 (1980–2 C.B. 113) (no gain or loss is recognized to a cash basis transferor with respect to unrealized accounts receivable and unrecognized accounts payable transferred in a section 351 transaction).

In 1990, the IRS issued proposed regulations (REG–209308–86) (55 FR 23755) that addressed the treatment of a mid-contract change in taxpayer of a contract accounted for using PCM for purposes of applying the look-back method. Generally, these proposed regulations provided that the successor to the contract ''stepped into the shoes'' of the predecessor with respect to the PCM. Thus, the successor was to continue to use the same PCM used by the predecessor both for purposes of reporting income under the contract and recomputing income under the look-back method. No look-back calculation was to be made until the successor completed the contract, and the successor was liable for look-back interest attributable to both pre- and post-transaction years. On the other hand, except in the case of taxable dispositions to unrelated parties, the successor could not recover look-back interest owed by the government that was attributable to pre-transaction years. These proposed regulations were withdrawn. One criticism of the regulations was that step-in-the-shoes treatment was inappropriate in the case of taxable dispositions.

Proposed Provisions

Consistent with the existing guidance described above and in response to comments received on the 1990 proposed regulations, these proposed regulations divide the rules regarding a mid-contract change in taxpayer of a long-term contract accounted for under a long-term contract method into two categories—constructive completion transactions and step-in-the-shoes transactions. For this purpose, the step-in-the-shoes rules apply to the following transactions—

(1) Transactions described in section 381 (i.e., liquidations under section 332 and reorganizations described in section 368(a)(1)(A), (C), (D), (F), or (G));

(2) Transactions described in section 351;

(3) Transactions described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met (divisive ''D'' reorganization);

(4) Transfers (e.g. sales) of S corporation stock;

(5) Conversion to or from an S corporation;

(6) Members joining or leaving a consolidated group; and

(7) Any other transaction designated in the Internal Revenue Bulletin by the Internal Revenue Service. See 26 CFR 601.601(d)(2)(ii).

The constructive completion rules apply to all other transactions.

A constructive completion transaction results in the taxpayer originally reporting income under the long-term contract (old taxpayer) recognizing income from the contract based on a contract price that takes into account any amounts realized from the transaction or paid by the old taxpayer to the taxpayer subsequently reporting income under the long-term contract (new taxpayer) that are allocable to the contract. Similarly, the new taxpayer in a constructive completion transaction is treated as though it entered into a new contract as of the date of the transaction, with the contract price taking into account the purchase price and any amount paid by the old taxpayer that is allocable to the contract.

In the case of a step-in-the-shoes transaction, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. The new taxpayer must assume the old taxpayer's methods of accounting for the contract, with both the contract price and allocable contract costs based on amounts taken into account by both parties. However, in the case of a tax avoidance transaction, the IRS may allocate income with respect to a transferred long-term contract between the old and new taxpayers. Section § 1.451–5(f) will not be applied to a mid-contract change in taxpayer of a contract accounted for under a long-term contract method.

In the case of a step-in-the-shoes transaction in which the transferor's basis in the stock of the transferee is determined by reference to its basis of the property transferred, the basis in the stock of the transferee attributable to the transfer of a long-term contract will not be appropriate unless the amount previously received by the transferor under the long-term contract equates to the amount previously recognized as gross receipts by the transferor. Under both the PCM and the CCM, however, it is common for the amount received with respect to a long-term contract to differ from the amount recognized because the receipt of progress payments does not affect the recognition of income. To address this situation, the proposed regulations provide that, in the case of a section 351 transaction or a divisive ''D'' reorganization, the old taxpayer must adjust its basis in the stock of the new taxpayer by the difference between the amount the old taxpayer has recognized with respect to the contract and the amount the old taxpayer has received or reasonably expects to receive under the contract. The IRS and Treasury Department specifically request comments with respect to this rule.

The proposed regulations also provide rules for applying the look-back method in the case of a mid-contract change in taxpayer. For constructive completion transactions, the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the transaction date and, if applicable, by the new taxpayer with respect to post-transaction years upon contract completion. For step-in-the-shoes transactions, the look-back method is applied only by the new taxpayer upon contract completion. The new taxpayer must account for pre- and post-transaction years, with special rules governing the calculation of look-back interest in the case of pre-transaction years. The proposed regulations also require the old taxpayer in such cases to provide certain information to the new taxpayer in order to enable the new taxpayer to make the necessary look-back calculations.

The proposed regulations reserve on whether a mid-contract change in taxpayer that results from a partnership transaction, including a transaction described in section 721, a transaction described in section 731, and a transfer (e.g., sale) of a partnership interest, should be treated as a constructive completion, or a step-in-the-shoes, transaction. Although these transactions are similar to other step-in-the-shoes transactions, such as nonrecognition transactions (e.g., sections 351 and 332) and transactions where the party responsible for performing the contract has not changed (e.g., sales of S corporation stock and members joining or leaving consolidated groups), the IRS and Treasury Department are concerned that step-in-the-shoes treatment for these partnership transactions could more readily facilitate the shifting of income to tax indifferent parties than in other situations and thus are concerned about monitoring such activities solely through an anti-abuse rule. In addition, other issues, such as the treatment of long-term contracts under section 704(c), 751, and 752, significantly complicate, and could thwart, the application of the step-in-the-shoes rule with respect to mid-contract changes involving partnership transactions. The IRS and Treasury Department request comments on the appropriate treatment for mid-contract changes in taxpayer resulting from these partnership transactions.

Proposed Effective Date

These regulations are proposed to be applicable for transactions on or after the date they are published in the **Federal Register** as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the relevant information is already maintained by taxpayers. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rule and how it could be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 13, 2001, at 10 a.m. in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenue, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by May 30, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is John Aramburu, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In § 1.381(c)(4)–1, a sentence is added at the end of paragraph (a)(2) to read as follows:

§ 1.381(c)(4)–1 Method of accounting.

(a) * * *

(2) * * * See § 1.460–4(k) for rules relating to transfers of contracts accounted for using a long-term contract method of accounting in a transaction to which section 381 applies.

* * * * *

Par. 3. Section 1.460–0 is amended by:

1. Revising the entry for paragraph (k) of § 1.460–4.
2. Adding entries for paragraphs (k)(1) through (k)(6) of § 1.460–4.
3. Revising the entry for paragraph (g) of § 1.460–6.
4. Adding entries for paragraphs (g)(1) through (g)(3) of § 1.460–6.

The revisions and additions read as follows:

§ 1.460–0 Outline of regulations under section 460.

* * * * *

§ 1.460–4 Methods of accounting for long-term contracts.

* * * * *

(k) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(i) Scope.
(ii) Old taxpayer.
(iii) New taxpayer.
(3) Step-in-the-shoes transactions.
(i) Scope.
(ii) Old taxpayer.
(iii) New taxpayer.
(A) Method of accounting.
(B) Contract price.
(C) Contract costs.
(4) Anti-abuse rule.
(5) Examples.
(6) Effective date.

* * * * *

§ 1.460–6 Look-back method.

* * * * *

(g) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(3) Step-in-the-shoes transactions.
(i) General rules.
(ii) Application of look-back method to pre-transaction period.
(A) Method.
(B) Interest accrual period.
(C) Information old taxpayer must provide.
(iii) Application of look-back method to post-transaction years.

* * * * *

Par. 4. Section 1.460–4 is amended by:

1. Adding a sentence at the end of paragraph (a).
2. Revising paragraph (k).

The revision and addition read as follows:

§ 1.460–4 Methods of accounting for long-term contracts.

(a) * * * Finally, paragraph (k) of this section provides rules relating to a mid-contract change in taxpayer of a contract accounted for using a long-term contract method of accounting.

* * * * *

(k) *Mid-contract change in taxpayer*—(1) *In general.* The rules in this paragraph (k) apply if prior to the completion of a long-term contract accounted for using a long-term contract method by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for reporting income from the same contract. For purposes of this paragraph (k) and § 1.460–6(g), an old taxpayer also includes any old taxpayer(s) (e.g., predecessors) of the old taxpayer. In addition, a change in status from taxable to tax exempt or from domestic to foreign, and vice versa, will be considered a change in taxpayer. Finally, a contract will be treated as the same contract if the terms of the contract are not substantially changed in connection with the transaction, whether or not the customer agrees to release the old taxpayer from any or all of its obligations under the contract. The rules governing constructive completion transactions are provided in paragraph (k)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (k)(3) of this section. For application of the look-back method to mid-contract changes in taxpayers for contracts accounted for using the PCM, see § 1.460–6(g).

(2) *Constructive completion transactions*—(i) *Scope.* The constructive completion rules in this paragraph (k)(2) apply to transactions that result in a change in the taxpayer responsible for reporting income from a contract and that are not described in paragraph (k)(3)(i) of this section (constructive completion transactions). Constructive completion transactions generally include, for example, taxable sales under section 1001 and deemed asset sales under section 338.

(ii) *Old taxpayer.* The old taxpayer is treated as completing the contract on the date of the transaction. The total contract price (or, gross contract price in the case of a long-term contract accounted for under the CCM) for the old taxpayer is the sum of any amounts realized from the transaction that are allocable to the contract and any amounts the old taxpayer has received or reasonably expects to receive under the contract after the transaction. Total contract price (gross contract price) is reduced by any amount paid by the old taxpayer to the new taxpayer, and by any transaction costs, that are allocable to the contract. Thus, the old taxpayer's allocable contract costs do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount realized from the transaction allocable to the contract is determined by using the residual method under §§ 1.338–6T and 1.338–7T.

(iii) *New taxpayer.* The new taxpayer is treated as entering into a new contract on the date of the transaction. The new taxpayer must evaluate whether the new contract should be classified as a long-term contract within the meaning of § 1.460–1(b) and account for the contract under a permissible method of accounting. For a new taxpayer who accounts for a contract using the PCM, the total contract price is any amount the new taxpayer reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Total contract price is reduced in the amount of any consideration paid as a result of the transaction, and by any transaction costs, that are allocable to the contract and is increased in the amount of any consideration received as a result of the transaction that is allocable to the contract. Similarly, the gross contract price for a contract accounted for using the CCM is all amounts the new taxpayer is entitled by law or contract to receive consistent with paragraph (d)(3) of this section, adjusted for any consideration paid (or received) as a result of the transaction that is allocable to the contract. Thus, the new taxpayer's allocable contract costs do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount of consideration paid that is allocable to the contract is determined by using the residual method under §§ 1.338–6T and 1.338–7T.

(3) *Step-in-the-shoes transactions*—(i) *Scope.* The step-in-the-shoes rules in this paragraph (k)(3) apply to the following transactions that result in a change in the taxpayer responsible for reporting income from a contract (step-in-the-shoes transactions)—

(A) Transactions described in section 381 (i.e., liquidations under section 332 and reorganizations described in section 368(a)(1)(A), (C), (D), (F), or (G));

(B) Transactions described in section 351;

(C) Transactions described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met;

(D) Transfers (e.g., sales) of S corporation stock;

(E) Conversion to or from an S corporation;

(F) Members joining or leaving a consolidated group; and

(G) Any other transaction designated in the Internal Revenue Bulletin by the Internal Revenue Service. See § 601.601(d)(2)(ii) of this chapter.

(ii) *Old taxpayer*—(A) *In general.* The new taxpayer will "step into the shoes" of the old taxpayer with respect to the contract. Thus, consistent with § 1.381(c)(4)–1(a)(1)(ii), the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer, as set forth in paragraph (k)(3)(iii) of this section. As a result, an old taxpayer using the PCM is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. Similarly, an old taxpayer using the CCM is not required to recognize any revenue and may not deduct allocable contract costs incurred with respect to the contract.

(B) *Basis adjustment.* In the case of transactions described in paragraph (k)(3)(i)(B) or (C) of this section, the old taxpayer must adjust its basis in the stock of the new taxpayer by reducing such basis to the extent the amount the old taxpayer has received or reasonably expects to receive under the contract exceeds the amount recognized by the old taxpayer with respect to the contract or by increasing such basis to the extent the amount the old taxpayer has recognized with respect to the contract exceeds the amount the old taxpayer has received or reasonably expects to receive under the contract. However, the old taxpayer may not reduce its basis in the stock of the new taxpayer below zero. If the old and new taxpayer do not join in the filing of a consolidated Federal income tax return, the old taxpayer must recognize income to the extent the basis in the stock of the new taxpayer otherwise would be reduced below zero. If the old and new taxpayer join in the filing of a consolidated Federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be reduced below zero. See §§ 1.1502–19 and 1.1502–32(a)(3)(ii).

(iii) *New taxpayer*—(A) *Method of accounting.* Beginning on the date of the transaction, the new taxpayer must account for the long-term contract by using the same method of accounting used by the old taxpayer prior to the transaction consistent with § 1.381(c)(4)–1(b)(4). The same method of accounting must be used for such contract regardless of whether the old taxpayer's method is the new taxpayer's principal method of accounting under § 1.381(c)(4)–1(b)(3) or whether the new taxpayer is otherwise eligible to use the old taxpayer's method. Thus, if the old taxpayer uses the PCM to account for the contract, the new taxpayer steps into the shoes of the old taxpayer with respect to its completion factor and percentage of completion methods (such as the 10-percent method), even if the new taxpayer has not elected such methods for similarly classified contracts. Similarly, if the old taxpayer uses the CCM, the new taxpayer steps into the shoes of the old taxpayer with respect to the CCM, even if the new taxpayer is not otherwise eligible to use the CCM. However, the new taxpayer is not necessarily bound by the old taxpayer's method for similarly classified contracts entered into by the new taxpayer subsequent to the transaction and must apply general tax principles, including section 381, to determine the appropriate method to account for these subsequent contracts. To the extent that general tax principles allow the taxpayer to account for similarly classified contracts using a method other than the old taxpayer's method, the taxpayer is not required to obtain the consent of the Commissioner to begin using such other method.

(B) *Contract price.* The total contract price for the new taxpayer is the sum of any amounts the old taxpayer or new taxpayer have received or reasonably expect to receive under the contract consistent with paragraph (b)(4) of this section. Similarly, the gross contract price in the case of a long-term contract accounted for under the CCM includes all amounts the old taxpayer or new taxpayer are entitled by law or by contract to receive consistent with paragraph (d)(3) of this section.

(C) *Contract costs.* Total allocable contract costs for the new taxpayer are the allocable contract costs as defined under paragraph (b)(5) of this section incurred by either the old taxpayer prior to or the new taxpayer after the transaction. Thus, any payments between the old taxpayer and the new taxpayer with respect to the contract are not treated as part of contract price or an allocable contract cost.

(4) *Anti-abuse rule.* Notwithstanding this paragraph (k), in tax avoidance cases, the Commissioner may allocate to the old (or new) taxpayer the income from a long-term contract properly allocable to the old (or new) taxpayer. For example, the Commissioner may scrutinize a transaction in which a long-term contract accounted for using the CCM, or using the PCM where the old taxpayer has received advance payments in excess of its contribution to the contract, is transferred to a tax indifferent party.

(5) *Examples.* The following examples illustrate the rules of this paragraph (k). For purposes of these examples, it is assumed that the contracts are long-term construction contracts accounted for using the PCM prior to the transaction unless stated otherwise and the contracts are not transferred in tax avoidance cases. The examples are as follows:

Example 1. Constructive completion—PCM.

(i) *Facts.* In Year 1, X enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $200,000. In Year 2, X incurs additional costs of $400,000 before selling the contract as part of the sale of its business in Year 2 to Y, an unrelated party. At the time of sale, X has received $650,000 in progress payments under the contract. The consideration allocable to the contract under section 1060 is $150,000. Pursuant to the sale, the new taxpayer Y immediately assumes X's contract obligations and rights. Y is required to account for the contract using the PCM. In Year 2, Y incurs additional allocable contract costs of $50,000. Y correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract.

(ii) *Old taxpayer.* For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000×$1,000,000)) and costs of $200,000, for a profit of $50,000. X is treated as completing the contract in Year 2 because it sold the contract. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and the total allocable contract costs are $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)). Thus, in Year 2, X reports receipts of $550,000 (total contract price minus receipts already reported ($800,000 − $250,000)) and costs incurred in year 2 of $400,000, for a profit of $150,000.

(iii) *New taxpayer.* Y is treated as entering into a new contract in Year 2. The total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 − $650,000 − $150,000)). The estimated total allocable contract costs at the end of Year 2 are $125,000 (the allocable contract costs that Y reasonably expects to incur to complete the contract ($50,000 + $75,000)). In Year 2, Y reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) × $200,000] and costs of $50,000 (the costs incurred after the purchase), for a profit of $30,000. For Year 3, Y reports receipts of $120,000 (total contract price minus receipts already reported ($200,000 − $80,000)) and costs of $75,000, for a profit of $45,000.

Example 2. Constructive completion—CCM.

(i) *Facts.* The facts are the same as in *Example 1,* except that X and Y properly account for the contract under the CCM.

(ii) *Old taxpayer.* X does not report any income or costs from the contract in Year 1. In Year 2, the contract is deemed complete for X, and X reports its gross contract price of $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and its total allocable contract costs of $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)) in that year.

(iii) *New taxpayer.* Y is treated as entering into a new contract in Year 2. Under the CCM, Y reports no gross receipts or costs in Year 2. Y reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 − $650,000 − $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that Y incurred to complete the contract ($50,000 + $75,000)) in Year 3, the completion year, for a profit of $75,000.

Example 3. Step-in-the-shoes—PCM.

(i) *Facts.* The facts are the same as in *Example 1,* except that X transfers the contract to Y in exchange for stock of Y in a transaction that qualifies as a statutory merger described in section 368(a)(1)(A) and does not result in gain or loss to X under section 361(a).

(ii) *Old taxpayer.* For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 × $1,000,000)) and costs of $200,000, for a profit of $50,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i) of this section, X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (the completion factor multiplied by the total contract price and minus the Year 1 gross receipts [($600,000/

$800,000 × $1,000,000) − $250,000]) and costs of $400,000, for a profit of $100,000.

(iii) *New taxpayer.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Total contract price is the sum of any amounts that X and Y have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and Y. Thus, the estimated total allocable contract costs at the end of Year 2 are $725,000 (the cumulative allocable contract costs of X and the estimated total allocable contract costs of Y ($200,000 + $400,000 + $50,000 + $75,000)). In Year 2, Y reports receipts of $146,552 (the completion factor multiplied by the total contract price minus receipts reported by the old taxpayer ([($650,000/ $725,000) × $1,000,000] − $750,000) and costs of $50,000, or a profit of $96,552. For Year 3, Y reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 − $896,552)) and costs of $75,000, for a profit of $28,448.

Example 4. Step-in-the-shoes—CCM.

(i) *Facts.* The facts are the same as in *Example 3,* except that X properly accounts for the contract under the CCM.

(ii) *Old taxpayer.* X reports no income or costs from the contract in Years 1, 2 or 3.

(iii) *New taxpayer.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Thus, in Year 3, the completion year, Y reports receipts of $1,000,000 and total contract costs of $725,000, for a profit of $275,000.

Example 5. Step in the shoes—Basis adjustment.

The facts are the same as in *Example 1,* except that X transfers the contract (including the uncompleted property with a basis of $0) and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in Z is $125,000. X must increase its basis in Z by $100,000 pursuant to paragraph (k)(3)(ii)(B) of this section because the amount X recognized with respect to the contract, $750,000 ($250,000 receipts in Year 1 + $500,000 receipts in Year 2), exceeds the amount X received under the contract, the $650,000 in progress payments, by $100,000.

Example 6. Step in the shoes—Basis adjustment.

The facts are the same as in *Example 2,* except that X receives progress payments of $800,000 (rather than $650,000) and transfers the contract (including the uncompleted property with a basis of $600,000) and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in Z is $725,000. X and Z do not join in filing a consolidated Federal income tax return. X must reduce its basis in the stock of Z by $725,000 to zero pursuant to paragraph (k)(3)(ii)(B) of this section because the amount X received under the contract, $800,000 in progress payments, exceeds the amount recognized by X with respect to the contract, $0. In addition, X must recognize income of $75,000 because X's basis in the stock of Z otherwise would have been reduced below zero by $75,000 (800,000 unrecognized progress payments—725,000 basis).

(6) *Effective date.* This paragraph (k) is applicable for transactions on or after the date they are published in the **Federal Register** as final regulations.

Par. 5. In § 1.460–6, paragraph (g) is revised to read as follows:

§ 1.460–6 Look-back method.

* * * * *

(g) *Mid-contract change in taxpayer*—(1) *In general.* The rules in this paragraph (g) apply if, as described in § 1.460–4(k), prior to the completion of a long-term contract accounted for using the PCM or the PCCM by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for reporting income from the same contract. The rules governing constructive completion transactions are provided in paragraph (g)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (g)(3) of this section. For purposes of this paragraph, pre-transaction years are all taxable years of the old taxpayer in which the old taxpayer reported (or should have reported) gross receipts from the contract, and post-transaction years are all taxable years of the new taxpayer in which the new taxpayer reported (or should have reported) gross receipts from the contract.

(2) *Constructive completion transactions.* In the case of a transaction described in § 1.460–4(k)(2)(i) (constructive completion transaction), the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the date of the transaction and, if the new taxpayer uses the PCM or the PCCM to account for the contract, by the new taxpayer with respect to post-transaction years upon completion of the contract. The contract price and allocable contract costs to be taken into account by the old taxpayer or the new taxpayer in applying the look-back method are described in § 1.460–4(k)(2).

(3) *Step-in-the-shoes transactions*—(i) *General rules.* In the case of a transaction described in § 1.460–4(k)(3)(i) (step-in-the-shoes transaction), the look-back method is not applied at the time of the transaction, but is instead applied for the first time when the contract is completed by the new taxpayer. Upon completion of the contract, the look-back method is applied by the new taxpayer with respect to both pre-transaction years and post-transaction years, taking into account all amounts reasonably expected to be received by either the old or new taxpayer and all allocable contract costs incurred during both periods as described in § 1.460–4(k)(3). The new taxpayer is liable for filing the Form 8697 and for interest computed on hypothetical underpayments of tax, and is entitled to receive interest with respect to hypothetical overpayments of tax, for both pre-and post-transaction years. Pursuant to section 6901, the old taxpayer will be secondarily liable for any interest required to be paid with respect to pre-transaction years reduced by any interest on pre-transaction overpayments.

(ii) *Application of look-back method to pre-transaction period*—(A) *Method.* The new taxpayer must apply the look-back method to each pre-transaction year that is a redetermination year using the simplified marginal impact method described in paragraph (d) of this section (regardless of whether or not the old taxpayer would have actually used that method and without regard to the tax liability ceiling).

(B) *Interest accrual period.* With respect to any hypothetical underpayment or overpayment of tax for a pre-transaction year, interest accrues from the due date of the old taxpayer's tax return (not including extensions) for the taxable year of the underpayment or overpayment until the due date of the new taxpayer's return (not including extensions) for the completion year or the year of a post-completion adjustment, whichever is applicable.

(C) *Information old taxpayer must provide.* In order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that reported income from a long-term contract under the PCM or PCCM for either regular or alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the taxable year ending with, or the first taxable year ending after, a step-in-the-shoes transaction described in § 1.460–4(k)(3)(i). The required information is as follows—

(*1*) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (i.e., whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

(*2*) The submethod used to apply PCM (e.g., the simplified cost-to-cost method or the 10-percent method);

(*3*) The amount of total contract price reported by year;

(*4*) The numerator and the denominator of the completion factor by year;

(*5*) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

(*6*) Whether the old taxpayer was a corporate or a noncorporate taxpayer by year; and

(*7*) Any other information required by the Commissioner by administrative pronouncement.

(iii) *Application of look-back method to post-transaction years.* With respect to post-transaction taxable years, the new taxpayer must use the same look-back method it uses for other contracts (i.e., the simplified marginal impact method or the actual method) to determine the amount of any hypothetical overpayment or underpayment of tax and the time period for computing interest on these amounts.

* * * * *

David A. Mader,

Acting Deputy Commissioner of Internal Revenue.

[FR Doc. 01–1992 Filed 2–15–01; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 40

[REG–106892–00]

RIN 1545–AX11

Deposits of Excise Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the requirements for excise tax returns, payments, and deposits. These regulations affect persons required to report liability for excise taxes on Form 720, ''Quarterly Federal Excise Tax Return.''

DATES: Written and electronic comments and requests for a public hearing must be received by May 17, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–106892–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–106892–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may send submissions electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslist.html.

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Guy Traynor, (202) 622–7180; concerning the regulations, Susan Athy (202) 622–3130 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Excise Tax Procedural Regulations (26 CFR part 40) relating to the requirements for excise tax returns, payments, and deposits. On January 7, 2000, an advance notice of proposed rulemaking was published in the **Federal Register** (65 FR 1076) that invited comments from the public on issues relating to the requirements for excise tax returns and deposits. Several written comments were received that were considered in drafting these proposed regulations.

The advance notice requested comments on: whether there should be a single deposit date for all excise taxes (other than those deposited under the alternative method), such as 14 days after the end of the semimonthly period; whether a taxpayer should be required to deposit only 95 percent of tax liability incurred for the semimonthly period (in lieu of the current requirement of 100 percent with safe harbor rules); and whether the amount required to be deposited for a quarter should be computed without reduction for the amounts of any claims made on Schedule C of the Form 720 for that quarter.

In general, commentators from the air transportation industry requested that the one-month filing extension provided to those reporting communications, air transportation, and ozone-depleting chemical taxes be retained because airlines need additional time to determine the proper amount of tax liability. The IRS and Treasury believe the need for additional time is adequately addressed by the retention of the alternative method for making deposits of communications and air transportation taxes. Filers choosing to use the alternative method for making deposits of these taxes also are allowed additional time to determine the amount of tax liability. For example, under the alternative method, the activity for December, January, and February is reported as tax liability for January, February, and March on the Form 720 due April 30th. Thus, even without the one-month filing extension, filers reporting under the alternative method have two months after the last activity to determine the amount of tax liability to be reported. In addition, retention of an extended filing date for certain industries would be inconsistent with the simplification and overall fairness sought to be achieved by these changes. Accordingly, the proposed amendments eliminate the one-month filing extension that is now allowed for returns related to taxes imposed by chapter 33 (relating to communications and air transportation) and section 4681 (relating to ozone-depleting chemicals) and require that all Forms 720 be filed by the last day of the month following the quarter for which the return is made.

Commentators generally supported a single deposit date for all taxes other than those deposited under the alternative method (regular method taxes). The proposed amendments provide that deposits for regular method taxes for a semimonthly period are due by the 14th day of the following semimonthly period. The proposed amendments change the requirement to deposit by class of tax. The 9-day rule, 14-day rule, and 30-day rule taxes are eliminated. Instead there are two classes: regular method and alternative method.

Commentators generally supported a reduction in the amount of the required deposit for a semimonthly period from 100 percent of net tax liability to 95 percent of net tax liability. However, they requested that the look-back quarter safe harbor rule be retained. One commentator noted that the look-back quarter safe harbor rule is easy for taxpayers to use and provides a way for taxpayers to meet the deposit requirements when taxpayers have not determined their liability for the current semimonthly period. Finally, some commentators requested that the provisions allowing deposits to be reduced by Schedule C claims be retained to avoid economic hardship. The proposed amendments adopt the suggestions of these commentators.

The proposed amendments require the deposit of at least 95 percent of net tax liability incurred during the semimonthly period. This rule replaces both the requirement to deposit 100 percent of net tax liability and the safe harbor rule for taxpayers depositing 95 percent of their current liability. The new requirement is, in fact, more generous than the current safe harbor,