the first column, a new amendatory instruction 6 to read as follows:

Appendix G (Consisting of Appendices G–1 and G–2), Appendix H (Consisting of Appendices H–1 and H–2), Appendix I (Consisting of Appendices I–1, I–2, I–3, I–4, I–5, I–6, I–7, and I–8), Appendix J (Consisting of Appendices J–1 and J–2), Appendix K (Consisting of Appendices K–1 Through K–4), Appendix L, Appendix M—[Removed]

6. Appendix G (consisting of Appendices G–1 and G–2), Appendix H (consisting of Appendices H–1 and H–2), Appendix I (consisting of Appendices I–1, I–2, I–3, I–4, I–5, I–6, I–7, and I–8), Appendix J (consisting of Appendices J–1 and J–2), Appendix K (consisting of Appendices K–1 through K–4), Appendix L, and Appendix M are removed.

Authority: 12 U.S.C. 2601 *et seq.;* 42 U.S.C. 3535(d).

Dated: April 19, 1996.

Camille E. Acevedo,

Assistant General Counsel for Regulations.

[FR Doc. 96–10533 Filed 4–26–96; 8:45 am]

BILLING CODE 4210–27–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8667]

RIN 1545–AT33

Lease Term; Exchanges of Tax-Exempt Use Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the lease term of tax-exempt use property. The final regulations also provide guidance regarding certain like-kind exchanges among related parties involving tax-exempt use property.

DATES: These regulations are effective April 29, 1996.

For dates of applicability see ''Effective dates'' section under the **SUPPLEMENTARY INFORMATION** portion of the preamble and §§ 1.168(h)–1(e) and 1.168(i)–2(g).

FOR FURTHER INFORMATION CONTACT: John M. Aramburu of the Office of Assistant Chief Counsel (Income Tax and Accounting) at (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations under section 168 of the Internal Revenue Code of 1986 (Code). The regulations provide guidance relating to certain exchanges of tax-exempt use property among related parties and the determination of lease term under certain circumstances. Proposed regulations (IA–18–95) were published in the Federal Register on April 21, 1995 (60 FR 19868). The IRS received a number of comments on the proposed regulations. A scheduled public hearing was cancelled because there were no requests to testify. After consideration of all the comments, the regulations proposed by IA–18–95 are adopted as revised by this Treasury decision. The revisions are discussed below.

Overview

Under section 168, property used in a trade or business, or held for the production of income, generally may be depreciated under the general depreciation system (GDS) using accelerated methods over relatively short recovery periods. However, certain property, including ''tax-exempt use property,'' must be depreciated under the alternative depreciation system (ADS) described in section 168(g). Section 168(h)(1)(A) generally defines tax-exempt use property to include tangible property (other than nonresidential real property) leased to a tax-exempt entity. For this purpose, certain foreign entities and persons are considered tax-exempt entities.

Congress subjected tax-exempt use property to a slower depreciation system than GDS to prevent tax-exempt entities from indirectly claiming tax benefits (in the form of reduced rentals) ''from investment incentives for which they [would] not qualify directly, and effectively gain[ing] the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property.'' S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. 123 (1984).

In particular, section 168(g)(3)(A) provides that tax-exempt use property subject to a lease must be depreciated using the straight-line method over a period equal to the greater of the property's class life or 125 percent of the lease term. Under section 168(i)(3), options to renew generally must be taken into account in determining the lease term and the periods of certain successive leases must be aggregated with the period of an original lease.

Lease Term

The proposed regulations generally include an additional period of time during which a lessee may not continue to be the lessee in the lease term if the lessee (or a related person) has agreed that one or both of them will or could be obligated to make a payment of rent, or a payment in the nature of rent, with respect to such period. The arrangements described in the proposed regulations are frequently referred to as ''replacement leases.'' One commentator requested that the portion of the proposed regulations dealing with replacement leases be withdrawn. The commentator argued that Congress would not have intended that the term of the replacement lease be taken into account in determining lease term. The IRS and Treasury believe that the proposed regulations are consistent with Congressional intent, and thus the final regulations retain this portion of the proposed regulations.

Another commentator indicated that application of the proposed regulations was unclear where property is subject to multiple leases, possibly involving multiple parties. The final regulations clarify that if property is subject to more than one lease (including any sublease) entered into as part of a single transaction (or a series of related transactions), the lease term shall include all periods described in one or more of such leases. Thus, for example, if one taxable corporation leases property to another taxable corporation for a 20-year term and, as part of the same transaction, the lessee subleases the property to a tax-exempt entity for a 10-year term, then the lease term of the property is 20 years, and during the period of tax-exempt use it must be depreciated using the straight line method over the greater of its class life or 25 years.

Finally, the final regulations provide that lease term also includes any period during which the lessee (or a related party) has assumed or retained any risk of loss with respect to the property (including, for example, by holding a note secured by the property). The IRS and Treasury believe that such an arrangement is generally similar to the replacement leases described in the proposed regulations. As in the case of a replacement lease, the lessee is assuming risk with respect to the value of the property at the termination of the initial lease term. In addition, the term of the debt provides an objective indication that the useful life of the property exceeds the original term of the lease, in which case failure to include the term of the debt in the lease term

could allow a tax-exempt lessee to benefit from depreciation deductions that exceed economic depreciation, which would be contrary to Congressional intent.

Like-kind Exchanges

The proposed regulations also address certain transactions between related persons that are designed to circumvent the tax-exempt use property rules through the use of a like-kind exchange described in section 1031. The proposed regulations provide that property (tainted property) transferred directly or indirectly to the taxpayer by a related person (the related party) as part of, or in connection with, a transaction described in section 1031 where the related party receives tax-exempt use property (related tax-exempt use property) will, if the tainted property is subject to an allowance for depreciation, be treated in the same manner as the related tax-exempt use property for purposes of determining the allowable depreciation deduction under section 167(a). Under this rule, the tainted property is depreciated by the taxpayer over the remaining recovery period of, and using the same depreciation method and convention as that of, the related tax-exempt use property.

The rule applies only with respect to direct or indirect transfers of property involving related persons where (1) section 1031 applies to any party, and (2) a principal purpose of the transfer is to avoid or limit the application of ADS. For purposes of this rule, a person is related to another person if they bear a relationship specified in section 267(b) or section 707(b)(1). An exchange between members of a consolidated group in a taxable year beginning on or after July 12, 1995, will not be subject to this provision because section 1031 does not apply to intercompany transactions. See § 1.1502–80(f).

No comments were received with respect to the treatment of like-kind exchanges under the proposed regulations. Accordingly, these provisions of the proposed regulations are adopted without modification by this Treasury decision.

Effective Dates

The definition of lease term is generally applicable to leases entered into on or after April 20, 1995. The changes made by the final regulations apply to leases entered into after April 26, 1996. The treatment of like-kind exchanges is applicable to transfers made on or after April 20, 1995. No inference is intended by these effective dates as to the treatment of any transaction under prior law. The regulations do not preclude the application of common law doctrines (such as the substance over form or step transaction doctrines) and other authorities to transactions described in the regulations (e.g., as to whether a particular transaction should be characterized as a lease or a conditional sale for federal income tax purposes).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and 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 Small Business Administration for comment on its impact on small business.

Drafting Information: The principal author of these regulations is John M. Aramburu of the Office of Assistant 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.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.168(h)–1 also issued under 26 U.S.C. 168. * * *

Section 1.168(i)–2 also issued under 26 U.S.C. 168. * * *

Par. 2. Sections 1.168(h)–1 and 1.168(i)–2 are added to read as follows:

§ 1.168(h)–1 Like-kind exchanges involving tax-exempt use property.

(a) *Scope.* (1) This section applies with respect to a direct or indirect transfer of property among related persons, including transfers made through a qualified intermediary (as defined in § 1.1031(k)–1(g)(4)) or other unrelated person, (a transfer) if—

(i) Section 1031 applies to any party to the transfer or to any related transaction; and

(ii) A principal purpose of the transfer or any related transaction is to avoid or limit the application of the alternative depreciation system (within the meaning of section 168(g)).

(2) For purposes of this section, a person is related to another person if they bear a relationship specified in section 267(b) or section 707(b)(1).

(b) *Allowable depreciation deduction for property subject to this section*—(1) *In general.* Property (tainted property) transferred directly or indirectly to a taxpayer by a related person (related party) as part of, or in connection with, a transaction in which the related party receives tax-exempt use property (related tax-exempt use property) will, if the tainted property is subject to an allowance for depreciation, be treated in the same manner as the related tax-exempt use property for purposes of determining the allowable depreciation deduction under section 167(a). Under this paragraph (b), the tainted property is depreciated by the taxpayer over the remaining recovery period of, and using the same depreciation method and convention as that of, the related tax-exempt use property.

(2) *Limitations*—(i) *Taxpayer's basis in related tax-exempt use property.* The rules of this paragraph (b) apply only with respect to so much of the taxpayer's basis in the tainted property as does not exceed the taxpayer's adjusted basis in the related tax-exempt use property prior to the transfer. Any excess of the taxpayer's basis in the tainted property over its adjusted basis in the related tax-exempt use property prior to the transfer is treated as property to which this section does not apply. This paragraph (b)(2)(i) does not apply if the related tax-exempt use property is not acquired from the taxpayer (e.g., if the taxpayer acquires the tainted property for cash but section 1031 nevertheless applies to the related party because the transfer involves a qualified intermediary).

(ii) *Application of section 168(i)(7).* This section does not apply to so much of the taxpayer's basis in the tainted property as is subject to section 168(i)(7).

(c) *Related tax-exempt use property.* (1) For purposes of paragraph (b) of this section, related tax-exempt use property includes—

(i) Property that is tax-exempt use property (as defined in section 168(h)) at the time of the transfer; and

(ii) Property that does not become tax-exempt use property until after the transfer if, at the time of the transfer, it

was intended that the property become tax-exempt use property.

(2) For purposes of determining the remaining recovery period of the related tax-exempt use property in the circumstances described in paragraph (c)(1)(ii) of this section, the related tax-exempt use property will be treated as having, prior to the transfer, a lease term equal to the term of any lease that causes such property to become tax-exempt use property.

(d) *Examples.* The following examples illustrate the application of this section. The examples do not address common law doctrines or other authorities that may apply to recharacterize or alter the effects of the transactions described therein. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. (i) X owns all of the stock of two subsidiaries, B and Z. X, B and Z do not file a consolidated federal income tax return. On May 5, 1995, B purchases an aircraft (*FA*) for $1 million and leases it to a foreign airline whose income is not subject to United States taxation and which is a tax-exempt entity as defined in section 168(h)(2). On the same date, Z owns an aircraft (*DA*) with a fair market value of $1 million, which has been, and continues to be, leased to an airline that is a United States taxpayer. Z's adjusted basis in DA is $0. The next day, at a time when each aircraft is still worth $1 million, B transfers FA to Z (subject to the lease to the foreign airline) in exchange for DA (subject to the lease to the airline that is a United States taxpayer). Z realizes gain of $1 million on the exchange, but that gain is not recognized pursuant to section 1031(a) because the exchange is of like-kind properties. Assume that a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Following the exchange, Z has a $0 basis in FA pursuant to section 1031(d). B has a $1 million basis in DA.

(ii) B has acquired property from Z, a related person; Z's gain is not recognized pursuant to section 1031(a); Z has received tax-exempt use property as part of the transaction; and a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Accordingly, the transaction is within the scope of this section. Pursuant to paragraph (b) of this section, B must recover its $1 million basis in DA over the remaining recovery period of, and using the same depreciation method and convention as that of, FA, the related tax-exempt use property.

(iii) If FA did not become tax-exempt use property until after the exchange, it would still be related tax-exempt use property and paragraph (b) of this section would apply if, at the time of the exchange, it was intended that FA become tax-exempt use property.

Example 2. (i) X owns all of the stock of two subsidiaries, B and Z. X, B and Z do not file a consolidated federal income tax return. B and Z each own identical aircraft. B's aircraft (*FA*) is leased to a tax-exempt entity as defined in section 168(h)(2) and has a fair market value of $1 million and an adjusted basis of $500,000. Z's aircraft (*DA*) is leased to a United States taxpayer and has a fair market value of $1 million and an adjusted basis of $10,000. On May 1, 1995, B and Z exchange aircraft, subject to their respective leases. B realizes gain of $500,000 and Z realizes gain of $990,000, but neither person recognizes gain because of the operation of section 1031(a). Moreover, assume that a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system.

(ii) As in *Example 1,* B has acquired property from Z, a related person; Z's gain is not recognized pursuant to section 1031(a); Z has received tax-exempt use property as part of the transaction; and a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Thus, the transaction is within the scope of this section even though B has held tax-exempt use property for a period of time and, during that time, has used the alternative depreciation system with respect to such property. Pursuant to paragraph (b) of this section, B, which has a substituted basis determined pursuant to section 1031(d) of $500,000 in DA, must depreciate the aircraft over the remaining recovery period of FA, using the same depreciation method and convention. Z holds tax-exempt use property with a basis of $10,000, which must be depreciated under the alternative depreciation system.

(iii) Assume the same facts as in paragraph (i) of this *Example 2,* except that B and Z are members of an affiliated group that files a consolidated federal income tax return. Of B's $500,000 basis in DA, $10,000 is subject to section 168(i)(7) and therefore not subject to this section. The remaining $490,000 of basis is subject to this section. But see § 1.1502–80(f) making section 1031 inapplicable to intercompany transactions occurring in consolidated return years beginning on or after July 12, 1995.

(e) *Effective date.* This section applies to transfers made on or after April 20, 1995.

§ 1.168(i)–2 Lease term.

(a) *In general.* For purposes of section 168, a lease term is determined under all the facts and circumstances. Paragraph (b) of this section and § 1.168(j)–1T, Q&A 17, describe certain circumstances that will result in a period of time not included in the stated duration of an original lease (additional period) nevertheless being included in the lease term. These rules do not prevent the inclusion of an additional period in the lease term in other circumstances.

(b) *Lessee retains financial obligation*—(1) *In general.* An additional period of time during which a lessee may not continue to be the lessee will nevertheless be included in the lease term if the lessee (or a related person)—

(i) Has agreed that one or both of them will or could be obligated to make a payment of rent or a payment in the nature of rent with respect to such period; or

(ii) Has assumed or retained any risk of loss with respect to the property for such period (including, for example, by holding a note secured by the property).

(2) *Payments in the nature of rent.* For purposes of paragraph (b)(1)(i) of this section, a payment in the nature of rent includes a payment intended to substitute for rent or to fund or supplement the rental payments of another. For example, a payment in the nature of rent includes a payment of any kind (whether denominated as supplemental rent, as liquidated damages, or otherwise) that is required to be made in the event that—

(i) The leased property is not leased for the additional period;

(ii) The leased property is leased for the additional period under terms that do not satisfy specified terms and conditions;

(iii) There is a failure to make a payment of rent with respect to such additional period; or

(iv) Circumstances similar to those described in paragraph (b)(2) (i), (ii), or (iii) of this section occur.

(3) *De minimis rule.* For the purposes of this paragraph (b), obligations to make de minimis payments will be disregarded.

(c) *Multiple leases or subleases.* If property is subject to more than one lease (including any sublease) entered into as part of a single transaction (or a series of related transactions), the lease term includes all periods described in one or more of such leases. For example, if one taxable corporation leases property to another taxable corporation for a 20-year term and, as part of the same transaction, the lessee subleases the property to a tax-exempt entity for a 10-year term, then the lease term of the property for purposes of section 168 is 20 years. During the period of tax-exempt use, the property must be depreciated under the alternative depreciation system using the straight line method over the greater of its class life or 25 years (125 percent of the 20-year lease term).

(d) *Related person.* For purposes of paragraph (b) of this section, a person is related to the lessee if such person is described in section 168(h)(4).

(e) *Changes in status.* Section 168(i)(5) (changes in status) applies if an additional period is included in a lease term under this section and the leased property ceases to be tax-exempt use property for such additional period.

(f) *Example.* The following example illustrates the principles of this section. The example does not address common law doctrines or other authorities that may apply to cause an additional period to be included in the lease term or to recharacterize a lease as a conditional sale or otherwise for federal income tax purposes. Unless otherwise indicated, parties to the transactions are not related to one another.

Example. Financial obligation with respect to an additional period—(i) *Facts.* X, a taxable corporation, and Y, a foreign airline whose income is not subject to United States taxation, enter into a lease agreement under which X agrees to lease an aircraft to Y for a period of 10 years. The lease agreement provides that, at the end of the lease period, Y is obligated to find a subsequent lessee (replacement lessee) to enter into a subsequent lease (replacement lease) of the aircraft from X for an additional 10-year period. The provisions of the lease agreement require that any replacement lessee be unrelated to Y and that it not be a tax-exempt entity as defined in section 168(h)(2). The provisions of the lease agreement also set forth the basic terms and conditions of the replacement lease, including its duration and the required rental payments. In the event Y fails to secure a replacement lease, the lease agreement requires Y to make a payment to X in an amount determined under the lease agreement.

(ii) *Application of this section.* The lease agreement between X and Y obligates Y to make a payment in the event the aircraft is not leased for the period commencing after the initial 10-year lease period and ending on the date the replacement lease is scheduled to end. Accordingly, pursuant to paragraph (b) of this section, the term of the lease between X and Y includes such additional period, and the lease term is 20 years for purposes of section 168.

(iii) *Facts modified.* Assume the same facts as in paragraph (i) of this *Example,* except that Y is required to guarantee the payment of rentals under the 10-year replacement lease and to make a payment to X equal to the present value of any excess of the replacement lease rental payments specified in the lease agreement between X and Y, over the rental payments actually agreed to be paid by the replacement lessee. Pursuant to paragraph (b) of this section, the term of the lease between X and Y includes the additional period, and the lease term is 20 years for purposes of section 168.

(iv) *Changes in status.* If, upon the conclusion of the stated duration of the lease between X and Y, the aircraft either is returned to X or leased to a replacement lessee that is not a tax-exempt entity as defined in section 168(h)(2), the subsequent method of depreciation will be determined pursuant to section 168(i)(5).

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section applies to leases entered into on or after April 20, 1995.

(2) *Special rules.* Paragraphs (b)(1)(ii) and (c) of this section apply to leases entered into after April 26, 1996.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

Approved: March 26, 1996.

Leslie Samuels,

Assistant Secretary of the Treasury.

[FR Doc. 96–10395 Filed 4–26–96; 8:45 am]

BILLING CODE 4830–01–U

Bureau of Alcohol, Tobacco and Firearms

27 CFR Part 47

[Notice No. 821]

Removal of Certain Restrictions on Importation of Defense Articles and Defense Services From the Russian Federation

AGENCY: Bureau of Alcohol, Tobacco and Firearms (ATF), Department of the Treasury.

ACTION: Statement of policy.

SUMMARY: The Bureau of Alcohol, Tobacco and Firearms (ATF) is announcing (1) that it will remove the Russian Federation from the list of countries from which defense articles and defense services may not be imported and (2) implementation of restrictions on the importation of certain firearms and ammunition located or manufactured in the Russian Federation or previously manufactured in the Soviet Union in accordance with an agreement between the United States and the Russian Federation and the guidance of the Secretary of State regarding matters affecting world peace and the external security and foreign policy of the United States as expressed in a letter dated April 5, 1996.

DATES: Removal of the Russian Federation from the list of proscribed countries was effective April 5, 1996.

FOR FURTHER INFORMATION CONTACT: Mary Jo Hughes, Chief, Firearms and Explosives Imports Branch, Bureau of Alcohol, Tobacco and Firearms, 650 Massachusetts Avenue, NW., Washington, DC 20226 (202–927–8320).

SUPPLEMENTARY INFORMATION: By letter dated April 5, 1996, the Secretary of State advised the Director, ATF, that, under the authority of Section 38 of the Arms Export Control Act (AECA), 22 U.S.C. § 2778, it is no longer the policy of the United States to deny licenses, other approvals, exports and imports of defense articles and defense services destined for or originating in the Russian Federation (Russia). The State Department has requested that the Director implement this decision immediately with respect to his authority over imports under Section 38 of the AECA and amend the regulation at 27 CFR 47.52(a) to reflect this change in foreign policy.

The State Department also advised that the President decided to negotiate an agreement with Russia concerning the export of munitions. Carrying out such an agreement and keeping out unacceptable types of munitions from the United States are U.S. foreign policy concerns. In addition, the State Department informed ATF that an Agreement between the Government of the United States of America and the Government of the Russian Federation on exports of firearms and ammunition from the Russian Federation to the United States of America (the Agreement) was signed on April 3, 1996, and entered into force on that date. On this basis, the State Department advised the Department of the Treasury that Treasury should exercise the authority delegated to it under Section 38 of the AECA by denying applications to import firearms and ammunition located or manufactured in Russia or previously manufactured in the Soviet Union that would be inconsistent with the Agreement. The State Department advised Treasury that the foregoing did not apply to conditional imports of firearms and ammunition which would serve as samples for purposes of determining whether the items are of a type authorized for importation under the Agreement.

The Agreement provides that Russia shall not allow the exportation to the United States of (1) firearms other than those specified on Annex A to the Agreement; and (2) ammunition specified in Annex B to the Agreement. Nine handguns and 29 rifles are listed in Annex A. One type of ammunition is listed in Annex B. The Agreement also provides that new types of firearms and ammunition manufactured after February 9, 1996, may not be exported by Russia under the Agreement unless the parties agree in writing to amend the Agreement accordingly. The Agreement is published in its entirety at the end of this notice.

ATF has taken or will take the following actions to implement the above:

(1) ATF will remove Russia from the list of countries from which defense articles and defense services may not be imported into the United States. A Treasury Decision amending § 47.52(a) to reflect this action will be published in the near future.