Thus, no basis adjustment under section 961 is necessary. In addition, upon the sale or exchange of the stock of such corporation in a transaction described in section 1248(a), the earnings and profits of the corporation attributable to such previously untaxed income shall not be subject to section 1248(a).

(2) Qualification as an ETC for last year.

Question 2: Must an ETC satisfy all of the tests set forth in section 971(a)(1) for the ETC's last taxable year beginning before January 1, 1985?

Answer 2: All of the tests in section 971(a)(1) must be satisfied, except that for purposes of the working capital requirements set forth in section 971(c)(1), the working capital of the ETC at the close of its last taxable year beginning before January 1, 1985 shall be deemed reasonable.

(3) Continuation of ETC status.

Question 3: May a corporation which chooses to remain an ETC after December 31, 1984 continue to do so?

Answer 3: Yes. However, previously untaxed income of such ETC shall not be treated as previously taxed income in accordance with Q&A #1 of this section.

(4) Discontinuation of ETC status.

Question 4: How does an ETC make an election to discontinue its operation as an ETC?

Answer 4: The United States shareholders (as defined in section 951(b)) must file a statement of election on behalf of the ETC indicating the intent of the ETC to discontinue operations as an ETC for taxable years beginning after December 31, 1984. In addition, the statement of election must include the name, address, taxpayer identification number and stock interest of each United States shareholder. The statement must also indicate that the corporation on behalf of which the shareholders are making the election qualified as an ETC for its last taxable year beginning before January 1, 1985, and also the amount of earnings attributable to previously excluded export trade income. The statement must be jointly signed by each United States shareholder with each shareholder stating under penalties of perjury that he or she holds the stock interest specified for such shareholder in the statement of election. A copy of the statement of election must be attached to Form 5471 (information return with respect to a foreign corporation) filed with respect to the ETC's last taxable year beginning before January 1, 1985.

(5) Transition transfers.

Question 5: Under what circumstances may an electing ETC transfer its assets to a FSC without incurring any tax liability on the transfer?

Answer 5: An electing ETC will recognize no income, gain, or loss on a transfer of its assets to a FSC but only if all of the following conditions are met:

(1) The assets transferred were held by the ETC on August 4, 1983, and were transferred by the ETC to the FSC in a transfer completed before January 1, 1986; and

(2) The assets are transferred in a transaction which would qualify for nonrecognition under subchapter C of Chapter 1 of the Code, or would so qualify but for section 367 of the Code.

In such case, section 367 shall not apply to the transfer. In addition, other provisions of Subchapter C will apply to the transfer such as section 358 (basis to shareholders), section 362 (basis to corporation) and section 381 (carryovers in corporate acquisitions). In determining whether a transfer by an ETC to a FSC qualifies for nonrecognition under Subchapter C, a liquidation of the assets of the ETC into a parent corporation followed by a transfer by the parent of those assets to the FSC will be treated as a transaction described in section 368(a)(1)(D).

(OMB control number 1545–0884)

§§ 1.921–1 and 1.922–1 [Removed]

Paragraph 2. Sections 1.921–1 and 1.922–1 are hereby removed.

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. The DISC election terminates on December 31, 1984, and a new election must be made which in a large number of cases will result in setting up a new corporation outside the United States. For this reason, it is found impracticable to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Approved by the Office of Management and Budget under control number 1545–0884. This Treasury decision is issued under the authority contained in sections 803 and 805 of the Tax Reform Act of 1984 (98 Stat. 1001) and section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

Approved: September 28, 1984.

Ronald A. Pearlman,

Acting Assistant Secretary of the Treasury.

[FR Doc. 84–26886 Filed 10–5–84; 4:43 pm]

BILLING CODE 4830–01–M

26 CFR Part 1

[T.D. 7984]

Income Tax, Taxable Years Beginning After December 31, 1953; Taxation of DISC Income to Shareholders

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains Income Tax Regulations relating to the taxation of Domestic International Sales Corporation (DISC) income to shareholders. Changes to the applicable tax law were made by the Tax Reform Act of 1976 and the Tax Equity and Fiscal Responsibility Act of 1982. In addition, amendments are also made to the regulations under section 993, one relating to the treatment of accrued interest on a producer's loan as a qualified export asset and another defining the term "trade receivables." A further amendment is made to the regulations under section 994 allowing treatment of a prior DISC dividend as an additional payment of transfer price or repayment of a commission by the DISC. The regulations provide the public with the guidance needed to comply with these Acts and would affect all corporations which have elected to be treated as a DISC and their shareholders.

DATES: The amendments under §§ 1.995–2(a), 1.995–6 and 1.995–7 are effective for taxable years beginning after December 31, 1975. The amendments under §§ 1.993–2(d) and 1.994–1(e) are effective for all open taxable years ending after December 31, 1971, and the amendment under § 1.996–3 is effective for taxable years of DISCs beginning after December 31, 1982. The amendments under § 1.993–2(f) apply for taxable years beginning after January 10, 1985, except that the taxpayer may at its option apply this provision for all open taxable years ending after December 31, 1971.

FOR FURTHER INFORMATION CONTACT: Jacob Feldman of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224, Attention: CC:LR:T (LR–246–76), 202–566–3289, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under sections 995 and 996 of the Internal Revenue Code of 1954. These amendments are proposed to conform the regulations to section 1101 of the Tax Reform Act of 1976 (90 Stat. 1655) and a portion of section 204(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 423), and are to be issued under the authority contained in sections 995(e) (7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655; 90 Stat. 1659; 68A Stat. 917, respectively). Amendments are also being made under section 993, one relating to the treatment of accrued interest on a producer's loan and another defining trade receivables; under section 994 allowing treatment of a prior DISC dividend as an additional payment of transfer price or repayment of a commission by the DISC; and under section 996 to conform to changes made by the Tax Equity and Fiscal Responsibility Act of 1982. A notice of proposed rulemaking was published in the **Federal Register** on January 9, 1984 (49 FR 1075). A number of comments were received, but no hearing was requested and none was held.

Discussion

A number of issues were raised by commenters with respect to the proposed regulations. With respect to the definition of trade receivables under proposed § 1.993–2(d)(1), it was suggested that the "arise by reason of" language in section 993(b)(3) be added to restrict the definition to its proper scope and that "evidences of indebtedness" should not be limited to "written evidences of indebtedness." Both of these comments were adopted.

With respect to proposed § 1.993–2(f) which permits accrued interest on a producer's loan to qualify if paid within 60 days following the close of the DISC's taxable year, objections were raised as to the 60-day period and with respect to the retroactive application of this provision. A 60-day rule was believed necessary to prevent the interest between the DISC and its related supplier from accruing indefinitely without ever being paid. The 60-day period was chosen since it is the same period as is provided in § 1.994–1(e)(3) for the payment of initial transfer price or commission. No change was, therefore, made with respect to the 60-day period. Another suggestion was that the 60-day payment of accrued interest on a producer's loan should not be limited to the payment of cash or other property, but should also include a written obligation and offsetting accounting entry as permitted under § 1.994–1(e)(3) with respect to the initial payment of transfer price or commission. This suggestion was adopted. With respect to the effective date of § 1.993–2(f), the final regulations provide that this provision is effective for taxable years of a DISC beginning after January 10, 1985, but may be applied retroactively at the option of the taxpayer. A suggestion that accrued interest on foreign trade receivables be treated as a qualified export asset in the same manner as accrued interest on producer's loans was not adopted.

With respect to the proposed change to § 1.994–1(e)(5) which allows the DISC to reclassify that which would otherwise be treated as a distribution as a repayment of a commission or an adjustment of transfer price, several commenters suggested that the provision apply for all open years. This suggestion has been adopted in the final regulations. Other commenters suggested that the provision should be expanded to include other adjustments of DISC income not involving related parties as well as voluntary adjustments. These suggestions were not adopted.

With respect to § 1.995–6 dealing with the deemed distribution with respect to taxable income attributable to military property, a commenter suggested that in the event that gross income from the sales of military property cannot be determined on an item-by-item basis, the apportionment should not be limited to fair market value apportionment. Instead the commenter suggested that the taxpayer should be permitted to use other methods of apportionment based, for example, on gross receipts or cost of goods sold where appropriate. In addition, where an apportionment is required, the commenter suggested that the apportionment should only be applied where the sales of military property cannot be determined on an item-by-item basis. Both of these suggestions were adopted.

With respect to the separation rules under § 1.995–7(e) a number of commenters suggested the double attribution should apply only if there has been tax avoidance. This suggestion was not adopted since the provisions of section 995(e)(9)(A) do not restrict the double attribution rule to tax avoidance situations and the only exceptions to the separation rule are provided under section 995(e)(9)(B). The double attribution rule is also specifically referred to in the legislative history (S.R. 938, 94th Cong., 2d Sess. 296 (1976)), and there is no language limiting the application of the double attribution rules to tax avoidance situations. A corollary issue which a commenter raised is whether a DISC which is disqualified and recaptures accumulated DISC income can requalify and have a pro rata reduction in its base period export gross receipts. The proposed regulations under § 1.995–7(e)(5) take the position that the recapture of accumulated DISC income results only in a reduction of the base period export gross receipts associated with the DISC, not with the separated trade or business. Unlike a newly formed DISC, a DISC which has been disqualified and then requalifies has had the benefit of deferral during the years it was a DISC, a benefit which was not available to a new DISC. Therefore, the suggestion was not adopted.

Several other suggestions including a change in the method of computation of base period export gross receipts where DISCs in a controlled group have different annual accounting periods and special short taxable year rules where DISCs with different annual accounting periods elect to adopt the same annual accounting period, were considered but where not adopted.

Sections 801 through 805 of the Tax Reform Act of 1984 have replaced the Domestic International Sales Corporation (DISC) provisions with new Foreign Sales Corporation (FSC) provisions. In addition to the FSC provisions, a qualified domestic corporate taxpayer may elect to defer income attributable to $10 million or less in qualified export receipts by electing to be treated as an "interest charge DISC" and the shareholders of such DISC pay an annual interest charge on the amount of income deferred. The major portion of this regulation deals with the "incremental distribution" under sections 995(b)(1)(E), 995(e), and 995(g) of the Code. The incremental distribution will not apply with respect to either a FSC or an interest charge DISC. Nevertheless, these regulations are necessary to compute DISC benefits for taxable years of a DISC prior to December 31, 1984.

Regulatory Flexibility Act and Executive Order 12291

The Service has concluded that the regulations do not constitute regulations subject to the Regulatory Flexibility Act [5 U.S.C. Chapter 6]. The Commissioner of Internal Revenue has also determined that this regulation is not a major regulation as defined in Executive Order 12291 and therefore a regulatory impact analysis is not required.

Drafting Information

The principal author of these regulations is Jacob Feldman of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal

Revenue Service and Treasury Department participated in developing these regulations, both on matters of substance and style.

List of Subjects in 26 CFR §§ 1.861–1 through 1.997–1

Income taxes, Aliens, Exports, DISC, Foreign investments in U.S., Foreign tax credit, Source of income, United States investments abroad.

PART 1—[AMENDED]

Amendments to the Regulations

The Income Tax Regulations (26 CFR Part 1) are amended as follows:

Paragraph 1. Section 1.993–2 is amended by adding the text of paragraph (d)(1) and revising paragraph (f) to read as follows:

§ 1.993-2 Definition of qualified export assets.

* * * * *

(d) *Trade receivables*—(1) *In general.* For purposes of this section, trade receivables are accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation or of another corporation which is a DISC and which is a member of a controlled group which includes such corporation described in subparagraph (A), (B), (C), (D), (G), or (H), of section 993(a)(1) and which are due the DISC (or, if it acts as an agent, due its principal) and held by the DISC.

* * * * *

(f) *Producer's loans.* For purposes of this section, a producer's loan is an evidence of indebtedness arising in connection with producer's loans which are made by a DISC and which meet the requirements of § 1.993–4. If a producer's loan is a qualified export asset, interest accrued with respect to the producer's loan will also be treated as a qualified export asset provided that payment is made in the form of money, property (valued at its fair market value on its date of transfer and including accounts receivable for sales by or through a DISC), a written obligation which qualifies as a debt under the safe harbor rule of § 1.992–1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction and that payment is made no later than 60 days following the close of the taxable year of accrual of the interest. This paragraph (f) is effective for taxable years beginning after January 10, 1985 except that the taxpayer may at its option apply the provisions of this paragraph to taxable years ending after December 31, 1971.

* * * * *

Par. 2. Section 1.994–1(e) is amended as follows:

1. The last sentence of paragraph (e)(4) is revised to read as set forth below:

2. The last sentence of subdivision (i)(*a*) of paragraph (e)(5) is amended by adding the phrase "due the DISC" after the term "account receivable" the first time such term appears.

3. Subdivision (v) of paragraph (e)(5) is renumbered as subdivision (vi) and a new subdivision (v) is added to read as set forth below.

§ 1.994-1 Inter-company pricing rules for DISCs.

* * * * *

(e) *Methods of applying paragraph (c) and (d) of this section.*

* * * * *

(4) *Subsequent determination of transfer price or commission.* * * * Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations thereunder or section 861 and § 1.861–8 which affects the amounts which entered into the determination of the transfer price or commission.

(5) *Procedure for adjustments to transfer price or commission.*

* * * * *

(v) (*a*) In lieu of establishing an account receivable in accordance with subdivision (i) of this subparagraph for all or part of an amount due a related supplier, the related supplier and DISC are permitted to treat all or part of any distribution which was made by the DISC out of its previously taxed income with respect to the year to which the determination or redetermination relates as an additional payment of transfer price or repayment of commission (and not as a distribution) made as of the date the distribution was made. Any additional amount arising on the determination or redetermination due the related supplier after this treatment shall be represented by an account receivable established under subdivision (i) of this subparagraph. To the extent that a distribution is so treated under this subdivision (v), it shall cease to qualify as distribution for any Federal income tax purpose, and the DISC's account for previously taxed income shall be adjusted accordingly. If all or part of any distribution made to a shareholder other than the related supplier is recharacterized under this subdivision (v), the related supplier shall establish an account receivable from that shareholder for the amount so recharacterized. Such account receivable shall be paid in the time and manner set forth in this paragraph (e)(5). In order to obtain the relief provided by this subdivision (v), the conditions and procedures prescribed by Revenue Procedure 84–3 must be met. The provisions of this paragraph (e)(5)(v) shall apply to all open taxable years ending after December 31, 1971.

(*b*) If, for example, during 1982, a DISC commission from a related supplier with respect to a transaction completed in 1980 was redetermined to be $1,000 less than the commission actually charged by, and paid to, the DISC, the amount of any distribution previously made by the DISC from its 1980 previously taxed income to the related supplies as a shareholder may, to the extent of $1,000, be treated not as a distribution but as a repayment of the commission.

* * * * *

Par. 3. Section 1.995–2 is amended by adding new paragraphs (a)(4) and (a)(5) and revising paragraph (a)(6)(i) as follows:

§ 1.995-2 Deemed distributions in qualified years.

(a) General rule.

* * * * *

(4) For taxable years beginning after December 31, 1975, an amount equal to 50 percent of the taxable income of the DISC for the taxable years attributable to military property (as defined in § 1.995–6).

(5) For taxable years beginning after December 31, 1975, the taxable income for the taxable year attributable to base period export gross receipts (as defined in § 1.995–7).

(6) The sum of—

(i)(A) In the case of a corporate share holder, an amount equal to 57.5 percent of the excess (if any) (one-half for DISCs' taxable years beginning before January 1, 1983) of the taxable income of the DISC for such year (computed as provided in § 1.991–1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraph (1), (2), (3), (4) and (5) of this paragraph, or

(B) in the case of a non-corporate share holder, an amount equal to one-half of the excess (if any) of the taxable income of the DISC for such year (computed as provided in § 1.991–1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraphs (1), (2), (3), (4), and (5) of this paragraph.

* * * * *

Par. 4. The following §§ 1.995–6 and 1.995 are added immediately after § 1.995–5:

§ 1.995–6 Taxable income attributable to military property.

(a) *Gross income attributable to military property.* For purposes of section 995(b)(3)(A)(i), the term "gross income which is attributable to military property" includes income from the sale, exchange, lease, or rental of military property (as described in paragraph (c) of this section). The term also includes gross income from the performance of services which are related and subsidiary (as defined in § 1.993–1(d)) to any qualified sale, exchange, lease, or rental of military property. Where gross income cannot be determined on an item by item basis, the gross income with respect to those items not so determinable shall be apportioned. Such apportionment shall be accomplished using appropriate facts and circumstances, so that the gross income apportioned to sale of military property bears a reasonably close factual relationship to the actual gross income earned on such sales. The apportionment shall be based on methods which include the fair market value of property sold or exchanged, the fair rental value of any leaseholds granted, the fair market value of any related or subsidiary services performed in connection with such sale or leases or methods based on gross receipts or costs of goods sold, where appropriate.

(b) *Deductions.* For purposes of section 995(b)(3)(A)(ii), deductions shall be properly allocated and apportioned to gross income, described in paragraph (a) of this section, in accordance with the rules of § 1.861–8. These deductions include all applicable deductions from gross income provided under part VI of subchapter B of chapter 1 of the Code.

(c) *Military property.* For purposes of this section, the term "military property" means any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778 which superseded 22 U.S.C. 1934) and the regulations thereunder (22 CFR 121.01).

(d) *Illustration.* The principles of this section may be illustrated by the following example:

Example. X Corporation elects to be a DISC for the first time in 1976. X has taxable income of $50,000, of which $30,000 is attributable to military property and $10,000 to interest on producer's loans. The total deemed distributions with respect to X are as follows:

(1) Gross interest from Producer's loans in 1976	$10,000
(2) 50 percent of the taxable income of the DISC attributable to military property in 1976	15,000
(3) One-half of the excess of taxable income for 1976 over the sum of lines (1) and (2) (½ of ($50,000 minus $25,000))	12,500
(4) Total deemed distributions (sum of total lines (1), (2), and (3))	37,500

§ 1.995–7 Taxable income attributable to base period export gross receipts.

(a) *General rule.* This section provides rules for the computation of taxable income attributable to base period export gross receipts. Section 995(b)(1)(E) treats taxable income attributable to base period export gross receipts as a deemed distribution to a shareholder of a DISC for taxable years of a DISC beginning after December 31, 1975. The amount attributable to base period export gross receipts that must be included in income of a shareholder will be referred to as the nonincremental distribution. The nonincremental distribution must be computed for each taxable year of a DISC. Such year will be referred to as the computation year.

(b) *Nonincremental distribution*—(1) *General rule.* The nonincremental distribution for a computation year of a DISC is computed by multiplying the adjusted taxable income of the DISC by a fraction. The numerator of the fraction is the amount of the adjusted base period export gross receipts and the denominator is the amount of the export gross receipts of the DISC for the computation year.

(2) *Adjusted taxable income.* The "adjusted taxable income" is the taxable income of a DISC for the computation year reduced by the amounts described under section 995(b)(1) (A) through (D) and the regulations thereunder.

(3) *Export gross receipts.* The "export gross receipts" is the qualified export gross receipts described in section 993(a)(1) (A), (B), (C), (G), and (H) of a DISC for a taxable year reduced by 50 percent of those receipts which are attributable to military property (as defined under § 1.995–6). For purposes of determining the denominator described in this paragraph (b), if the computation year is a short taxable year, the amount of export gross receipts for that year is multiplied by a fraction. The numerator of the fraction is the number of days which would have been in the taxable year of the taxpayer if there had been a full taxable year and the denominator is the number of days in the short taxable year.

(4) *Adjusted base period export gross receipts.* The amount of adjusted base export gross receipts is 67 percent of the average of the base period export gross receipts.

(c) *Average base period export gross receipts*—(1) *Base period of 48 months or less.* If a DISC has a base period of 48 months or less, the amount of average base period export gross receipts is determined by dividing the base period export gross receipts by number four (4).

(2) *Base period or more than 48 months.* If a DISC has a base period of more than 48 months, the amount of average base period export gross receipts is determined by multiplying the base period export gross receipts by a fraction. The numerator of the fraction is the number 365.25 and the denominator is the total number of days in the base period.

(3) *Change of accounting period.* Notwithstanding paragraph (c)(1) of this section, if a corporation that is a DISC changes its annual accounting period (other than during the first taxable year of its existence), and the effect of such a change creates a base period of less than 48 months, the average base period export gross receipts are determined under paragraph (c)(2) of this section. This paragraph (c)(3) applies with respect to changes of accounting period permitted under § 1.995–7(d)(5).

(4) *Base period export gross receipts.* "Base period export gross receipts" means the aggregate export gross receipts of a DISC for all taxable years beginning during the base period reduced by the base period export gross receipts attributable to property that is excluded from export gross receipts during the computation year. Excluded property is property described in section 993(c)(2) (C) or (D) without regard to the fixed contract exception under § 1.993–3(g)(6). When the fixed contract exception applies, the amount of excluded property is multiplied by a fraction. The numerator of the fraction is the amount of the gross receipts in the computation year attributable to excluded property less the amount of the export gross receipts by reason of the fixed contract exception under § 1.993–3(g)(6). The denominator of the fraction is the total amount of gross receipts in the computation year attributable to excluded property. For taxable years of a DISC ending before November 15, 1982, base period export gross receipts do not include receipts attributable to property sold or leased to a WHTC or receipts which arose in the absence of a written supplier's agreement unless the receipts were treated as qualified export by the taxpayers

(5) *Illustration.* The following example illustrates the application of paragraph (c)(4) of this section:

Example. X Corporation, a DISC since 1972, derived $2000 from sales of coal and $3000 from sales of foodstuffs in 1976. In 1975 gross receipts from the sale of agricultural products were $1000 and from the sale of coal were $3000. One thousand dollars of the $3000 was derived from sales prior to March 19, 1975, and $2000 from sales made after March 18, 1975, of which $500 of the latter sales were pursuant to a fixed contract. Assume that all gross receipts are qualified export receipts (and, therefore, export gross receipts as provided in paragraph (b)(3) of § 1.995–7) except to the extent that section 993 (c)(2)(C) (which treats natural resources such as coal as excluded property) is applicable. Assume further that the gross receipts for 1972, 1973, and 1974 were each $500, all derived entirely from the sale of foodstuffs and all qualifying as export gross receipts. Under these facts the adjusted base period export gross receipts are determined as follows:

(1) Export gross receipts for 1975:	
(i) Export gross receipts—agricultural products	$1,000
(ii) Export gross receipts—coal	$1,500
(*a*) Sales prior to March 19, 1975	$1,000
(*b*) Sales subsequent to March 18, 1975:	
(1) Fixed Contract sales	$500
(2) Non-fixed contract sales	$1,500
Total	$2,000

$$\text{Excluded property receipts (\$2,000} \times \frac{\text{Excluded property receipts (\$2,000)}}{\text{Excluded property receipts (\$2,000)}} - \text{Fixed contract receipts (\$500)}$$

Total export gross receipts ($1,000 + 1,500)	$2,500
(2) Adjusted export gross receipts:	
1972 export gross receipts	$500
1973 export gross receipts	500
1974 export gross receipts	500
1975 export gross receipts	2,500
Base period export gross receipts	4,000
Average base period export gross receipts 1972–75	1,000
Adjusted base period export gross receipts (.67 × average for base years	670

(6) *Base years.* The base period is a 4-year period attributable to a computation year. For computation years of a DISC beginning before January 1, 1980, the base period calendar years are 1972, 1973, 1974, and 1975. For other computation years, the base period calendar years are the fourth, fifth, sixth and seventh calendar years preceding the calendar year in which the computation year begins. If a DISC has taxable years beginning in every base period calendar year, the base period is the period which begins on the first day of the first taxable year beginning in the earliest base period calendar year and ends on the last day of the last taxable year beginning in the latest base period calendar year. A corporation that revoked its election to be treated as a DISC or failed to satisfy the conditions of section 992(a)(1) for a taxable year to be a DISC will, for purposes of computing its base period export gross receipts, be treated as a DISC newly established in such subsequent taxable year. However, see paragraph (e)(3) of this section, which treats a disqualification as a separation. This paragraph (c)(6) applies whether or not the DISC qualified (or was treated) as a DISC (within the meaning of section 992(a)(1) and § 1.992–1) for all taxable years beginning in the base period calendar years. If a DISC does not have a taxable year beginning in every base period calendar year, the base period is the period which begins on the the date during the earliest base period calendar year that corresponds to the date on which the first taxable year of the DISC begins, and ends on the last day of the last taxable year of the DISC beginning in the latest base period calendar year.

(7) *Illustrations.* The following examples illustrate the application of this paragraph (c):

Example (1). X Corporation, a DISC, was organized on March 1, 1972, and adopted a taxable year beginning on March 1. With respect to the computation year beginning on March 1, 1976, X's base period calendar years are 1972, 1973, 1974, and 1975. The base period is the period which begins on March 1, 1972, and ends on February 29, 1976.

Example (2). Y Corporation, a DISC, was organized on March 15, 1974, and adopted a taxable year beginning on October 1. With respect to the computation year beginning on October 1, 1977, Y's base period is the period which begins on March 15, 1972, and ends on September 30, 1976.

Example (3). Z Corporation, a DISC, was organized on December 10, 1974, and adopted a taxable year beginning on February 1. With respect to the computation year beginning on February 1, 1980, Z's base period calendar years are 1973, 1974, 1975, and 1976. The base period is the period which begins on December 10, 1973, and ends on January 31, 1977.

(d) *Controlled group*—(1) *General rule.* Where more than one member of a controlled group of corporations (as defined in section 993(a)(3) and § 1.993-1(k)) qualifies or is treated as a DISC, special rules are used to calculate the nonincremental distribution. In such a case, the fraction described in paragraph (d)(2) of this section to compute the nonincremental distribution is the aggregate of the adjusted base period export gross receipts over the aggregate of the computation year export gross receipts for the computation year of every member DISC within the controlled group. This fraction is multiplied by the aggregate adjusted taxable income of each member DISC within the controlled group. The computation of the nonincremental distribution described in this paragraph applies to shareholders of a DISC that is a member of a controlled group even though such shareholder is not a related person within the meaning of § 1.993-1(a)(6).

(2) *Aggregate adjusted base period export gross receipts.* If any DISC that is a member of the controlled group uses a taxable year that is different from another DISC that is a member of the same controlled group, the aggregate of the adjusted base period export gross receipts consists of the sum of the adjusted base period export gross receipts of each of the following DISCs:

(i) The DISC (primary DISC) with respect to which the nonincremental distribution is being determined; and

(ii) All other DISCs (secondary DISCs) that are members of the same controlled group (as defined in section 993(a)(3)) as the primary DISC and whose computation years end with or within the computation year of the primary DISC.

For purposes of this paragraph (d)(2), the base period calendar years of any secondary DISC is the base period calendar years of the primary DISC.

(3) *Aggregate current year export gross receipts.* If paragraph (d)(2) of this section applies, the aggregate of the export gross receipts for the computation year consists of the sum of the export gross receipts of the primary DISC and the export gross receipts of all secondary DISCs for their computation years described in paragraph (d)(2)(ii) of this section.

(4) *Illustrations.* The following examples illustrate the application of this paragraph (d):

Example (1). P Corporation owns all of the stock of V and X Corporations. V owns all of the stock of Y Corporation, a DISC. X owns all of the stock of Z Corporation, a DISC. P, V, X, Y, and Z are members of the same controlled group for all periods involved. V uses a fiscal year ending June 30 as its taxable year. X uses the calendar year as its taxable year. Y and Z both use the calendar year as their taxable years. For the computation year ending in 1980, Y has adjusted taxable income (as defined under paragraph (b)(2) of this section) of $3,000, adjusted base period export gross receipts (as defined under paragraph (b)(4) of this section) of $2,000, and export gross receipts (as defined under paragraph (b)(3) of this section) of $5,000. For the same year, Z has adjusted taxable income of $4,000, adjusted base period export gross receipts of $6,000 and export gross receipts of $5,000. The numerator of the fraction to determine the nonincremental distribution is $8,000, the aggregate of the adjusted base period export gross receipts of Y and Z. The denominator of the fraction is $10,000, the aggregate of the export gross receipts of Y and Z. The nonincremental distribution under paragraph (b)(1) of this section with respect to Y is $2,400 ($3,000 × $\frac{8}{10}$), and with respect to Z is $3,200 ($4,000 × $\frac{8}{10}$).

Example (2). The facts are the same as in example (1) except that Y uses a fiscal year ending January 31 as its taxable year and the computation year ends in 1980. In computing the nonincremental distribution with respect to Z, a calendar year DISC, Z is the primary DISC described in paragraph (d)(2)(i) of this section. In computing the adjusted base period export gross receipts of Y, Y's base period is the same as that of Z even though Y's computation year begins in the calendar year 1979. The adjusted taxable income and current year export gross receipts of Z are for the calendar year beginning January 1, 1980, and the current year export gross receipts of Y are for Y's fiscal year ending January 31, 1980.

(5) *Change of annual accounting period.* Where more than one member of a controlled group of corporations (as defined in section 993(a)(3) and § 1.993-1(k)) qualifies or is treated as a DISC and where any two or more of the member DISCs have different annual accounting periods, the annual accounting periods of the member DISCs may be changed without the approval of the Secretary if, and only if

(i) All member DISCs have the same annual accounting period after the change; and

(ii) The period chosen is the annual accounting period of one of the member DISCs.

In the case of an existing controlled group with member DISCs having different annual accounting periods, the change may be made within one year after (the date of adoption of the regulations as a Treasury decision); and in the case of a newly acquired DISC, the accounting period of such DISC may be changed by adopting the period of any existing DISC within one year after acquisition.

(e) *Separation of DISC and trade or business*—(1) *General rule.* If, at any time after the beginning of the base period of a DISC, there has been a separation of the ownership of the stock in that DISC from the ownership of a trade or business that produced export gross receipts of the DISC, the persons who own the trade or business during the taxable year are treated as having in any DISC in which they have (or acquire) a direct or indirect interest additional export gross receipts attributable to the trade or business for purposes of computing base period export gross receipts. Notwithstanding the separation, the base period export gross receipts remain with the DISC after separation and are taken into account by shareholders of the DISC (whether or not there are new shareholders of the DISC as a result of the separation) in computing the adjusted base period export gross receipts of the DISC for taxable years beginning prior to the year in which the separation occurs.

(2) *Ownership.* A person will be treated as an owner of a trade or business which produced export gross receipts of a DISC if the person owns stock, directly or indirectly, in a corporation that conducts the trade or business. A person will also be treated as an owner of a trade or business if that person is, for example, a partner in a partnership that either conducts the business or owns stock, directly or indirectly, in a corporation that conducts it, a lessee of substantially all the assets of a trade or business, or a licensee of a patent, copyright, trademark, or similar property essential to the conduct of a trade or business. For purposes of this paragraph (e)(2), a person who owns indirectly less than 5 percent of the entity conducting the trade or business shall not be treated as the owner of the trade or business. For purposes of this paragraph (e)(2), stock owned, directly, or indirectly, by or for a corporation, partnership, trust, or estate shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence may be treated as actually owned by such person.

(3) *Separation.* A separation occurs if the ratio of a person's percentage ownership interest in a DISC to his percentage ownership in the trade or business which produced export gross receipts of the DISC changes at any time during the year. Thus, if A Corporation owns all the stock of B, C, and D Corporations, and D is a DISC and B and C produced export gross receipts for D, the transfer of the stock of B and C will result in a separation. Similarly, the transfer of the stock of C and the stock of D will result in a separation as will the liquidation of D by A. The disqualification of a DISC by revocation of the election or by failing to satisfy the conditions of section 992(a)(1) for a taxable year shall be treated as a separation, and the export gross receipts produced prior to the disqualification will be attributed to the separated trade or business. A requalified DISC will be treated as having additional export gross receipts attributable to the separated trade or business. For purposes of this paragraph (e)(3), members of the same controlled group (as defined in section 993(a)(3)) will be treated as one person.

(4) *Amount of attribution.* If a separation described in paragraph (e)(3) of this section occurs, the additional amount referred to in paragraph (e)(1) of this section is the amount of the export gross receipts attributable to the separated trade or business.

(5) *Recapture of accumulated DISC income.* If a shareholder of a DISC recaptures accumulated DISC income (as defined in section 996(f)(1)) as a result of a disposition (as described in section 995(c)) of stock in a DISC or a disqualification which results in a separation, the base period export gross receipts of the DISC for base period years prior to the disposition are reduced on a pro rata basis to the extent of the recapture in the taxable year. This reduction does not apply for purposes of determining the amount described in paragraph (e) (1) and (4) of this section which is attributable to the owner of a trade or business after the separation.

(6) *Illustrations.* The principles of this paragraph (e) are illustrated by the following examples:

Example (1). A Corporation owns all the stock of B, C and D Corporations. D is a DISC and B and C each produced $5,000 of the export gross receipts of D. A sells the stock of B to Z, an unrelated party, which organizes P Corporation, a DISC, for which B produces export gross receipts. Under paragraph (e)(3) of § 1.995-7, the sale of the stock of B constitutes a separation and under paragraph (e) (1) and (4), $5,000 of export gross receipts is attributable to P. Under paragraph (e)(1) the export gross receipts of D are $10,000 unchanged by the separation. If D is liquidated by A and F Corporation a new DISC is organized, F will have export gross receipts of $5,000. Under paragraph (3)(5), the export gross receipts of D are eliminated. However, paragraph (e)(5) does not apply to amounts attributable to the owner of the trade or business after the separation under paragraph (e)(4). Therefore, $5,000 is attributable to P (by B) and $5,000 is attributable to F (by C).

Example (2). G Corporation owns all the stock of H and I Corporations and H Corporation owns all the stock of J Corporation, a DISC. During the base period H produces all the export gross receipts of J, which amounts to $25,000. The sale of the stock of H to B does not constitute a separation within the meaning of paragraph (e)(3). If J is liquidated, there will be attributed to any future DISC organized with respect to H the export gross receipts attributable to the separate trade or business. Although the liquidation will result in a recapture of accumulated DISC income, paragraph (e)(5) does not apply for purposes of determining the amount attributable to the owner of the trade or business after the separation, and under paragraph (e)(1) such amount is attributed to any future DISC for which H produces export gross receipts.

Example (3). P Corporation owns several corporations including R Corporation, a DISC, and M Corporation, which has produced export gross receipts for R. P also owns several other DISC's. The stock of M is sold to W Corporation. Assuming that M produced $100,000 of export gross receipts during the base period and that those receipts were the only receipts produced with respect to R, there is a separation under paragraph (e)(3) and under paragraph (e)(1) $100,000 in export gross receipts will be attributable to any DISC that W organizes with respect to M. In addition, under paragraph (e)(1) the export gross receipts of R are unreduced and taken into account in computing base period export gross receipts under the controlled group rules of paragraph (d). If R is liquidated there will be a recapture of accumulated DISC income and under paragraph (e)(5) a reduction of the export gross receipts of R, but no reduction with respect to any DISC that W organizes with respect to M.

(f) *DISC base period attributed through shareholders*—(1) *In general.* If—

(i) Any person owns 5 percent or more of the stock of a DISC (referred to as the "first DISC"), and

(ii) that person at any time during the base period of the first DISC owned 5 percent or more of the stock of a second DISC, and

(iii) Both DISCs derived export gross receipts from the sale of the same or similar property, or from the performance of the same or similar services,

then the base period export gross receipts of the first DISC are increased by the shareholder's pro rata portion of the base period export gross receipts of the second DISC.

(2) *Exception.* Paragraph (f)(1) of this section does not apply to the extent paragraph (d) or (e) of this section apply.

(3) *Ownership of stock.* For purposes of this paragraph (f), the ownership of stock is determined under section 318.

(4) *Recapture of accumulated DISC income.* The rules with respect to recapture of accumulated DISC income described in paragraph (e)(5) of this section apply with respect to base period attribution under this paragraph.

(5) *Illustration.* The following example illustrates the application of this paragraph.

Example. A Corporation owns all the stock of B and C Corporations and B owns all the stock of D Corporation, a DISC. B produced $10,000 of export gross receipts of D for the base period 1972-1975. On January 1, 1976, A sells all the stock of C to X Corporation, an unrelated corporation. Subsequently A purchases 50 percent of the stock of F Corporation, another DISC, and B conducts all of its export business through F with B as the related supplier. Neither the sale of C by A nor the purchase of F result in a separation with respect to A under paragraph (e) of this section. In addition, D and F are not members of the same controlled group within the meaning of section 993(a)(3), and paragraph (d) of this section does not apply. However, under paragraph (f)(1) of this section, the base period export gross receipts of F are increased by $10,000.

(g) *Small DISC exception*—(1) *Adjusted taxable income of $100,000 or less.* Except as provided in paragraph (g)(4) of this section, if a DISC has adjusted taxable income of $100,000 or less for the taxable year, section 995(b)(1)(E) and this section do not apply for that year.

(2) *Partial exception.* If, for a taxable year, a DISC has adjusted taxable income of more than $100,000 but less than $150,000, the nonincremental distribution under paragraph (b)(1) of this section is reduced (but not below zero) by an amount equal to twice the excess of $150,000 over the adjusted taxable income.

(3) *Short taxable year.* In computing a DISC's adjusted taxable income for purposes of this paragraph (g), when the current taxable year is a short taxable year, the adjusted taxable income for the year is multiplied by a fraction. The numerator of the fraction is the number of days in the full taxable year and the denominator is the number of days in the short taxable year.

(4) *Controlled groups.* If more than one member of a controlled group (as defined in section 993(a)(3)) qualifies, or is treated, as a DISC for the current taxable year, the adjusted taxable income of each member of the group is aggregated for purposes of determining the application of paragraph (g) (1) or (2) of this section. The adjusted taxable income of any DISC for purposes of this aggregation may not be less than zero. The aggregation is made in the same manner and with respect to those DISCs described in paragraph (d)(2) of this section. If the adjusted taxable income of the member DISCs is more than $100,000, but less than $150,000, the nonincremental distribution under paragraph (b)(1) of this section is determined in accordance with paragraph (d) of this section. The reduction determined under paragraph (g)(2) of this section is apportioned among the DISCs described in paragraph (d)(2) of this section in accordance with the ratio which the adjusted taxable income of each member DISC for the year bears to the total adjusted taxable income of all member DISCs for the year. This paragraph (g)(4) applies to a shareholder of a DISC even though the shareholder is not a related person as defined in § 1.993-1(a)(6).

(h) *Certain transfer of DISC assets*—(1) *In general.* If—

(i) A corporation owns all the stock of a subsidiary and a DISC,

(ii) The corporation transfers (within the meaning of paragraph (h)(4) of this section) all the stock of the subsidiary,

(iii) The subsidiary has been engaged in the active conduct of a trade or business (within the meaning of section 355(b) and regulations thereunder) throughout the 5-year period ending on the date of the transfer, and continues to be so engaged thereafter,

(iv) During the taxable year of the subsidiary in which its stock is transferred, and its preceding taxable year, the trade or business produced qualified export receipts with respect to the subsidiary and the DISC,

(v) The DISC transfers all of its assets related to the conduct of the trade or business to a new DISC in exchange for all the stock of the new DISC, the DISC distributes the stock in the new DISC to the corporation and the corporation transfers the stock in the new DISC to the subsidiary, and

(vi) The transfers described in paragraph (h)(1)(v) of this section are undertaken for the sole purpose of avoiding the application of section 995(e)(9) and paragraph (e) of this section, and, therefore, preventing double attribution under paragraph (e)(1),

then notwithstanding any other rule or regulation to the contrary, the transfer described in paragraph (h)(1)(v) will be a reorganization within the meaning of section 368(a)(1)(D) to which section 355 applies and an exchange of stock of the new DISC by the corporation for stock of the subsidiary to which section 351 applies.

(2) *Special rule.* If—

(i) A corporation owns, directly or indirectly, all the stock of a subsidiary and a DISC,

(ii) A transfer or transfers described in this paragraph (h)(2) of the stock or assets of the subsidiary and the DISC are for the purpose described in paragraph (h)(1)(vi) of this section, and

(iii) The transfer or transfers occur in a transaction other than one described in paragraph (h)(1)(v) of this section but which satisfies the requirements of paragraphs (h)(1) (iii) and (iv) of this section,

then the transfer or transfers described in this paragraph (h)(2)(iii) will be a reorganization within the meaning of section 368, a transaction to which section 355 applies, an exchange of stock to which section 351 applies, or a combination of these, as the case may be, provided the transfer or transfers are consistent with the purpose and effect of those described in paragraph (h)(1)(v) of this section.

(3) *Ownership.* Stock owned, directly or indirectly, by a corporation shall be considered as owned proportionately by its shareholders.

(4) *Transfer.* The term "transfer" includes a sale, exchange, or other disposition of property.

(5) *Illustrations.* The following examples illustrate the application of this paragraph (h):

Example (1). P Corporation, which was organized on January 1, 1966, owns all the stock of X and Y Corporations, both also organized on January, 1 1966. X has been engaged in the manufacture of shoes. Y has been engaged in the manufacture of recreational equipment. On January 1, 1972, P organizes Z Corporation, a DISC. X and Y serve as the related suppliers of Z. On January 1, 1977, U Corporation offers to buy the stock of X. As part of an overall plan to avoid the application of section 995(e)(9), Z transfers all the export assets that relate to the trade or business conducted by X to V Corporation in exchange for all of the stock of V. Z then distributes all the stock of V to P, which transfers all the V stock to X. Immediately after this series of transactions, P sells all of the X stock to U Corporation. Under paragraph (h)(1) of this section, the transfer and distribution by Z constitute a reorganization under section 368(a)(1)(D) to which section 355 applies, and the exchange by P constitutes and exchange to which section 351 applies. The result would be the same even if P sold less than all of the stock in X.

Example (2). The facts are the same as in example (1), except that Y organizes and owns all the stock of Z. Accordingly, after the transfer by Z, Z distributes the stock of V to Y, which in turn distributes the stock to P. P transfers all the V stock to X. Under paragraph (h)(2) of this section, the transfers by Z to Y, and Y to P constitute a reorganization described in section 368(a)(1)(D) to which section 355 applies. The transfer by P to X constitutes an exchange to which section 351 applies.

* * * * *

Par. 5. Section 1.996-3 is amended by adding a new paragraph (g) as follows:

§ 1.996-3 Divisions of earnings and profits.

* * * * *

(g) *DISCs having corporate and noncorporate shareholders.* In the case of a DISC having one or more corporate shareholders but less than all of its shareholders subject to the special rules of section 291(a)(4), relating to certain deferred DISC income as a corporate preference item, accumulated DISC income and previously taxed income of the DISC are divided between the corporate shareholders, as a class, and the other shareholders, as a class, in proportion to amounts of DISC income not deemed distributed and amounts deemed distributed to each class. Subsequent taxation of actual and qualifying distributions shall be based upon this division. Thus, if a DISC is owned 50 percent by corporate shareholders and 50 percent by individual shareholders and has undistributed taxable income of $2,000 for its year, the division is made as follows:

Corporate shareholders:	
Previously taxed income (57.5% of $2,000÷2)	$575
Accumulated DISC income (42.5% of $2,000÷2)	425
Individual shareholders:	
Previously taxed income (50% of $2,000÷2)	500
Accumulated DISC income (50% of $2,000÷2)	500

* * * * *

This Treasury decision is issued under the authority contained in sections 995(e) (7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995(e) (7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat. 917, 26 U.S.C. 7805).

Approved: September 26, 1984.

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

Ronald A. Pearlman,

Acting Assistant Secretary of the Treasury.

[FR Doc. 84-26928 Filed 10-11-84; 8:45 am]

BILLING CODE 4830-01-M

DEPARTMENT OF THE INTERIOR

Minerals Management Service

30 CFR Part 229

Implementation of the Provisions of Subsections 205 (c) and (d) of Title II of the Federal Oil and Gas Royalty Management Act of 1982

AGENCY: Minerals Management Service (MMS), Interior.

ACTION: Interim final rule; request for comments.

SUMMARY: This interim final rule would implement provisions of subsections 205 (c) and (d) of Title II of the Federal Oil and Gas Royalty Management Act of 1982 (the Act). Section 205 of the Act provides for delegation of authority by the Secretary of the Interior to the States to conduct inspections, audits, and investigations with respect to all Federal lands within a State, and with respect to Indian lands with the permission of the affected Indian tribe or allottee.

MMS recently issued general regulations implementing the Act. However, subsection (c) of section 205 requires the Secretary to promulgate regulations defining functions which must be carried out jointly to avoid duplication of effort. Subsection (d) requires the Secretary to promulgate regulations and standards pertaining to the authorities and responsibilities which a State would administer under a delegation of authority. This interim rule would establish the standards required by the provisions of subsections (c) and (d). The Secretary of the Interior has delegated to MMS the authority to administer and implement these provisions of the Act.

DATES: Effective date November 13, 1984. Comments by November 13, 1984.

ADDRESS: Send comments to: Chief, Office of Royalty Regulations, Development and Review, Minerals Management Service (Mail Stop 660), 12203 Sunrise Valley Drive, Reston, Virginia 22091.

FOR FURTHER INFORMATION CONTACT: Mr. Orie L. Kelm (703) 860-7511, (FTS) 928-7511.

SUPPLEMENTARY INFORMATION: The principal author of this rulemaking is Mr. Robert E. Boldt, Associate Director for Royalty Management, Minerals Management Service.

The Act, 30 U.S.C. 1701 *et seq.*, has established new avenues for cooperative efforts between States and the Federal Government in carrying out royalty management activities for onshore Federal leases and mineral leases on Indian lands. In particular, sections 202 and 205 of Title II of the Act, 30 U.S.C. 1732 and 1735, provide new authority for cooperative efforts with State governments. Under section 202, the MMS is authorized to enter into cooperative agreements with State and Indian governments to carry out audit and investigative activities related to oil and gas royalties paid and collected on Federal and Indian leases. Under section 205 the Secretary, after proper notice, opportunity for hearing, and rulemaking, is authorized to delegate to any State that properly petitions for it, all or part of the authorities and responsibilities of the Secretary to conduct inspections, audits, and investigations with respect to all Federal and Indian lands within that State; except that the Secretary may not undertake such a delegation with respect to any Indian Lands unless the permission of the affected Indian tribe or allottee involved has been obtained.

On September 20, 1984, MMS adopted a set of regulations to implement its new authorities under the Federal Oil and Gas Royalty Management Act of 1982. Part 229 of the new regulations implements section 205 of the Act by providing the general procedures for delegations of authority to the States. However, the Act contemplated more detailed regulations governing delegations of authority. The purpose of this interim final rule is to define those MMS authorities and responsibilities subject to delegation to State governments, those authorities and responsibilities reserved to the Secretary, and to promulgate standards by which State governments would carry out audit activities under a section 205 delegation of authority.

These standards by which State governments are to carry out audit activities are those contemplated by the Act. Included are the terms of authorities and responsibilities subject to delegation and the standards for: (a) Procedures for obtaining regulatory and policy guidance from MMS; (b) required recordkeeping; (c) coordination of State audit activities with those of the Department of the Interior (DOI); (d) procedures for the development, maintenance, and referencing of workpapers; and (e) standards for carrying out audit activities under a delegation of authority.

Some related items are also addressed in this interim rulemaking. These include: (a) Procedures for the preparation and issuance of enforcement documents; (b) procedures for handling appeals; and (c) disbursement of revenues received as a result of audits conducted under a delegation of authority.

Section 205 of the Act does not authorize the Secretary to delegate enforcement authority to the States. Accordingly, the interim rules do not address this issue.

Administrative Procedures Act

The MMS has determined that good cause exists pursuant to 5 U.S.C. 553(b) to issue this rule as an interim final rule. Notice is impracticable and unnecessary for two principal reasons. First, a substantial amount of comment was received on the State delegation issue when MMS proposed its 30 CFR Part 229 regulations (since adopted on September 21, 1984), together with the other MMS rules implementing the Act. Moreover, extensive informal discussions were held with the States industry on the delegation issue during that rulemaking process.

The second reason why notice is impracticable and unnecessary is that section 205(b) of the Act requires notice and opportunity for a hearing before any authority under the Act actually is delegated to the State. Since the requirements of this rulemaking are general in nature, opportunity for comment on a specific delegation proposal will be more meaningful.

The MMS is providing a 30-day comment period on the interim final rule and encourages interested persons to submit comments. If any comments are received which warrant a change to the rules issued today, an appropriate amendment will be made when the interim final rule is issued in final form. MMS will not finally approve the delegation of authority to a State until final regulations are issued. This will allow for consideration of all comments and possible changes to the rule before any State's delegation petition is acted upon.

For the above reasons, MMS has determined that good cause exists to issue interim final rules.

Executive Order 12291

The Department has determined that this interim rule is not a major rule and does not require the preparation of a regulatory impact analysis under Executive Order 12291.

This rulemaking has minimal economic effect on any business, large or small, as it only addresses who will perform the functions. The delegated functions will be no more stringent than are presently being performed.

Regulatory Flexibility

Some portion of the lessees/payors who will be assessed for royalty underpayments resulting from the implementation of this rulemaking will be small businesses. However, because the requirement to pay royalties is imposed by other regulations and because most of the affected lessees/payors are not small businesses, the Department has determined that this rule will not have a significant economic effect on a substantial number of small entities. Therefore, a small entity flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) is not required.

Paperwork Reduction Act of 1980

The information collection requirements contained in this rule do not require approval by the Office of Management and Budget under 44 U.S.C. 3501 *et seq.*, because there will be fewer than 10 respondents annually.

National Environmental Policy Act of 1969

It is hereby determined that this rule does not constitute a major Federal action significantly affecting the quality of the human environment and that no detailed statement pursuant to section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332(2)(C)) is required.

List of Subjects in 30 CFR Part 229

Auditing standards, Delegations of authority, Intergovernmental relations, Investigations, Mineral royalties.

Under the authority of the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. 1735), Chapter II, Title 30 of the Code of Federal Regulations is amended as set forth below.

Dated: September 18, 1984.

Garrey E. Carruthers,

Assistant Secretary for Land and Minerals Management.

PART 229—[AMENDED]

1. 30 CFR Part 229, Subpart C is amended as shown in the following redesignation table.

REDESIGNATION TABLE

Old 30 CFR Part 229, Subpart C	New 30 CFR Part 229, Subpart C designations
	Inserting new subheading—ADMINISTRATION OF DELEGATIONS.
229.100(a)	229.101(a).
229.100(b)	229.101(b).
229.100(c)	229.101(c).
229.100(d)	229.101(d).
229.100(e)	Removed.
229.101(a)	229.102(a).
229.101(b)	229.102(b).
229.102	229.102(c).
229.103	229.103.
229.104	229.105.
229.105	Removed.
229.106	Removed.
229.120	229.106.
229.110	229.108.
229.109	229.109.
229.108	229.110.
	Insert new subheading—DELEGATION REQUIREMENTS.
229.107	229.127.

§ 229.103 [Amended]

2. 30 CFR Part 229, Subpart C is further amended by revising the title of § 229.103 to read "Duration of delegations; termination of delegations."

3. 30 CFR Part 229, Subpart C is further amended by adding a new table of contents and the following new §§ 229.100, 229.104, 229.107, 229.120, 229.121, 229.122, 229.123, 229.124, 229.125, and 229.126 to read as follows:

PART 229—DELEGATION TO STATES

* * * * *

Subpart C—Oil and Gas, Onshore

Administration of Delegations

Sec.

Delegation Requirements

229.125 Preparation and issuance of enforcement documents.
229.126 Appeals.
229.127 Reports from States.

Authority: The Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. 1701 *et seq.*)

* * * * *

Subpart C—Oil and Gas, Onshore

Administration of Delegations

§ 229.100 Authorities and responsibilities subject to delegation.

(a) All or part of the following authorities and responsibilities of the Secretary under the Act may be delegated to a State authority:

(1) Conduct of audits related to oil and gas royalty payments made to the MMS which are attributable to leased Federal or Indian lands within the State. Delegations with respect to any Indian lands require the written permission, subject to the review of the MMS, of the affected Indian tribe or allottee.

(2) Conduct of investigations related to oil and gas royalty payments made to the MMS which are attributable to leased Federal lands or Indian lands within the State. Delegation with respect to any Indian lands require the written permission, subject to the review of the MMS, of the affected Indian tribe or allottee. No investigation will be initiated without the specific approval of the MMS or the Secretary's designee and in accordance with the Departmental Manual.

(b) The following authorities and responsibilities are specifically reserved to the MMS and are not delegable under these regulations:

(1) Enforcement actions to assess and collect additional royalties identified as a consequence of audits, inspections, and investigations. These include all actions related to resolution of royalty obligations so identified, and the establishement and maintenance of payment performance bonds which may be required during the resolution process.

(2) Enforcement actions to collect civil penalties and interest charges related to findings of audits, inspections, and investigations.

(3) Administration of all appeals and all actions of the Department related to administrative and judicial litigation.

(4) Issuance of subpoenas.

(c) The provisions of this section do not limit the authority provided to the States by section 204 of the Act.

* * * * *

§ 229.104 Terms of delegation of authority.

Each delegation of authority under this part shall be in writing, shall incorporate all the requirements of this part, and shall specifically include:

(a) Terms obligating the State to conduct audit and investigative activities for a specific period of time;

(b) Terms describing the authorities and responsibilities reserved by the MMS, including, but not limited to, those specified under § 229.100;

(c) Terms requiring the State to provide annual audit workplans to include the lease universe by company, or by individual lease accounts, a description of the audit work product(s) to be delivered, and the State resources (staff and otherwise) to be committed to the delegation;

(d) Terms requiring the State to notify the MMS of any changed circumstances which would affect the State's ability to carry out the terms of the delegation;

(e) Terms requiring coordination of delegated activities among the State, the MMS, and the land management agencies responsible for management of the leases included in the audit universe;

(f) Terms requiring the State to maintain and make available to the MMS all audit workpapers, documents, and information gained or developed as a consequence of activities conducted under the delegation;

(g) Terms obligating the State to adhere to all Federal laws, rules and regulations, and Secretarial determinations and orders relating to the calculation, reporting, and payment of oil and gas royalties, in all activities performed under the delegation.

* * * * *

§ 229.107 Disbursement of revenues.

(a) The additional royalties and late payment charges resulting from State audit work done under a delegation of authority shall be collected by MMS. The State's share of any amounts so collected shall be paid to the State in accordance with the provisions of 30 U.S.C. 191 and Part 219 of this chapter.

(b) Amounts collected for Indian leases shall be transferred to the appropriate Indian accounts (designated Treasury accounts) managed by the Bureau of Indian Affairs at the earliest practicable date after such funds are received, but in no case later than the last business day of the month in which such funds are received.

(c) MMS shall provide to the State on a monthly basis, an accounting of collections resulting from audit work and enforcement actions resulting from a delegation of authority. Such accounting will identify collections broken down by royalties, penalties and interest paid.

* * * * *

§ 229.111 Materials furnished to State necessary to perform delegation.

The MMS shall provide to the State all reports, files, and supporting materials within its possession necessary to allow the State to effectively carry out the terms of the delegation specified in § 229.104.

Delegation Requirements

§ 229.120 Obtaining regulatory and policy guidance.

All activities performed by a State under a delegation must be in full accord with all Federal laws, rules and regulations, and Secretarial and agency determinations and orders relating to the calculation, reporting, and payment of oil and gas royalties. In those cases when guidance or interpretations are necessary, the State will direct written requests for such guidance or interpretation to the appropriate MMS officials. All policy and procedural guidance or interpretation provided by the MMS shall be in writing and shall be binding on the State.

§ 229.121 Recordkeeping requirements.

(a) The State shall maintain in a safe and secure manner all records, workpapers, reports, and correspondence gained or developed as a consequence of audit or investigative activities conducted under the delegation. All such records shall be made available for review and inspection upon request by representatives of the Secretary and the Department's Office of Inspector General (OIG).

(b) The State must maintain in a confidential manner all data obtained from DOI sources or from payor or company sources under the delegation which have been deemed "confidential or proprietary" by DOI or a company or payor. In this regard, the State regulatory authority shall be bound by provisions of 30 U.S.C. 1733. MMS shall provide to the State guidelines for determining confidential and proprietary material.

(c) All records subject to the requirements of subsection (a) must be maintained for a 6-year period measured from the end of the calendar year in which the records were created. All dispositions or records must be with the written approval of the MMS. Upon termination of a delegation, the State shall, within 90 days from the date of termination, assemble all records specified in subsection (a), complete all working paper files in accordance with § 229.124, and transfer such records to the MMS.

(d) The State shall maintain complete cost records for the delegation in accordance with generally accepted accounting principles. Such records shall be in sufficient detail to demonstrate the total actual costs associated with the project and to permit a determination by MMS whether delegation funds were used for their intended purpose. All such records shall be made available for review and inspection upon request by representatives of the Secretary and the Department's Office of Inspector General (OGIG).

§ 229.122 Coordination of audit activities.

(a) Each State with a delegation of authority shall submit annually to the MMS an audit workplan specifically identifying leases, resources, companies, and payors scheduled for audit. This workplan must be submitted 120 days prior to the beginning of each fiscal year. A State may request changes to its workplan (including the companies and leases to be audited) at the end of each quarter of each fiscal year. All requested changes are subject to approval by the MMS and must be submitted in writing.

(b) When a State plans to audit leases of a lessee or royalty payor for which there is an MMS or OIG resident audit team, all audit activities must be coordinated through the MMS or OIG resident supervisor. Such activities include, but are not limited to, issuance of engagement letters, arranging for entrance conferences, submission of data requests, scheduling of audit activities including site visits, submission of issue letters, and closeout conferences.

(c) The State shall consult with the MMS and/or OIG regarding resolution of any coordination problems encountered during the conduct of delegation activities.

§ 229.123 Standards for audit activities.

(a) All audit activities performed under a delegation of authority must be in accordance with the "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions" as issued by the Comptroller General of the United States.

(b) The following audit standards also shall apply to all audit work performed under a delegation of authority.

(1) *General standards*—(i) *Qualifications*. The auditors assigned to perform the audit must collectively possess adequate professional proficiency for the tasks required, including a knowledge of accounting, auditing, agency regulations, and industry operations.

(ii) *Independence*. In all matters relating to the audit work, the audit organization and the individual auditors must be free from personal or external impairments to independence and shall maintain an independent attitude and appearance.

(iii) *Due professional care*. Due professional care is to be used in conducting the audit and in preparing related reports.

(iv) *Quality control*. The State governments must institute quality control review procedures to ensure that all audits are performed in conformity with the standards established herein.

(2) *Examination and evaluation standards—Standards and requirements for examination and evaluation*. Auditors should be alert to situations or transactions that could be indicative of fraud, abuse, or illegal acts with respect to the program. If such evidence exists, auditors should forward this evidence to the Royalty Compliance Division (RCD) of the MMS. The RCD will contact the appropriate Federal law enforcement agencies. The scope of examinations are to be governed by the principle of a justifiable-relationship between cost and benefit as determined by the auditor or audit supervisor. Audit procedures should reflect the most efficient method of obtaining the requisite degree of satisfaction. The auditor should determine, to the extent possible, the effect on royalty reporting of the non-arms'-length nature of related party transactions, such as transfers of oil to refinery units affiliated with the producer. A review should be made of compliance with the appropriate laws and regulations applicable to program operations. MMS shall issue guidelines as to the definition and nature of arms'-length and non-arms'-length transactions for use in carrying out delegated audit activities.

(3) *Standards of reporting*. (i) Written audit reports are to be submitted to the appropriate MMS officials at the end of each field examination.

(ii) A statement in the auditors' report that the examination was made in accordance with the generally accepted program audit standards (including the applicable General Accounting Office (GAO) standards) for royalty compliance audits should be in the appropriate language to indicate that the audit was made in accordance with this statement of standards.

(iii) The auditor's report should contain a statement of positive assurance on those items tested and negative assurance on those items not tested. It should also include all instances of noncompliance and instances or indications of fraud, abuse, or illegal acts found during or in connection with the audit.

(iv) The auditor's report should contain any other material deficiency identified during the audit not covered in paragraph (b)(3)(iii) of this section.

(v) When factors external to the program and to the auditor restrict the audit or interfere with the auditor's ability to form objective opinions and conclusions (such as denial of access to information by a company), the auditor is to notify the MMS. If the limitation is not removed, a description of the matter must be included in the auditor's report. MMS will take all legally enforceable steps necessary to seek information necessary to complete the audit.

(vi) If certain information is prohibited from general disclosure, the auditor's report should state the nature of the information omitted and the requirement that makes the omission necessary.

(vii) Written audit reports are to be prepared in the format prescribed by the RCD.

(viii) In instances where the extent of the audit findings or the amounts involved do not warrant it, a formal audit report need not be issued. In lieu of an audit report, a memorandum of audit findings will be prepared and placed on the case file.

§ 229.124 Documentation standards.

Every audit performed by a State under a delegation of authority must meet certain documentation standards. In particular, detailed workpapers must be developed and maintained.

(a) "Workpapers" are defined to include all records obtained or created in performing an audit.

(b) Each audit performed varies in scope and detail. As a result, the audit team must determine the best presentation of the workpapers for a particular audit. The following general standards of workpaper preparation are consistent with the goal of achieving proper documentation while maintaining sufficient flexibility.

(1) All relevant information obtained orally must be promptly recorded in writing and incorporated in the workpapers.

(2) Workpapers must be complete and accurate in order to provide support for findings and conclusions.

(3) Workpapers should be clear and understandable without the need for supplementary oral explanations. The information they contain must be clear, complete, and concise, so that anyone using the workpapers will be able to

readily determine their purpose, the nature and scope of the work done, and the conclusions drawn.

(4) Workpapers must be legible and as neat as practicable. They must meet standards which allow their use as evidence in judicial and administrative proceedings.

(5) The information contained in workpapers should be restricted to matters which are materially important and relevant to the objectives established for the assignment.

(6) Workpapers must be in sufficient detail to permit a subsequent independent execution of each audit procedure, assuming the target company retains its accounting documentation.

§ 229.125 Preparation and issuance of enforcement documents.

(a) Determinations of additional royalties due resulting from audit activities conducted under a delegation of authority must be formally communicated by the State, to the companies or other payors by an issue letter prior to any enforcement action. The issue letter will serve to ensure that all audit findings are accurate and complete by obtaining advance comments from officials of the companies or payors audited. Issue letters must be prepared in a format specified by the MMS, and transmitted to the company or payor. The company or payor shall be given 30 days from receipt of the letter to respond to the State on the findings contained in the letter.

(b) After evaluating the company or payor's response to the issue letter, the State shall draft a demand letter which will be submitted with supporting workpaper files to the MMS for appropriate enforcement action. Any sustantive revisions to the demand letter will be discussed with the State prior to issuance of the letter. Copies of all enforcement action documents shall be provided to the State by MMS upon their issuance to the company or payor.

§ 229.126 Appeals.

(a) Appeals made pursuant to the rules and procedures at 30 CFR Parts 243 and 290 related to demand letters issued by officers of the MMS for additional royalties identified under a delegation of authority shall be filed with the MMS for processing. The State regulatory authority shall, upon the request of the MMS, provide competent and knowledgeable staff for testimony, as well as any required documentation and analyses, in support of the lessor's position during the appeal process.

(b) An affected State, upon the request of the MMS, shall provide expert witnesses from their audit staff for testimony as well as required documentation and analyses to support the Department's position during the litigation of court cases arising from denied appeals. The cost of providing expert witnesses including travel and per diem is reimbursable under the provisions of a delegation of authority, at the Federal Government's existing per diem rates.

* * * * *

[FR Doc. 84-26933 Filed 10-11-84; 8:45 am]
BILLING CODE 4310-MR-M

Office of Surface Mining Reclamation and Enforcement

30 CFR Part 938

Permanent State Regulatory Program of Pennsylvania; Modification of Deadline

AGENCY: Office of Surface Mining Reclamation and Enforcement (OSM), Interior.

ACTION: Final rule.

SUMMARY: This document amends 30 CFR Part 938 by modifying the deadlines for Pennsylvania to meet two of the conditions of approval of the State permanent regulatory program under the Surface Mining Control and Reclamation Act of 1977 (SMCRA). After providing opportunity for public comment, the Secretary has decided to extend the deadline for the State to resolve conditions (d) and (k) to November 30, 1984. Condition (d) pertains to prime farmland requirements for a permit applicant who proposed to mine coal in the anthracite region and condition (k) pertains to Pennsylvania's hearings provision for bond release.

EFFECTIVE DATE: October 12, 1984.

FOR FURTHER INFORMATION CONTACT: Robert Biggi, Director, Harrisburg Field Office, Office of Surface Mining Reclamation and Enforcement, 101 South 2nd Street, Suite L-4, Harrisburg, Pennsylvania 17101, Telephone: (717) 782-4036.

SUPPLEMENTARY INFORMATION:

I. Background on Conditional Approval

Under 30 CFR 732.13(i), the Secretary may conditionally approve a State permanent regulatory program which contains minor deficiencies where the deficiencies are of such a size and nature as to render no part of the program incomplete, the State is actively proceeding with steps to correct the deficiencies, and the State agrees to correct the deficiencies according to a schedule set in the notice of conditional approval. The curing of each deficiency is a condition of the approval. Steps to terminate the conditional approval must be taken if the conditions are not met according to the schedule. The dates are established in consultation with the State, based on the regulatory and administrative needs of the State's permanent program and SMCRA and the time required for changes to be adopted under State procedures or legislative schedules.

II. Background on Pennsylvania State Program

On February 29, 1980, the Secretary of the Interior received a proposed regulatory program from the State of Pennsylvania. On October 22, 1980, following a review of that proposed program as outlined in 30 CFR Part 732, the Secretary of the Interior disapproved the program. The State resubmitted its program on January 25, 1982, and, subsequently the Secretary approved the program conditioned on the correction of minor deficiencies. Information pertinent to the general background of the permanent program submission, as well as the Secretary's findings, the disposition of comments and explanations of the conditions of approval of the Pennsylvania program can be found in the July 30, 1982 **Federal Register** (47 FR 33050). Additionally, on April 20, 1983, the United States District Court for the Middle District of Pennsylvania in *Pennsylvania Coal Mining Association* v. *Watt*, Civil No. 82-1129, remanded to the Secretary with instructions to rectify the corresponding provision in the Pennsylvania program concerning the timing of the bond release hearing and the decision. Pursuant to 30 CFR 732.17(e), the Secretary notified Pennsylvania by a letter dated June 7, 1983, that a State program amendment was required to rectify the matter. In the **Federal Register** (48 FR 27102) dated June 13, 1983, OSM announced its intention to impose new condition (k) on the approval of the Pennsylvania program to comply with the District court decision. The State responded to OSM's June 7, 1983 letter on July 27, 1983 and advised OSM that it would amend its regulations (PA 86.171) to rectify the matter. In the **Federal Register** dated September 6, 1983 (48 FR 40223), OSM imposed condition (k) and required that Pennsylvania correct its program by August 1, 1984.

Pennsylvania agreed at the time of conditional approval to correct condition (d) by August 1, 1983. However, in a letter dated April 25, 1983, it requested an extension of time to