Executive Order 12291

Because the amendment relates to the Customs field organization, and will not result in a "major rule" as defined in E.O. 12291, a regulatory impact analysis is not required.

Drafting Information

The principal author of this document was Arnold L. Sarasky, Regulations and Disclosure Law Branch, Office of Regulations and Rulings, U.S. Customs Service. However, personnel from other offices participated in its development.

Authority

These changes are made under the authority vested in the President by section 1 of the Act of August 1, 1914, 38 Stat. 623, as amended (19 U.S.C. 2), and delegated to the Secretary of the Treasury by E.O. 10289, September 17, 1951 (3 CFR 1949–1953 Comp., Ch. II), and pursuant to the authority provided by Treasury Department Order No. 101–05 dated February 17, 1987 (52 FR 6282).

List of Subjects in 19 CFR Part 101

Customs duties and inspection, Exports, Imports, Organization and functions (Government agencies).

Amendments to the Regulations

Part 101, Customs Regulations (19 CFR Part 101), is amended as set forth below.

PART 101—GENERAL PROVISIONS

1. The authority citation for Part 101, Customs Regulations (19 CFR Part 101), continues to read as follows:

Authority: 5 U.S.C. 301, 19 U.S.C. 1, 66, 1202 (Gen. Headnote 11), 1624, Reorganization Plan 1 of 1965: 3 CFR 1965 Supp.

§ 101.3 [Amended]

2. The list of Customs regions, districts, and ports of entry in § 101.3(b), Customs Regulations (19 CFR 101.3(b)), is amended by altering the geographic descriptions of the Chicago, Illinois, and the Cleveland, Ohio, Customs Districts, which come under the administrative jurisdiction of Customs North Central Region, as set forth below:

a. In the North Central Region, under the column headed "Area", directly opposite "Chicago, Ill.", the description is revised to read as follows:

"The State of Illinois lying north of latitude 39° N; that part of the State of Indiana north of Latitude 41° N and west of longitude 86° W; and the States of Iowa and Nebraska."

b. In the North Central Region, under the column headed "Area", directly opposite "Cleveland, Ohio", the description is revised to read as follows:

"The States of Ohio, Kentucky; that part of the State of Indiana lying south of latitude 41° N; that part of the state of Indiana lying east of longitude 86° W; and the county of Erie in the State of Pennsylvania."

§ 101.4 [Amended]

3. The list of Customs districts, stations, and ports of entry having supervision, in § 101.4(c), Customs Regulations (19 CFR 101.4(c)) is amended by inserting, in appropriate alphabetical order, in the listings for "Cleveland, Ohio," under the "District" column, "Fort Wayne, Indiana," in the column headed "Customs stations", and on the same line, "Indianapolis" in the column headed "Port of entry having supervision".

Approved: May 26, 1988.

William von Raab,
Commissioner of Customs.

Francis A. Keating II,
Assistant Secretary of the Treasury.

[FR Doc. 88–14400 Filed 6–24–88; 8:45 am]

BILLING CODE 4820-02-M

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8211]

Income Taxes; Income of Foreign Governments and International Organizations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary Income Tax Regulations relating to current taxation of income of foreign governments from investment sources within the United States. This action is necessary because of changes to the applicable tax law made by the Tax Reform Act of 1986. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register**.

EFFECTIVE DATE: These temporary regulations are to be effective for taxable years beginning after June 30, 1986.

FOR FURTHER INFORMATION CONTACT: David A. Juster of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224.

(Attention: CC:LR:T) (202–566–6384, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in this regulation has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545–1053. The estimated average burden associated with the collection of information in this regulation is 15 hours per respondent.

For further information concerning this collection of information, and where to submit comments on this collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register.**

Background

This document contains temporary Income Tax Regulations (26 CFR Part 1) under sections 892 and 1441 of the Internal Revenue Code of 1986.

Need for Temporary Regulations

The proper application of sections 892 and 1441 is dependent upon the Internal Revenue Service's detailed specifications of the manner in which the requirements of the statute will be administered. These regulations are necessary to provide taxpayers with immediate guidance in the application of changes made to section 892 by section 1247 of the Act of October 22, 1986 (Pub. L. 99–514, 100 Stat. 2085, 2583).

Explanation of Provisions

Paragraph (a) of §1.892–1T sets forth the purpose and scope of the regulations. Paragraph (b) sets forth the effective date of the regulations

Paragraph (a) of § 1.892–2T generally defines the term "foreign government." Paragraph (b) provides when income of a foreign government will be deemed to inure to the benefit of private persons. Paragraph (c) provides rules when pension trusts will be considered foreign governments. Paragraph (d) extends the rules that apply to foreign governments to political subdivisions and transnational entities.

Paragraph (a) of § 1.892–3T describes the types of income that generally qualify for exemption and certain limitations on the exemption. Paragraph (b) illustrates through examples the principles set forth in paragraph (a).

Section 1.892–4T provides rules concerning the characterization of activities as either commercial or noncommercial activities. Paragraph (a) sets forth the reason for determining whether an activity is commercial or noncommercial in nature for section 892 purposes. Paragraph (b) defines when an activity will be considered commercial. Paragraph (c) sets forth rules concerning when activities will be considered noncommercial.

Section 1.892–5T sets forth rules concerning controlled commercial entities. Paragraph (a) defines the term "controlled commercial entity." Paragraph (b) sets forth rules for determining when an entity will be considered to be engaged in commercial activity. Paragraph (c) sets forth rules for determining whether a foreign government controls an entity. Paragraph (d) sets forth rules with regard to income earned by related entities.

Section 1.892–6T provides rules concerning the manner of taxing international organizations. Paragraph (a) indicates to what extent income of an international organization from sources within the U.S. will qualify for exemption from taxation. Paragraph (b) sets forth to what extent income received by an organization, prior to Presidential designation, will be exempt from taxation.

Section 1.892–7T sets forth the relationship of section 892 to other Internal Revenue Code sections. Paragraph (a) sets forth the relationship between sections 892 and 893. Paragraph (b) sets forth the relationship between section 892 and 895. Paragraph (c) sets forth the relationship between sections 892 and 883(b). Paragraph (d) sets forth the relationship between section 892 and 884. Paragraph (e) sets forth the relationship between sections 892, 1441 and 1442.

Paragraph (a) § 1.441–8T sets forth the rule that withholding is not required under § 1.144–1 with regard to any item of income which is exempt from taxation under section 892. Paragraph (b) of § 1.1441–8T sets forth that a statement must be filed with the withholding agent in order to avoid withholding with regard to income which is exempt from taxation under section 892 and sets forth what information must be contained in the statement.

Special Analyses

These rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations.

Therefore, these rules do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis is not required.

Drafting Information

The principal author of these regulations is David A. Juster of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations on matters of substance and style.

List of Subjects

26 CFR 1.861–1 through 1.997–1

Income taxes, Corporate deductions, Aliens, Exports, DISC, Foreign investment in U.S., Foreign tax credit, FSC, Sources of income, U.S. investments abroad.

26 CFR 1.1441–1 to 1.1465–1

Income taxes, Aliens, Foreign corporations.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

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

Income Tax Regulations

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 continues to read in part:

Authority: 26 U.S.C. 7805. * * * Sections 1.892–1T through 1.892–7T also issued under 26 U.S.C. 892(c). * * *

Par. 2. Sections 1.892–1 and 1.892–2 are removed and new §§ 1.892–1T through 1.892–7T are added in their place to read as follows:

§ 1.892–1T Purpose and scope of regulations (Temporary regulations).

(a) *In general.* These regulations provide guidance with respect to the taxation of income derived by foreign governments and international organizations from sources within the United States. Under section 892, certain specific types of income received by foreign governments are excluded from gross income and are exempt, unless derived from the conduct of a commercial activity or received from or by a controlled commercial entity. This section sets forth the effective date of the regulations. Section 1.892–2T defines a foreign government. In particular it describes the extent to which either an integral part of a foreign sovereign or an entity which is not an integral part of a foreign sovereign will be treated as a foreign government for purposes of section 892. Section 1.982–3T describes the types of income that generally qualify for exemption and certain limitations on the exemption. Section 1.892–4T provides rules concerning the characterization of activities as commercial activities. Section 1.892–5T defines a controlled commercial entity. Section 1.892–6T sets forth the extent to which income of international organizations from sources within the United States is excluded from gross income and is exempt from taxation. Section 1.892–7T sets forth the relationship of section 892 to other Internal Revenue Code sections.

(b) *Effective date.* The regulations set forth in §§ 1.892–1T through 1.892–7T apply to income received by a foreign government on or after July 1, 1986. No amount of income shall be required to be deducted and withheld, by reason of the amendment of section 892 by section 1247 of the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 2583) from any payment made before October 22, 1986.

§ 1.892–2T Foreign government defined (Temporary regulations).

(a) *Foreign government*—(1) *Definition.* The term "foreign government" means only the integral parts or controlled entities of a foreign sovereign.

(2) *Integral part.* An "integral part" of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. An integral part does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity. Consideration of all the facts and circumstances will determine whether an individual is acting in a private or personal capacity.

(3) *Controlled entity.* The term "controlled entity" means an entity that is separated in form from a foreign sovereign or otherwise constitute a separate juridical entity if it satisfies the following requirements:

(i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;

(ii) It is organized under the laws of the foreign sovereign by which owned;

(iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and

(iv) Its assets vest in the foreign sovereign upon dissolution.

A controlled entity does not include partnerships or any other entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section

(b) *Inurement to the benefit of private persons.* For purposes of this section, income will be presumed not to inure to the benefit of private persons if such persons (within the meaning of section 7701(a)(1)) are the intended beneficiaries of a governmental program which is carried on by the foreign sovereign and the activities of which constitute governmental functions (within the meaning of § 1.892–4T(c)(4)). Income will be considered to inure to the benefit of private persons if such income benefits:

(1) Private persons through the use of a governmental entity as a conduit for personal investment; or

(2) Private persons who divert such income from its intended use by the exertion of influence or control through means explicitly or implicitly approved of by the foreign sovereign.

(c) *Pension trusts*—(1) *In general.* A controlled entity includes a separately organized pension trust if it meets the following requirements:

(i) The trust is established exclusively for the benefit of (A) employees or former employees of a foreign government or (B) employees or former employees of a foreign government and non-governmental employees or former employees that perform or performed governmental or social services;

(ii) The funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government;

(iii) The trust forming a part of the pension plan provides for retirement, disability, or death benefits in consideration for prior services rendered; and

(iv) Income of the trust satisfies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.

Income of a pension trust is subject to the rules of § 1.892–5T(b)(3) regarding the application of the rules for controlled commercial entities to pension trusts. Income of a superannuation or similar pension fund of an integral part or controlled entity (which is not a separate pension trust as defined in this paragraph (c)(1)) is subject to the rules that generally apply to a foreign sovereign. Such a pension fund may also benefit non-governmental employees or former employees that perform or performed governmental or social services.

(2) *Illustrations.* The following examples illustrate the application of paragraph (c)(1).

Example (1). The Ministry of Welfare (MW), an integral part of foreign sovereign FC, instituted a retirement plan for FC's employees and former employees. Retirement benefits under the plan are based on a percentage of the final year's salary paid to an individual, times the number of years of government service. Pursuant to the plan, contributions are made by MW to a pension trust managed by persons appointed by MW to the extent actuarially necessary to fund accrued pension liabilities. The pension trust in turn invests such contributions partially in United States Treasury obligations. The income of the trust is credited to the trust's account and subsequently used to satisfy the pension plan's obligations to retired employees. Under these circumstances, the income of the trust is not deemed to inure to the benefit of private persons. Accordingly, the trust is considered a controlled entity of FC.

Example (2). The facts are the same as in *Example* (1), except that the retirement plan also benefits employees performing governmental or social services for the following non-government institutions: (i) A university in a local jurisdiction; (ii) a harbor commission; and (iii) a library system. The retirement benefits under the plan are based on the total amounts credited to an individual's account over the term of his or her employment. MW makes annual contributions to each covered employee's account equal to a percentage of annual compensation. In addition, the income derived from investment of the annual contributions is credited annually to individual accounts. The annual contributions do not exceed an amount that is determined to be actuarially necessary to provide the employee with reasonable retirement benefits. Notwithstanding that retirement benefits vary depending upon the investment experience of the trust, no portion of the income of the trust is deemed to inure to the benefit of private persons. Accordingly, the trust is considered a controlled entity of FC.

Example (3). The facts are the same as in *Example* (1), except that employees are allowed to make unlimited contributions to the trust, and such contributions are credited to the employee's account as well as interest accrued on such contributions. Retirement benefits will reflect the amounts credited to the individual accounts in addition to the usual annuity computation based on the final year's salary and years of service. A pension plan established under these rules is in part acting as an investment conduit. As a result, the income of the trust is deemed to inure to the benefit of private persons. Accordingly, the trust is not considered a controlled entity of FC.

Example (4). (a) The facts are the same as in *Example* (2), except that MW establishes a pension fund rather than a separate pension trust. A pension fund is merely assets of an integral part or controlled entity allocated to a separate account and held and invested for purposes of providing retirement benefits. Under these circumstances, the income of the pension fund is not deemed to inure to the benefit of private persons. Accordingly, income earned from the United States Treasury obligations by the pension fund is considered to be received by a foreign government and is exempt from taxation under section 892.

(b) The facts are the same as in *Example* (4)(a), except that MW is a controlled entity of foreign sovereign FC. The result is the same as in *Example* (4)(a). However, should MW engage in commercial activities (whether within or outside the United States), the income from the Treasury obligations earned by the pension fund will not be exempt from taxation under section 892 since MW will be considered a controlled commercial entity within the meaning of § 1.892–5T(a).

(d) *Political subdivision and transnational entity.* The rules that apply to a foreign sovereign apply to political subdivisions of a foreign country and to transnational entities. A transnational entity is an organization created by more than one foreign sovereign that has broad powers over external and domestic affairs of all participating foreign countries stretching beyond economic subjects to those concerning legal relations and transcending state or political boundaries.

§ 1.892–3T Income of foreign governments (Temporary regulations).

(a) *Types of income exempt*—(1) *In general.* Subject to the exceptions contained in §§ 1.892–4T and 1.892–5T for income derived from the conduct of a commercial activity or received from or by a controlled commercial entity, the following types of income derived by a foreign government (as defined in § 1.892–2T) are not included in gross income and are exempt:

(i) Income from investments in the United States in stocks, bonds, or other securities;

(ii) Income from investments in the United States in financial instruments held in the execution of governmental financial or monetary policy; and

(iii) Interest on deposits in banks in the United States of moneys belonging to such foreign government.

Income derived from sources other than described in this paragraph (such as income earned from a U.S. real property interest described in section 897(c)(1)(A)(i)) is not exempt from taxation under section 892. Furthermore, any gain derived from the disposition a U.S. real property interest defined in section 897(c)(1)(A)(i) shall in no event qualify for exemption under section 892.

(2) *Income from investments.* For purposes of paragraph (a) of this section, income from investments in stocks, bonds or other securities includes gain from their disposition and income earned from engaging in section 1058 securities lending transactions. Gain on the disposition of an interest in a partnership or a trust is not exempt from taxation under section 892.

(3) *Securities.* For purposes of paragraph (a) of this section, the term "other securities" includes any note or other evidence of indebtedness. Thus, an annuity contract, a mortgage, a banker's acceptance or a loan are securities for purposes of this section.

However, the term "other securities" does not include partnership interests (with the exception of publicly traded partnerships within the meaning of section 7704) or trust interests. The term also does not include commodity forward or futures contracts and commodity options unless they constitute securities for purposes of section 864(b)(2)(A).

(4) *Financial instrument.* For purposes of paragraph (a) of this section, the term "financial instrument" includes any forward, futures, options contract, swap agreement or similar instrument in a functional or nonfunctional currency (see section 985(b) for the definition of functional currency) or in precious metals when held by a foreign government or central bank of issue (as defined in § 1.895-1(b)). Nonfunctional currency or gold shall be considered a "financial instrument" also when physically held by a central bank of issue.

(5) *Execution of financial or monetary policy*—(i) *Rule.* A financial instrument shall be deemed held in the execution of governmental financial or monetary policy if the primary purpose for holding the instrument is to implement or effectuate such policy.

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

Example. In order to ensure sufficient currency reserves, the monetary authority of foreign country FC issues short-term government obligations. The amount received from the obligations is invested in U.S. financial instruments. Since the primary purpose for obtaining the U.S. financial instruments is to implement FC's monetary policy, the income received from the financial instruments is exempt from taxation under section 892.

(b) *Illustrations.* The principles of paragraph (a) of this section may be illustrated by the following examples.

Example (1). X, a foreign corporation not engaged in commercial activity anywhere in the world, is a controlled entity of a foreign sovereign within the meaning of § 1.892-2T(a)(3). X is not a Central bank of issue as defined in § 1.895-1(b). In 1987, X received the following items of income from investments in the United States: (i) Dividends from a portfolio of publicly traded stocks in U.S. corporations in which X owns less than 50 percent of the stock; (ii) dividends from BTB Corporation, an automobile manufacturer, in which X owns 50 percent of the stock; (iii) interest from bonds issued by noncontrolled entities and from interest-bearing bank deposits in noncontrolled entities; (iv) rents from a net lease on real property; (v) gains from silver futures contracts; (vi) gains from wheat futures contracts; (vii) gains from spot sales of nonfunctional foreign currency in X's possession; (viii) gains from the disposition of a publicly traded partnership interest, and (ix) gains from the disposition of the stock of Z Corporation, a United States real property holding company as defined in section 897, of which X owns 12 percent of the stock. Only income derived from sources described in paragraph (a)(1) of this section is treated as income of a foreign government eligible for exemption from taxation. Accordingly, only income received by X from items (i), (iii), (v) provided that the silver futures contracts are held in the execution of governmental financial or monetary policy, and (ix) is exempt from taxation under section 892.

Example (2). The facts are the same as in *Example* (1), except that X is also a central bank of issue within the meaning of section 895. Since physical possession of nonfunctional foreign currency when held by a central bank of issue is considered a financial instrument, the item (vii) gains from spot sales of nonfunctional foreign currency are exempt from taxation under paragraph (a)(1) of this section, if physical possession of the currency was an essential part of X's reserve policy in the execution of its governmental financial or monetary policy.

Example (3). State Concert Bureau, an integral part of a foreign sovereign within the meaning of § 1.892-2T(a)(2), entered into an agreement with a U.S. corporation engaged in the business of promoting international cultural programs. Under the agreement the State Concert Bureau agreed to send a ballet troupe on tour for 5 weeks in the United States. The Bureau received approximately $60,000 from the performances. Regardless of whether the performances themselves constitute commercial activities under § 1.892-4T, the income received by the Bureau is not exempt from taxation under section 892 since the income is from sources other than described in paragraph (a)(1) of this section.

§ 1.892-4T Commercial activities (Temporary regulations).

(A) *Purpose.* The exemption generally applicable to a foreign government (as defined in § 1.892-2T) for income described in § 1.892-3T does not apply to income derived from the conduct of a commercial activity or income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity. This section provides rules for determining whether income is derived from the conduct of a commercial activity. These rules also apply in determining under § 1.892-5T whether an entity is a controlled commercial entity.

(b) *In general.* Except as provided in paragraph (c) of this section, all activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain are commercial activities. An activity may be considered a commercial activity even if such activity does not constitute the conduct of a trade or business in the United States under section 864(b).

(c) *Activities that are not commercial*—(1) *Investments*—(i) *In general.* Subject to the provisions of paragraphs (ii) and (iii) of this paragraph (c)(1), the following are not commercial activities: Investments in stocks, bonds, and other securities; loans; investments in financial instruments held in the execution of governmental financial or monetary policy; the holding of net leases on real property or land which is not producing income (other than on its sale or from an investment in net leases on real property); and the holding of bank deposits in banks. Transferring securities under a loan agreement which meets the requirements of section 1058 is an investment for purposes of this paragraph (c)(1)(i). An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

(ii) *Trading.* Effecting transactions in stocks, securities, or commodities for a foreign government's own account does not constitute a commercial activity regardless of whether such activities constitute a trade or business for purposes of section 162 or a U.S. trade or business for purposes of section 864. Such transactions are not commercial activities regardless of whether they are effected by the foreign government through its employees or through a broker, commission agent, custodian, or other independent agent and regardless of whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. An activity undertaken as a dealer, however, as defined in § 1.864-2(c)(2)(iv)(*a*) will not be an investment for purposes of this paragraph (c)(1)(i). For purposes of this paragraph (c)(1)(ii), the term "commodities" means commodities of a kind customarily dealt in on an organized commodity exchange but only if the transaction is of a kind customarily consummated at such place.

(iii) *Banking, financing, etc.* Investments (including loans) made by a banking, financing, or similar buisness constitute commercial activities, even if the income derived from such investments is not considered to be income effectively connected to the active conduct of a banking, financing, or similar business in the U.S. by reason of the application of § 1.864-4(c)(5).

(2) *Cultural events.* Performances and exhibitions within or outside the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities.

(3) *Non-profit activities.* Activities that are not customarily attributable to or carried on by private enterprise for profit are not commercial activities. The fact that in some instances Federal, State, or local governments of the United States also are engaged in the same or similar activity does not mean necessarily that it is a non-profit activity. For example, even though the United States Government may be engaged in the activity of operating a railroad, operating a railroad is not a non-profit activity.

(4) *Governmental functions.* Governmental functions are not commercial activities. The term "governmental functions" shall be determined under U.S. standards. In general, activities performed for the general public with respect to the common welfare or which relate to the administration of some phase of government will be considered governmental functions. For example, the operation of libraries, toll bridges, or local transportation services and activities substantially equivalent to the Federal Aviation Authority, Interstate Commerce Commission, or United States Postal Service will all be considered governmental functions for purposes of this section.

(5) *Purchasing.* The mere purchasing of goods for the use of a foreign government is not a commercial activity.

§ 1.892-5T Controlled commercial entity (Temporary regulations).

(a) *In general.* The exemption generally applicable to a foreign government (as defined in § 1.892-2T) for income described in § 1.892-3T does not apply to income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity. The term "controlled commercial entity" means any entity engaged in commercial activities as defined in § 1.892-4T (whether conducted within or outside the United States) if the government—

(1) Holds (directly or indirectly) any interest in such entity which (by value or voting power) is 50 percent or more of the total of such interests in such entity, or

(2) Holds (directly or indirectly) a sufficient interest (by value or voting power) or any other interest in such entity which provides the foreign government with effective practical control of such entity.

For purposes of this paragraph, the term "entity" encompasses corporations and trusts (including pension trusts described in § 1.892-2T(c)) and estates.

(b) Entities treated as engaged in commercial activity—(1) *U.S. real property holding corporations.* A United States real property holding corporation, as defined in section 897(c)(2) or a foreign corporation that would be a United States real property holding corporation if it was a United States corporation, shall be treated as engaged in commercial activity and, therefore, is a controlled commercial entity if the requirements of paragraph (a)(1) or (a)(2) of this section are satisfied.

(2) *Central banks.* Notwithstanding paragraph (a) of this section, a central bank of issue (as defined in § 1.895-1(b)) shall be treated as a controlled commercial entity only if it engages in commercial activities within the United States.

(3) *Pension trusts.* A pension trust, described in § 1.892-2T(c), which engages in commercial activities within or outside the United States, shall be treated as a controlled commercial entity. Income derived by such a pension trust is not income of a foreign government for purposes of the exemption from taxation provided in section 892. A pension trust described in § 1.892-2T(c) shall not be treated as a controlled commercial entity if such trust solely earns income which would not be unrelated business taxable income (as defined in section 512(a)(1)) if the trust were a qualified trust described in section 401(a). However, only income derived by a pension trust that is described in § 1.892-3T and which is not from commercial activities as defined in § 1.892-4T is exempt from taxation under section 892.

(c) *Control*—(1) *Attribution*—(i) *Rule.* In determining for purposes of paragraph (a) of this section the interest held by a foreign government, any interest in an entity (whether or not engaged in commercial activity) owned directly or indirectly by an integral part or controlled entity of a foreign sovereign shall be treated as actually owned by such foreign sovereign.

(ii) *Illustration.* The following example illustrates the application of paragraph (c)(1)(i) of this section.

Example. FX, a controlled entity of foreign sovereign FC, owns 20 percent of the stock of Corp 1. Neither FX nor Corp 1 is engaged in commercial activity anywhere in the world. Corp 1 owns 60 percent of the stock of Corp 2, which is engaged in commercial activity. The remaining 40 percent of Corp 2's stock is owned by Bureau, an integral part of foreign sovereign FC. For purposes of determining whether Corp 2 is a controlled commercial entity of FC, Bureau will be treated as actually owning the 12 percent of Corp 2's stock indirectly owned by FX. Therefore, since Bureau directly and indirectly owns 52 percent of the stock of Corp 2, Corp 2 is a controlled commercial entity of FC within the meaning of paragraph (a) of this section. Accordingly, dividends or other income received, directly or indirectly, from Corp 2 by either Bureau or FX will not be exempt from taxation under section 892. Furthermore, dividends from Corp 1 to the extent attributable to dividends from Corp 2 will not be exempt from taxation. Thus, a distribution from Corp 1 to FX shall be exempt only to the extent such distribution exceeds Corp 1's earnings and profits attributable to the Corp 2 dividend amount received by Corp 1.

(2) *Effective practical control.* An entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government holds sufficient interests in such entity to give it "effective practical control" over the entity. Effective practical control may be achieved through a minority interest which is sufficiently large to achieve effective control, or through creditor, contractual, or regulatory relationships which, together with ownership interests held by the foreign government, achieve effective control. For example, an entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government, in addition to holding a small minority interest (by value or voting power), is also a substantial creditor of the entity or controls a strategic natural resource which such entity uses in the conduct of its trade or business, giving the foreign government effective practical control over the entity.

(d) *Related controlled entities*—(1) *Brother/sister entities.* Commercial activities of a controlled entity are not attributed to such entity's other brother/sister related entities. Thus, investment income described in § 1.892–2T that is derived by a controlled entity that is not itself engaged in commercial activity within or outside the United States is exempt from taxation notwithstanding the fact that such entity's brother/sister related entity is a controlled commercial entity.

(2) *Parent/subsidiary entities*—(i) *Subsidiary to parent attribution.* Commercial activities of a subsidiary controlled entity are not attributed to its parent. Thus, investment income described in § 1.892–3T that is derived by a parent controlled entity that is not itself engaged in commercial activity within or outside the United States is exempt from taxation notwithstanding the fact that its subsidiary is a controlled commercial entity. Dividends or other payments of income received by the parent controlled entity from the subsidiary are not exempt under section 892, because it constitutes income received from a controlled commercial entity. Furthermore, dividends paid by the parent are not exempt to the extent attributable to the dividends received by the parent from the subsidiary. Thus, a distribution by the parent shall be exempt only to the extent such distribution exceeds earnings and profits attributable to the dividend received from its subsidiary.

(ii) *Parent to subsidiary attribution.* Commercial activities of a parent controlled entity are attributed to its subsidiary. Thus, investment income described in § 1.892–3T that is derived by a subsidiary controlled entity (not engaged in commercial activity within or outside the United States) is not exempt from taxation under section 892 if its parent is a controlled commercial entity.

(3) *Partnerships.* Except for partners of publicly traded partnerships, commercial activities of a partnership are attributable to its general and limited partners for purposes of section 892. For example, where a controlled entity is a general partner in a partnership engaged in commercial activities, the controlled entity's distributive share of partnership income (including income described in § 1.892–3T) will not be exempt from taxation under section 892.

(4) *Illustrations.* The principles of this section may be illustrated by the following examples.

Example (1). (a) The Ministry of Industry and Development is an integral part of a foreign sovereign under § 1.892–2T(a)(2). The Ministry is engaged in commercial activity within the United States. In addition, the Ministry receives income from various publicly traded stocks and bonds, soybean futures contracts and net leases on U.S. real property. Since the Ministry is an integral part, and not a controlled entity, of a foreign sovereign, it is not a controlled commercial entity within the meaning of paragraph (a) of this section. Therefore, income described in § 1.892–3T is ineligible for exemption under section 892 only to the extent derived from the conduct of commercial activities. Accordingly, the Ministry's income from the stocks and bonds is exempt from U.S. tax.

(b) The facts are the same as in *Example* (1)(a), except that the Ministry also owns 75 percent of the stock of R, a U.S. holding company that owns all the stock of S, a U.S. operating company engaged in commercial activity. Ministry's dividend income from R is income received indirectly from a controlled commercial entity. The Ministry's income from the stocks and bonds, with the exception of dividend income from R, is exempt from U.S. tax.

(c) The facts are the same as in *Example* (1)(a), except that the Ministry is a controlled entity of a foreign sovereign. Since the Ministry is a controlled entity and is engaged in commercial activity, it is a controlled commercial entity within the meaning of paragraph (a) of this section, and none of its income is eligible for exemption.

Example (2). (a) Z, a controlled entity of a foreign sovereign, has established a pension trust as part of a pension plan for the benefit of its employees and former employees. The pension trust (T), which meets the requirements of § 1.892–2T(c), has investments in the U.S. in various stocks, bonds, annuity contracts, and a shopping center which is leased and managed by an independent real estate management firm. T also makes securities loans in transactions that qualify under section 1058. T's investment in the shopping center is not considered an unrelated trade or business within the meaning of section 513(b). Accordingly, T will not be treated as engaged in commercial activity. Since T is not a controlled commercial entity, its investment income described in § 1.892–3T, with the exception of income received from the operations of the shopping center, is exempt from taxation under section 892.

(b) The facts are the same as *Example* (2)(a), except that T has an interest in a limited partnership which owns the shopping center. The shopping center is leased and managed by the partnership rather than by an independent management firm. Managing a shopping center, directly or indirectly through a partnership of which a trust is a member, would be considered an unrelated trade or business within the meaning of section 513(b) giving rise to unrelated business taxable income. Since the commercial activities of a partnership are attributable to its partners, T will be treated as engaged in commercial activity and thus will be considered a controlled commercial entity. Accordingly, none of T's income will be exempt from taxation under section 892.

(c) The facts are the same as *Example* (2)(a), except that Z is a controlled commercial entity. The result is the same as in *Example* (2)(a).

Example (3). (a) The Department of Interior, an integral part of foreign sovereign FC, wholly owns corporations G and H. G, in turn, wholly owns S. G, H and S are each controlled entities. G, which is not engaged in commercial activity anywhere in the world, receives interest income from deposits in banks in the United States. Both H and S do not have any investments in the U.S. but are both engaged in commercial activities. However, only S is engaged in commercial activities within the United States. Because neither the commercial activities of H nor the commercial activities of S are attributable to the Department of Interior or G, G's interest income is exempt from taxation under section 892.

(b) The facts are the same as *Example* (3)(a), except that G rather than S is engaged in commercial activities and S rather than G receives the interest income from the United States. Since the commercial activities of G are attributable to S, S's interest income is not exempt from taxation.

Example (4). (a) K, a controlled entity of a foreign sovereign, is a general partner in the Daj partnership. The Daj partnership has investments in the U.S. in various stocks and bonds and also owns and manages an office building in New York. K will be deemed to be engaged in commercial activity by being a general partner in Daj even if K does not actually make management decisions with regard to the partnership's commercial activity, the operation of the office building. Accordingly K's distributive share of partnership income (including income derived from stocks and bonds) will not be exempt from taxation under section 892.

(b) The facts are the same as in *Example* (4)(a), except that the Daj partnership has hired a real estate management firm to lease offices and manage the building. Notwithstanding the fact that an independent contractor is performing the activities, the partnership shall still be deemed to be engaged in commercial activity. Accordingly, K's distributive share of partnership income (including income derived from stocks and bonds) will not be exempt from taxation under section 892.

(c) The facts are the same as in *Example* (4)(a), except that K is a partner whose partnership interest is considered a publicly traded partnership interest within the meaning of section 7704. Under paragraph (d)(3) of this section, the partnership's commercial activity will not be attributed to K. Since K will not be deemed to be engaged in commercial activity, K's distributive share of partnership income derived from stocks and bonds will be exempt from taxation under section 892.

§ 1.892–6T Income of international organizations (Temporary regulations).

(a) *Exempt from tax.* Subject to the provisions of section 1 of the International Organizations Immunities Act (22 U.S.C. 288) (the provisions of which are set forth in paragraph (b)(3) of § 1.893–1), the income of an international organization (as defined in section 7701(a)(18)) received from investments in the United States in stocks, bonds, or other domestic securities, owned by such international organization, or from interest on deposits in banks in the United States of moneys belonging to such international organization, or from any other source within the United States, is exempt from Federal income tax.

(b) *Income received prior to Presidential designation.* An organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act may enjoy the benefits of the exemption with respect to income of the prescribed character received by such organization prior to the date of the issuance of such Executive order, if (i) the Executive order does not provide otherwise and (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time such income is received.

§ 1.892-7T Relationship to other Internal Revenue Code sections (Temporary regulations).

(a) *Section 893.* The term "foreign government" referred to in section 893 (relating to the exemption for compensation of employees of foreign governments) has the same meaning as given such term in § 1.892-2T.

(b) *Section 895.* A foreign central bank of issue (as defined in § 1.895-1(b)) that fails to qualify for the exemption from tax provided by this section (for example, it is not wholly owned by a foreign sovereign) may nevertheless be exempt from tax on the items of income described in section 895.

(c) *Section 883(b).* Nothing in section 892 or these regulations shall limit the exemption provided under section 883(b) relating generally to the exemption of earnings derived by foreign participants from the ownership or operation of communications satellite systems.

(d) *Section 884.* Earnings and profits attributable to income of a controlled entity of a foreign sovereign which is exempt from taxation under section 892 shall not be subject to the tax imposed by section 884(a).

(e) *Sections 1441 and 1442.* No withholding is required under sections 1441 and 1442 in the case of income exempt from taxation under section 892.

Par. 3. A new § 1.1441-8T is added immediately after § 1.1441-7 to read as follows:

§ 1.1441-8T Foreign government exemption from withholding (Temporary regulations).

(a) *Foreign governments.* Under section 892, certain specific types of income received by foreign governments are excluded from gross income and are exempt from taxation, unless derived from the conduct of a commercial activity or received from or by a controlled commercial entity. Accordingly, withholding is not required under § 1441.1 with regard to any item of income which is exempt from taxation under section 892.

(b) *Statement claiming exemption.* To avoid withholding of tax at source under § 1.1441-1, a foreign government which is entitled to the income must file with each withholding agent from whom amounts of income are to be received, a statement under penalties of perjury (in duplicate) indicating the extent to which such income described in the statement is exempt from taxation under section 892. This statement should contain (i) the name and address of the foreign government entitled to the income, (ii) the items of income and their amount with respect to which the statement is filed, (iii) an explanation indicating why the specific items of income are exempt from taxation under section 892, and (iv) the taxable year during which such exemption is to apply. This statement shall be filed with the withholding agent for each taxable year the foreign government is entitled to the income, and before payment of the income in respect of which it applies. Any statement so filed shall be effective only with respect to the item or items of income specified therein and only with respect to the types of income specified in § 1.892-3T(a)(1) (i), (ii) or (iii). The statement shall constitute authorization to the withholding agent to pay such income during the taxable year without deduction of the tax at source under § 1441-1. Any statement required by this subparagraph may be made on a form prescribed by the Internal Revenue Service.

OMB Control Numbers Under The Paperwork Reduction Act

PART 602—[AMENDED]

Par. 4. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. Section 602.101(c) is amended by inserting in the appropriate place in the table "§ 1.1441-8T . . . 1545-1053".

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved May 27, 1988.

O. Donaldson Chapoton,
Assistant Secretary of the Treasury.

[FR Doc. 88-14429 Filed 6-24-88; 8:45 am]

BILLING CODE 4830-01-M

DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 266

[DoD Directive 7600.10]

Audits of State and Local Governments

AGENCY: Department of Defense.

ACTION: Final rule.

SUMMARY: This part implements Pub. L. 98-502, "Single Audit of 1984," October 19, 1984, and OMB Circular No. A-128, "Audits of State and Local Governments," April 12, 1985. It requires that DOD Components rely upon and use financial and compliance audits by non-Federal auditors under Pub. L. 98-502 and OMB Circular No. A-128 in the oversight of Federal financial assistance provided to State and local governments. The part also authorizes the DOD Components to provide for additional audits of Federal financial assistance when required by regulation or to ensure effective use of such assistance. It also specifies the responsibilities of the Inspector General, Department of Defense, and the Heads of the DOD Components for monitoring compliance with the provisions of new 32 CFR Part 266.

EFFECTIVE DATE: February 12, 1988.

FOR FURTHER INFORMATION CONTACT: Mr. V. Stone, Office of the Assistant Inspector General for Audit Policy, Department of Defense, 400 Army Navy Drive, Room 1076, Arlington, VA 22202, telephone (202) 693-0017.

SUPPLEMENTARY INFORMATION:

List of Subjects in 32 CFR Part 266

State and local governments.

Accordingly, Title 32, Chapter 1, is amended to add Part 266 as follows:

PART 266—AUDITS OF STATE AND LOCAL GOVERNMENTS

Sec.
266.1 Purpose.
266.2 Applicability.

Sec.
266.3 Definitions.
266.4 Policy.
266.5 Responsibilities.
266.6 Cost of audits.
266.7 Effective date.

Authority: Single Audit Act of 1984, Pub. L. 98-502, 98 Stat. 2327; 31 U.S.C. 7501 note.

§ 226.1 Purpose.

This part:

(a) Implements Pub. L. 98–502 and OMB Circular No. A–128 to establish audit requirements for State and local governments that receive Federal financial assistance.

(b) Assigns responsibilities within the Department of Defense for monitoring compliance with those requirements.

§ 226.2 Applicability.

This part applies to the Office of the Secretary of Defense (OSD); the Inspector General, Department of Defense (IG, DOD); the Military Departments; the Defense Agencies; and DOD Field Activities (hereafter referred to collectively as "DOD Components") that provide Federal financial assistance to State and local governments.

§ 226.3 Definitions.

Cognizant Agency. The Federal Agency assigned by OMB to carry out the responsibilities described in OMB Circular No. A–128.

Desk Review. A review of an audit report performed by the cognizant audit organization at its offices to determine whether the audit report meets the requirements of Pub. L. 98–502 and OMB Circular No. A–128.

Federal Financial Assistance. Assistance provided by a Federal Agency in the form of grants, contracts, cooperative agreements, loans, loan guarantees, property, interest subsidies, insurance, or direct appropriations, but does not include direct Federal cash assistance to individuals. Funds paid by the National Guard Bureau to States under facilities' operation and maintenance agreements do not constitute "Federal financial assistance" for purposes of Pub. L. 98–502 and OMB Circular No. A–128.

Local Government. A unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

Non-Federal Auditor. A State or local government auditor who meets the standards on independence specified in generally accepted Government auditing standards or a public accountant who meets such standards' independence.

Qualtiy Control Review. A review of the audit report and supporting work papers of the non-Federal auditor to assess compliance with OMB Circular No. A–128.

State. Any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Somoa, the Commonwealth of the Northern Mariana Islands, the Trust Territory of the Pacific Islands, any instrumentality thereof; and any multistate, regional, or interstate entity that has governmental functions, and any Indian tribe.

§ 226.4 Policy.

The DOD Components shall rely upon the use financial and compliance audits by non-Federal auditors under Pub. L. 98–502 and OMB Circular No. A–128 in the oversight of Federal financial assistance provided to State or local governments. The DOD Components, however, may provide for additional audits of such assistance when required by regulation or to ensure effective use of such assistance. Such additional audits include economy and efficiency audits, program results audits, and program evaluations. Any additional audit effort shall be planned and carried out in such a way as to avoid duplication and shall be separately funded.

§ 226.5 Responsibilities.

(a) The *Inspector General, Department of Defense* (IG, DOD) shall:

(1) Serve as the DOD senior official under OMB Circular No. A–128 for policy guidance, direction, and coordination with DOD Components and other Federal Agencies on single-audit matters.

(2) For State and local governments for which OMB has assigned DOD cognizance, do the following:

(i) Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of OMB Circular No. A–128.

(ii) Provide technical advice and liaison to State and local governments and non-Federal auditors.

(iii) Make desk reviews of all reports received, and also make quality control reviews of selected audits made by non-Federal audit organizations and provide the results, when appropriate, to other interested organizations.

(iv) Inform other affected Federal Agencies and appropriate law enforcement officials of any reported illegal acts of irregularities.

(v) Advise the recipient of audits that have been found not meeting the requirements of OMB Circular No. A–128.

(vi) Coordinate, to the extent practicable, audits requested by DOD Components, in addition to those required by OMB Circular No. A–128.

(vii) Oversee the resolution of audit findings and recommendations that affect DOD programs and those findings affecting programs of more than one Federal Agency.

(3) For other State and local governments, receive and distribute copies of single-audit reports to appropriate DOD Components for appropriate action and follow-up by designated program officials.

(b) The *Heads of the DOD Components* shall:

(1) Designate an official to coordinate with the IG, DOD, on matters dealing with audits of financial assistance provided by the DOD Component to State and local governments.

(2) Advise the IG, DOD, of financial assistance provided to State or local governments when such assistance to any State or local government exceeds $100,000 in a year.

(3) Ensure that the State or local government takes appropriate actions to correct audit deficiencies involving financial assistance provided by the DOD Component.

(4) Coordinate with the IG, DOD, on requests for audits of State and local governments, in addition to those required by OMB Circular No. A–128.

§ 226.6 Cost of audits.

The costs of audits made by non-Federal auditors under OMB Circular No. A–128 are allowable charges to Federal financial assistance programs. The charges may be considered as a direct cost or an allocated indirect cost in accordance with OMB Circular No. A–87. Generally, the percentage of costs charged to Federal assistance programs for an audit shall not exceed the percentage of Fedral funds expended to the total funds expended by the recipient during the fisal year. No cost, however, may be charged to Federal programs for audits not made in accordance with OMB Circular No. A–128.

§ 226.7 Effective date.

This part is effective February 12, 1988.

June 21, 1988.

Linda M. Bynum,

Alternate OSD Federal Register Liaison Officer, Department of Defense.

[FR Doc. 88–14307 Filed 6–24–88; 8:45 am]

BILLING CODE 3810-01-M