entertainment value (In instances where the Commission has paid for a member's or employee's admission to a conference or seminar, the member or employee may participate in all events hosted by the conference organizers as part of the paid admission. However, attendance and acceptance of food and refreshments at receptions and other events hosted by parties other than the conference sponsor, but held during the course of the conference, must be approved in advance by the General Counsel in accordance with the requirements of this section.);

(iv) The food and refreshments offered in conjunction with the event will be excessive;

(v) There are any other relevant factors that should be considered in reaching a determination.[14b]

* * * * *

Issued in Washington, DC, on July 26, 1989 by the Commission.

Jean A. Webb,

Secretary to the Commission.

[FR Doc. 89-17903 Filed 8-1-89; 8:45 am]

BILLING CODE 6351-01-M

[14b] The Commission, with the concurrence of the Office of Government Ethics, may grant other exceptions if the Commission determines that an exception is warranted and appropriate in a particular situation. See 5 CFR § 735.202(b).

DEPARTMENT OF JUSTICE

Drug Enforcement Administration

21 CFR Part 1308

Schedules of Controlled Substances; Extension of Temporary Placement of N,N-Dimethylamphetamine into Schedule I

AGENCY: Drug Enforcement Administration, Justice.

ACTION: Final rule.

SUMMARY: This final rule is issued by the Administrator of the Drug Enforcement Administration (DEA) to extend the temporary scheduling of *N,N*-dimethylamphetamine in Schedule I of the Controlled Substances Act (CSA) (21 U.S.C. 801 *et seq*). The temporary scheduling of this substance is due to expire on August 3, 1989. This notice will extend the temporary scheduling of N,N-dimethylamphetamine for six months or until rulemaking proceedings pursuant to 21 U.S.C. 811(a) are completed, whichever occurs first.

EFFECTIVE DATE: August 2, 1989.

FOR FURTHER INFORMATION CONTACT: Howard McClain, Jr., Chief, Drug Control Section, Drug Enforcement Administration, Washington, DC 20537, Telephone: (202) 307-7183.

SUPPLEMENTARY INFORMATION: On August 3, 1988, the Administrator of DEA published a final rule in the **Federal Register** (53 FR 29232) amending § 1308.11(g) of Title 21 of The Code of Federal Regulations to temporarily place *N,N*-dimethylamphetamine into Schedule I of the CSA pursuant to the emergency scheduling provisions of 21 U.S.C. 811(h).

The final rule which became effective on August 3, 1988, was based on findings by the Administrator that the emergency scheduling of the above-referenced substance was necessary to avoid an imminent hazard to the public safety. Section 201(h)(2) of the CSA (21 U.S.C. 811(h)(2)) requires that the emergency scheduling of a substance expires at the end of one year from the effective date of the order. However, during the pendency of proceedings under 21 U.S.C. 811(a)(1) with respect to the substance, temporary scheduling of that substance may be extended for up to six months. Proceedings for the scheduling of a substance under 21 U.S.C. 811(a) may be initiated by the Attorney General (delegated to the Administrator of DEA pursuant to 28 CFR 0.100) on his own motion, at the request of the Secretary of the Department of Health and Human Services, or on the petition of any interested party. Such proceedings regarding *N,N*-dimethylamphetamine have been initiated by the Administrator.

Therefore, the temporary scheduling of *N,N*-dimethylamphetamine, which is due to expire on August 3, 1989, may be extended until February 3, 1990, or until proceedings initiated in accordance with 21 U.S.C. 811(a) are completed, whichever occurs first.

Pursuant to 21 U.S.C. 811(h)(2) the Administrator hereby orders that the temporary scheduling of *N,N*-dimethylamphetamine be extended until February 3, 1990 or until the conclusion of scheduling proceedings initiated in accordance with 21 U.S.C. 811(a), whichever occurs first.

Pursuant to Title 5, United States Code, section 605(b), the Administrator certifies that the extended scheduling of *N,N*-dimethylamphetamine into Schedule I of the CSA will have no impact upon small businesses or other entities whose interests must be considered under the Regulatory Flexibility Act (Pub. L. 96-354). *N,N*-Dimethylamphetamine has no commercial use or manufacturer in the United States.

It has been determined that the extension of the temporary placement of *N,N*-dimethylamphetamine in Schedule I of the CSA under the emergency scheduling provision is a statutory exception to the requirements of Executive Order 12291 (46 FR 13193). This action has been analyzed in accordance with the principles and criteria contained in Executive Order 12612, and it has been determined that this matter does not have sufficient federalism implications to warrant the preparations of a Federalism Assessment.

List of Subjects in 21 CFR Part 1308

Administrative practice and procedure, Drug traffic control, Narcotics, Prescription drugs.

Date: July 27, 1989.

John C. Lawn,

Administrator, Drug Enforcement Administration.

[FR Doc. 89-18028 Filed 8-1-89; 8:45 am]

BILLING CODE 4410-09-M

DEPARTMENT OF STATE

22 CFR Parts 60, 61, 62, 63, 64, 65

[108.888]

RIN 1400-AA19

South Africa and Fair Labor Standards

AGENCY: Department of State.

ACTION: Final rule.

SUMMARY: The Comprehensive Anti-Apartheid Act of October 2, 1986 (Pub. L. 99-440) contains provisions on the fair labor standards to be implemented by U.S. firms in South Africa and Namibia. This final rule contains certain technical amendments to the regulations implementing the Act.

EFFECTIVE DATE: August 2, 1989.

FOR FURTHER INFORMATION CONTACT: Robert L. Bruce, Office of Southern African Affairs, (202) 647-8433, or John R. Byerly or Antonio F. Perez, Office of the Legal Adviser, (202) 647-4110, Department of State.

SUPPLEMENTARY INFORMATION: Section 2 of Executive Order 12532 of September 9, 1985 (50 FR 36861) deals with the labor practices of U.S. nationals and their firms in South Africa. On November 8, 1985 the Department of State published draft implementing regulations as a proposed rule for public comment (50 FR 46455). The final rule was published on December 31, 1985 (50 FR 53308).

The Comprehensive Anti-Apartheid Act of 1986 (Pub. L. 99–440) ("the Act") codified the measures required under the September 9, 1985 Executive Order. The Act contains a Code of Conduct (section 208) which codifies the fair labor standards specified in Executive Order 12532. It also contains several provisions relating to the fair labor standards to be implemented by U.S. firms. These provisions were implemented by the final rule that was published by the Department of State on October 30, 1986 (51 FR 39655).

The Department of State has determined that certain technical amendments are required in the existing regulations. These amendments include clarifying requirements for questionnaires, correcting citations to the criminal penalty provisions of the Comprehensive Anti-Apartheid Act, updating citations of authority to take into account the expiration of the President's determinations under the International Emergency Economic Powers Act (50 U.S.C. 1701), and changing current regulations to require any national that receives a Category IIIB standing in the Signatory Companies annual rating program to file a questionnaire on February 15 during the calendar year after it has received that rating.

These amendments deal with a foreign affairs function of the United States and are thus excluded from the major rule procedures of Executive Order 12291 (46 FR 13193) and the procedures of 5 U.S.C. 553 and 554. The basic regulations that are amended by this final rule were the subject of public comment because of the desirability of obtaining the public's views. However, the amendments deal with technical corrections and the continuing implementation of statutory requirements that have entered into force and consequently the amended regulations are promulgated as a final rule.

For the foregoing reasons, Title 22, Chapter I, Subchapter G, of the Code of Federal Regulations, is amended as set forth below:

1. The authority citations for Parts 60, 61, 62, 63, 64, and 65 are revised to read as follows:

Authority: Sec. 207, 208, 601, 603, and 604, Pub. L. 99–440 (22 U.S.C. 5035 (c)).

PARTS 60 AND 63—[AMENDED]

2. Parts 60 and 63 are amended to remove the word "Sullivan" and add in its place "Signatory Companies", and to remove the words "Sullivan Code" and add in their place "Statement of Principles for South Africa" in the following places:

(a) Section 60.1(b);
(b) Section 63.1(d);
(c) Section 63.3(c).

3. Section 63.1(b) is revised to read as follows:

§ 63.1 General policies.

* * * * *

(b) Failure to Register. Any such U.S. national who does not register with the Department of State prior to February 15, 1986 or thereafter within sixty days of meeting the criteria for registration, in accordance with § 62.1 shall be ineligible to receive the assistance specified in § 65.1 and shall be subject to the penalties specified in § 65.2.

* * * * *

4. Section 63.1(c) is amended to remove the second and third sentences and to replace them with the following sentence:

(c) * * * They shall so do by submitting to the Office of Southern African Affairs of the Department of State not later than February 15 of each calendar year a completed questionnaire furnished by the Department of State on an annual basis to all registrants.

* * * * *

5. Section 63.1(d)(1) is amended to remove the last two sentences and to replace them with the following sentence:

(d) * * *
(1) * * *

Any U.S. national participating in the Signatory Companies System who receives a Category IIIB standing shall not be deemed to be a *bona fide* participant pursuant to this subsection and must complete the required State Department questionnaire, in accordance with § 63.1(c).

* * * * *

6. Section 63.1(d)(2) is revised to read as follows:

(d) * * *

(2) Any U.S. national who becomes a participant in the Signatory Companies system during a calendar year and does not receive a rating during that calendar year shall be deemed to be a *bona fide* participant pursuant to § 63.1(d)(1) if, not later than February 15 of the following calendar year, it certifies by letter to the Office of Southern African Affairs of the Department of State that it is a participant in the Signatory Companies system.

PART 65—[AMENDED]

7. Section 65.2(a) is amended by revising the first two sentences to read as follows:

§ 65.2 Civil and criminal penalties.

(a) This subchapter is promulgated pursuant to the authority of the Comprehensive Anti-Apatheid Act of 1986 (Pub. L. 99–440). Sections 601 and 603 of the Comprehensive Anti-Apatheid Act are applicable to violations of this subchapter and to any license, ruling, regulation, order, direction, or instruction issued hereunder.* * *

* * * * *

Dated: June 21, 1989.

Herman J. Cohen,

Assistant Secretary of State for African Affairs.

[FR Doc. 89–17898 Filed 8–1–89; 8:45 am]

BILLING CODE 4710–06–M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8257]

RIN 1545–AN10

Transition Rules for the Allocation and Apportionment of Interest Expense and Rules Concerning the Treatment of Financial Products That Alter Effective Cost of Borrowing

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary Income Tax Regulations relating to transition rules for the allocation and apportionment of interest expense for purposes of the foreign tax credit rules and certain other international tax provisions. This document also provides rules concerning the treatment of financial products that alter effective cost of borrowing. Changes to the transition rules were made by the Technical and Miscellaneous Revenue Act of 1988. These regulations are necessary to provide guidance needed by taxpayers engaging in international transactions in order to comply with these changes. 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 regulations are effective for taxable years beginning after December 31, 1986, except for § 1.861–9T(b)(6), which is effective for transactions entered into after September 14, 1988.

FOR FURTHER INFORMATION CONTACT: Charles Plambeck 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:CORP:T:R (INTL-952-86)) (202-566-6284, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On September 11, 1987, the **Federal Register** published proposed regulations (52 FR 34580) to the Income Tax Regulations (26 CFR Part 1) under section 861 of the Internal Revenue Code of 1986. These regulations were issued under section 1215(c)(2) of the Tax Reform Act of 1986. Written comments responding to this notice were received. A public hearing was held on November 13, 1987. Section 1012(h)(2)(D) of the Technical and Miscellaneous Revenue Act of 1988 amended section 1215(c)(2) of the Tax Reform Act of 1986. The comments and revisions are discussed below.

Explanation of Provisions

These rules provide transition relief from the expense allocation rules of section 864(e), which reversed the provisions of prior law in a number of ways. While prior law permitted taxpayers to allocate and apportion interest expense on a separate company basis, section 864(e) requires a consolidated approach. While prior law permitted the use of a gross income method of apportionment, section 864(e) requires the use of an asset method. Other changes include the treatment of tax exempt assets and an earnings and profits adjustment to the basis of certain stock. These new rules are generally phased in over a three-year period in 25 percent increments, commencing with 1987. Generally, these percentages are applied to the amount of indebtedness outstanding on November 16, 1985 in order to compute the amount of a taxpayer's transition relief.

In addition, the rules provide supplemental transition relief from the consolidated approach to interest allocation for taxpayers that experienced net increases in total indebtedness in two different time periods. Taxpayers that are entitled to this kind of relief apply the rules of new law on a separate company basis to the amount of interest expense that is eligible for such treatment. Thus, interest expense for a given transition year can fall into one of three categories: old law, new law, and new law/separate company. This supplemental relief phases in over a four and five-year period, depending on the time period in which the net increase in indebtedness occurred.

The amount of indebtedness that is eligible for transition relief is reduced by any net decrease in indebtedness outstanding at any month-end since November 16, 1985. For taxpayers that experienced such a reduction, the reduced amount is used in lieu of the November 16, 1985 amount as the basis for computing transition relief. In the year in which a new month-end low is attained, the taxpayer may average its historic month-end low amounts for that year and use such average in lieu of the November 16, 1985 amount. In subsequent tax years, however, such averaging is not permitted. The averaging rule was adopted in response to criticism voiced concerning the rule of the proposed regulations that measured reductions solely on the basis of month-end debt levels, under a grant of authority contained in section 1215(c)(2)(A)(iii) of the Tax Reform Act of 1986, as amended by the Technical and Miscellaneous Revenue Act of 1988.

Reductions in indebtedness are deemed to first offset five-year indebtedness and then four-year indebtedness, both of which constitute subsets of the November 16, 1985 amount.

Thus, reductions first eliminate the supplemental relief from the consolidation rule, regardless of which particular indebtedness is reduced. Because a reduction in indebtedness by one affiliated corporation may be deemed to offset the indebtedness of another affiliated corporation under this stacking rule, an affiliated group must maintain separate company accounts of reductions reflecting the impact of reductions on the individual indebtedness of its members. If the transition indebtedness of a member of the affiliated group is reduced due to a paydown by another member of the group, the reduced level of transition indebtedness of that member does not change if either member leaves the affiliated group. Thus, if any member is transferred, the transferee must take account of reductions that precede its ownership. Although some commenters criticized the complexity associated with this rule, no alternative was presented that would preserve the effect of a reduction in indebtedness in the event of the transfer of an affiliated corporation and the rule was therefore retained.

As a general rule, the transition attributes of any corporation convey with the corporation. Commenters criticized a rule in the proposed regulations that permitted a transferee to take account of all the transition attributes of a transferred corporation in the year of transfer, regardless of when the transfer occurred. This rule has been modified to require a proration of transition attributes of a transferred corporation between the transferor and the transferee based on total months of ownership.

Commenters criticized a rule in the proposed regulations limiting the assumption of indebtedness, for purposes of these regulations, to a section 381 successor. This rule has been modified so that the transition-qualified indebtedness of one member of an affiliated group can be assumed by any other member. However, in the case of the disposition of any corporation that was relieved of indebtedness in such an assumption, the transferee must assume on or before the date of acquisition of the transferred corporation the transition-qualified indebtedness for which the transferred corporation was liable at the time of the acquisition. Otherwise, the assumed indebtedness ceases to qualify for transition relief.

Commenters requested guidance concerning the definition of indebtedness. The regulations clarify that only interest-bearing obligations and obligations having original issue discount constitute indebtedness for purposes of these regulations. An obligation must have attained that status as of any critical date identified in the regulations in order to be taken into account. It is not necessary to show that the debts outstanding at the end of any month were the same debts as were outstanding on any critical date.

For purposes of determining the actual percentage of indebtedness of any member of an affiliated group that is subject to any of the three possible sets of rules, commenters questioned the use of the year-end debt level as the denominator of the fraction (with computed relief in a given category serving as the numerator). The regulations have been modified to require the use of an average of month-end debt levels for the year as the denominator.

With respect to the addition of paragraph (b)(6) to § 1.861-9T, several commenters raised the question of whether losses on interest rate swaps or other derivative financial products that alter a taxpayer's effective cost of borrowing would constitute an expense equivalent to interest within the meaning of § 1.861-9T(b)(1). Other commenters asked whether gain on such financial products would offset allocable interest expense. When such financial products operate to hedge a liability or themselves constitute the functional equivalent of a liability, they are within the intended scope of § 1.861-9T(b)(1). Losses from such financial products should be allocated and apportioned in the same manner as interest expense. The addition of paragraph (b)(6) is intended to clarify these issues. Paragraph (b)(6) is limited to financial products that alter the effective cost of borrowing where the financial product and borrowing are in the same currency. It should be noted that section 988 applies to transactions in nonfunctional currency. Where applicable, forthcoming regulations under section 988 will take precedence over the rules of this paragraph (b)(6). *See, e.g.*, Notice 87-11, 1987-1 C.B. 423.

Although the rules of paragraph (b)(1) were effective for taxable years commencing after December 31, 1986, the Service believes that it would be inappropriate to apply the rules of paragraph (b)(6) under the generally applicable effective date of paragraph (b)(1). Thus, the rules of paragraph (b)(6) are effective with respect to losses incurred on any of the financial products described in paragraph (b)(6)(i) that were entered into after September 14, 1988, which was the date of publication of paragraph (b)(1). The Service does not intend that losses on transactions described in paragraph (b)(6)(i) that were entered into prior to September 15, 1988 should be subject to the rule of paragraph (b)(1).

In contrast to the rules of paragraph (b)(1), the rules of paragraph (b)(6) permit taxpayers under certain circumstances effectively to reduce their apportionable interest expense by the amount of gains derived from the financial products that are the subject of paragraph (b)(6).

The Service has determined that, under certain conditions, taxpayers should be able to apply retroactively the paragraph (b)(6) rule for the netting of gains and interest expense with respect to gains realized on any of the financial products described in paragraph (b)(6)(i) that were entered into after September 14, 1988. These conditions are that the taxpayer must be able to demonstrate to the satisfaction of the Commissioner that substantially all of the financial products described in paragraph (b)(6)(i) (*i.e.*, liability hedges) to which the taxpayer became a party during the period between September 15, 1988 and August 2, 1989, were identified with the liabilities of the taxpayer in a substantially contemporaneous manner and that all losses attributable to such products were treated consistently. For this purpose, financial products described in paragraph (b)(6)(i) that were identified in a substantially contemporaneous manner with the taxpayer's assets (rather than its liabilities) shall be ignored.

Although the Service believes that similar treatment should be accorded to the gains and losses of financial services entities and other taxpayers, paragraph (b)(6)(iii) reserves on the treatment of financial services entities. The fact that paragraph (b)(6) does so reserve should not be interpreted to mean that the losses of a financial services entity from these transactions do not constitute an interest equivalent under paragraph (b)(1). The Service invites financial services entities to comment with respect to appropriate rules for computing such gains and losses, particularly with respect to identification and the interaction of such rules with Notice 87-4, 1987-1 C.B. 416. Losses on interest rate swaps that are not described in paragraph (b) and are not incurred by a financial services entity or a dealer are governed by Notice 87-4.

The Service will issue additional regulations concerning the timing and characterization of gains and losses realized or incurred in connection with the financial products that are the subject of paragraph (b)(6). See Notice 89-21, I.R.B. 1989-9 (Feb. 21, 1989), regarding rules concerning timing.

Some commenters have asked whether paragraph (b)(2) represents a comprehensive treatment of nonfunctional currency borrowings or whether other such borrowings would be subject to the rules of paragraph (b)(1). The Service has added paragraph (b)(7) in order to clarify that, as a general rule, gain or loss on section 988 transactions (other than those described in paragraph (b)(1), (b)(2), or (b)(6)) will only be considered to be an adjustment to interest expense to the extent required by the regulations to be issued under section 988. However, certain nonfunctional currency borrowings alter the effective cost of borrowing in functional currency in a manner similar to the rule of paragraph (b)(1) in the sense that a taxpayer borrowing nonfunctional currency can incur a loss in a series of related transactions while securing the use of funds in its functional currency. In such a case, it is appropriate to require the apportionment of the loss in the same manner as interest expense. New *Example* (2) has been added to paragraph (b)(1) to demonstrate how a loss on a nonfunctional currency borrowing that would not be subject to paragraph (b)(2) can operate as an interest equivalent.

New *Example* (3) has been added to demonstrate how the disposition of one leg of an interest rate swap, even if not properly recharacterized as an actual borrowing, can produce a constructive borrowing, rendering the swap payments on the other leg an interest equivalent subject to allocation and apportionment under the rule of paragraph (b)(1). The example goes on to note that the same result would apply in the case of a swap agreement in which the swap payments were not substantially contemporaneous if the pricing of the transaction is materially affected by the time value of money, but only to the extent that the expense or loss is incurred in consideration of the time value of money. The Service does not generally intend that this rule apply to noncontemporaneous swap payments that are found in standard interest rate swap contracts where the pricing of the transaction is not materially affected by the time value of money. Taxpayers are invited to comment concerning appropriate circumstances (including safe harbors) in which this rule should not apply.

Although *Example* (3) involves a swap contract, this swap contract differs from those described in paragraph (b)(6) in the sense that it does not adjust the effective cost of borrowing with respect to actual liabilities of the taxpayer, but, like the gold example already contained in paragraph (b)(1), has the effect of creating a cost of borrowing unrelated to an actual liability.

Finally, the first sentence of § 1.861-2(a)(1) is modified by replacing the words "issued or assumed" with the words "issued, assumed, or incurred." This revision is made in order to conform the regulations to the opinion by the Second Circuit in *Iglesias* v. *U.S.*, 848 F.2d 362 (2d Cir. 1988).

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) and the Regulatory Flexibility Act (5 U.S.C. Chapter 6) do not apply to these regulations, and, therefore, an initial Regulatory Flexibility Analysis is not required.

Drafting Information

The principal author of these regulations is David Merrick of the Office of Associate Chief Counsel

(International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from offices of the Internal Revenue Service and Treasury Department participated in developing these regulations.

List of Subjects in 26 CFR 1.861-1 Through 1.997-1

Income taxes, Aliens, Exports, DISCs, Foreign investment in U.S., Foreign tax credit, FSC, Source of income, U.S. investments abroad.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—[AMENDED]

Income Tax Regulations

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

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

Par. 2. The first sentence of § 1.861-2(a)(1) is amended by removing the words "issued or assumed" and by inserting in their place the words "issued, assumed or incurred."

Par. 3. Section 1.861-9T is amended as follows:

1. By revising paragraph (b)(1) to read as set forth below, and

2. By adding immediately after paragraph (b)(5) a new paragraph (b)(6) and (b)(7).

§ 1.861-9T Allocation and apportionment of interest expense (Temporary regulations)

* * * * *

(b) *Interest equivalents*—(1) *Certain expenses and losses*—(i) *General rule.* Any expense or loss (to the extent deductible) incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time shall be subject to allocation and apportionment under the rules of this section if such expense or loss is substantially incurred in consideration of the time value of money. However, the allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.

(ii) Examples. The rule of this paragraph (b)(1) may be illustrated by the following examples.

Example (1). W, a domestic corporation, borrows from X two ounces of gold at a time when the spot price for gold is $500 per ounce. W agrees to return the two ounces of gold in six months. W sells the two ounces of gold to Y for $1000. W then enters into a contract with Z to purchase two ounces of gold six months in the future for $1,050. In exchange for the use of $1,000 in cash, W has sustained a loss of $50 on related transactions. This loss is subject to allocation and apportionment under the rules of this section in the same manner as interest expense.

Example (2). X, a domestic corporation with a dollar functional currency, borrows 100 pounds on January 1, 1987 for a three-year term at an interest rate greater than the applicable federal rate for dollar loans. At this time, the interest rate on the pound was approximately equal to the interest rate on dollar borrowings and the forward price on the pound, vis-a-vis the dollar, was approximately equal to the spot price. On January 1, 1987, X converted 100 pounds into dollars and entered into a currency swap that substantially hedged X's foreign currency exposure on the pound borrowing, both with respect to interest and principal. The borrowing, coupled with the swap, represents a series of related transactions in which the taxpayer secures the use of funds in its functional currency. Any net foreign currency loss on this series of transactions constitutes a loss incurred substantially in consideration of the time value of money and shall be apportioned in the same manner as interest expense. Thus, if the pound depreciates against the dollar, such that when the first payment on the pound borrowing is due the taxpayer has a currency loss on the swap payment hedging its first interest payment, such loss shall, even if the transaction is not integrated under section 988(d), be allocated and apportioned in the same manner as interest expense under the authority of this paragraph (b)(1).

Example (3). On January 1, 1987, X, a domestic corporation with a dollar functional currency, enters into a dollar interest rate swap contract with Y, a domestic counterparty. Under the terms of this agreement, X agrees to pay Y floating rate interest with respect to a notional principal amount of $100 for five years. In return, Y agrees to pay X fixed rate interest at 10 percent with respect to a notional principal amount of $100 for five years. On the same day, Y prepays the fixed leg of the swap by making a lump sum payment of $37 to X. This lump sum payment represents the present value of five $10 swap payments. Because X secures the use of $37 in this transaction, any net swap expense arising from the transaction represents an expense incurred substantially in consideration of the time value of money. Assuming this lump sum payment is not otherwise characterized as a loan from Y to X, and that X must amortize the $37 lump sum payment under the principles of Notice 89-21, any net swap expense incurred by X with respect to this transaction (*i.e.*, the excess, if any, of X's annual swap payment to Y over the annual amortization of the $37 lump sum payment that is taken into income by X) represents an expense equivalent to interest expense. The result would be the same if X sold the fixed leg to a third party for $37. While this example presents the case of a lump sum payment, the rules of paragraph (b)(1) would also apply to any transaction in which the swap payments are not substantially contemporaneous if the pricing of the transaction is materially affected by the time value of money. Thus, expenses and losses will be subject to apportionment under the rules of this section to the extent that such expenses or losses were incurred in consideration of the time value of money.

* * * * *

(6) *Financial products that alter effective cost of borrowing*—(i) *In general.* Various derivative financial products can be part of transactions or series of transactions described in paragraph (b)(1) of this section. Such derivative financial products, including interest rate swaps, options, forwards, caps, and collars, potentially alter a taxpayer's effective cost of borrowing with respect to an actual liability of the taxpayer. For example, a taxpayer that is obligated to pay interest at a fixed rate may, in effect, pay interest at a floating rate by entering into an interest rate swap. Similarly, a taxpayer that is obligated to pay interest at a floating rate may, in effect, limit its exposure to rising interest rates by purchasing a cap. Such a taxpayer may have gains or losses associated with such derivative financial products. This paragraph (b)(6) provides rules for the treatment of gains and losses from such derivative financial products ("financial products") that are part of transactions described in paragraph (b)(1) of this section and that are used by the taxpayer to alter its effective cost of borrowing with respect to an actual liability. This paragraph (b)(6) shall only apply where the hedge and the borrowing are in the same currency and shall not apply to the extent otherwise provided in section 988 and the regulations thereunder. The allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.

(ii) *Definition of gain and loss.* For purposes of this paragraph (b)(6), the term "gain" refers to the excess of the amounts properly taken into income under a financial product that alters the effective cost of borrowing over the amounts properly allowed as a deduction thereunder within a given taxable year. See, *e.g.*, Notice 89-21. The term "loss" refers to the excess of the amounts properly allowed as a deduction under such a financial product over the amounts properly taken into income thereunder within a given taxable year.

(iii) *Treatment of gain or loss on the disposition of a financial product.* [Reserved.]

(iv) *Entities that are not financial services entities.* An entity that does not constitute a financial services entity within the meaning of § 1.904-4(e)(3) shall treat gains and losses on financial products described in paragraph (b)(6)(i) of this section as follows.

(A) *Losses.* Losses on any financial product described in paragraph (b)(6)(i) of this section shall be apportioned in the same manner as interest expense whether or not such financial product is identified by the taxpayer under paragraph (b)(6)(iv)(C) of this section as a liability hedge.

(B) *Gains.* Gains on any financial product described in paragraph (b)(6)(i) of this section shall reduce the taxpayer's total interest expense that is subject to apportionment, but only if such financial product is identified by the taxpayer under paragraph (b)(6)(iv)(C) of this section as a liability hedge. Such reduction is accomplished by directly allocating interest expense to the income derived from such a financial product.

(C) *Identification of financial products.* A taxpayer can identify a financial product described in paragraph (b)(6)(i) of this section as hedging a particular interest-bearing liability (or any group of such liabilities) by clearly identifying on its books and records on the same day that it becomes a party to such arrangement that such arrangement hedges a given liability (or group of liabilities). In the case of a partial hedge, such identification shall apply to only that part of the liability that is hedged. If the taxpayer clearly identifies on its books and records a financial product as a hedge of an interest-bearing asset (or any group of such assets), it will create a rebuttable presumption that such financial product is not described in paragraph (b)(6)(i) of this section. A taxpayer may identify a hedge as relating to an anticipated liability, provided that such liability is in fact incurred within 120 days following the date of such identification. Gains and losses on such an anticipatory arrangement accruing prior to the time at which the liability is incurred shall constitute an adjustment to interest expense.

(v) *Financial services entities.* [Reserved.]

(vi) *Dealers.* The rule of paragraph (b)(6)(iv) of this section shall not apply to a person acting in its capacity as a regular dealer in the financial products described in paragraph (b)(6)(i) of this section. Instead, losses sustained by a regular dealer in connection with such financial products shall be allocated to the class of gross income from such arrangements. Gains of a regular dealer in notional principal contracts are governed by the rules of § 1.863-7T(b). Amounts received or accrued by any person from any financial product that is integrated as specified in Notice 89-90 with an asset shall not be treated as amounts received or accrued by a person acting in its capacity as a regular dealer in financial products.

(vii) *Examples.* The principles of this paragraph (b)(6) may be illustrated by the following examples.

Example (1). X is not a financial services entity or regular dealer in the financial products described in paragraph (b)(6)(i) of this section and has a dollar functional currency. In 1990, X incurred a total of $200 of interest expense. On January 1, 1990, X entered into an interest rate swap agreement with Y, in order to hedge its interest rate exposure with respect to a pre-existing floating rate liability. On the same day, X properly identified the agreement as a hedge of such liability. Under the agreement, X is required to pay Y an amount equal to a fixed rate of 10 percent on a notional principal amount of $1,000. Y is required to pay X an amount equal to a floating rate of interest on the same notional principal amount. Under the agreement, X received from Y during 1990 a net payment of $25. Because X identified the swap agreement as a liability hedge under the rules of paragraph (b)(6)(iv)(C), X may effectively reduce its total allocable interest expense for 1990 to $175 by directly allocating $25 of interest expense to the swap income. Had X not properly identified the swap as a liability hedge, this swap payment would have been treated as domestic source income in accordance with the rule of § 1.863-7T(b).

Example (2). Assume the same facts as Example (1), except that X did not properly identify the agreement as a liability hedge on January 1, 1990. In 1990, X made a net payment of $25 to Y under the swap agreement. This swap payment is allocated and apportioned in the same manner as interest expense under the rules of paragraph (b)(6)(iv)(A).

(viii) *Effective dates*—(A) *Losses.* The rules of this paragraph (b)(6) shall apply to losses on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988.

(B) *Gains.* Except as provided in paragraph (b)(6)(viii)(C) of this section, the rules of this paragraph (b)(6) shall apply to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after August 14, 1989.

(C) *Exception for interim gains.* Taxpayers shall be permitted to apply the rules of this paragraph (b)(6) to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988 and on or before August 14, 1989, if the taxpayer can demonstrate to the satisfaction of the Commissioner that substantially all of the arrangements described in paragraph (b)(6)(i) of this section to which the taxpayer became a party during that interim period were identified on the taxpayer's books and records with the liabilities of the taxpayer in a substantially contemporaneous manner and that all losses and expenses that are subject to the rules of this paragraph (b)(6) were treated in the same manner as interest expense. For this purpose, arrangements that were identified in a substantially contemporaneous manner with the taxpayer's assets shall be ignored.

(7) *Foreign currency gain or loss.* In addition to the rules of paragraph (b)(1), (b)(2), and (b)(6) of this section, any foreign currency loss that is treated as an adjustment to interest expense under regulations issued under section 988 shall be allocated and apportioned in the same manner as interest expense. Any foreign currency gain that is treated as an adjustment to interest expense under regulations issued under section 988 shall offset apportionable interest expense.

Par. 4. The text of § 1.861-13T is added to read as follows:

§ 1.861-13T Transition rules for interest expenses (temporary regulations).

(a) *In general*—(1) *Optional application.* The rules of this section may be applied at the choice of a corporate taxpayer. In the case of an affiliated group, however, the choice must be made on a consistent basis for all members. Therefore, a corporate taxpayer (or affiliated group) may allocate and apportion its interest expense entirely on the basis of the rules contained in §§ 1.861-8T through 1.861-12T and without regard to the rules of this section. The choice is made on an annual basis and, thus, is not binding with respect to subsequent tax years.

(2) *Transition relief.* This section contains transitional rules that limit the application of the rules for allocating and apportioning interest expense of corporate taxpayers contained in §§ 1.861-8T through 1.861-12T, which are applicable in allocating and apportioning the interest expense of corporate taxpayers generally for taxable years beginning after 1986. Sections 1.861-9(d) (relating to individuals, estates, and certain trusts) and 1.861-9(e) (relating to partnerships) are effective for taxable years beginning after 1986. Thus, the taxpayers to whom those sections apply do not qualify for transition relief under this section.

(3) *Indebtedness defined.* For purposes of this section, the term "indebtedness" means any obligation or other evidence of indebtedness that generates an expense that constitutes interest expense within the meaning of § 1.861–9T(a). In the case of an obligation that does not bear interest initially, but becomes interest bearing with the lapse of time or upon the occurrence of an event, such obligation shall only be considered to constitute indebtedness when it first bears interest. Obligations that are outstanding as of November 16, 1985 shall only qualify for transition relief under this section if they bear interest-bearing as of that date. For this purpose, any obligation that has original issue discount within the meaning of section 1273(a)(1) of the Code shall be considered to be interest-bearing.

(4) *Exceptions.* The term "indebtedness" shall not include any obligation existing between affiliated corporations, as defined in § 1.861–llT(d). Moreover, the term "indebtedness" shall not include any obligation the interest on which is directly allocable under §§ 1.861–10T(b) and 1.861–10T(c). Under § 1.861–9T(b)(6)(iv)(B), certain interest expense is directly allocated to the gain derived from an appropriately identified financial product. When interest expense on a liability is reduced by such gain, the principal amount of such liability shall be reduced pro rata by the relative amount of interest expense that is directly allocated.

(b) *General phase-in*—(1) *In general.* In the case of each of the first three taxable years of the taxpayer beginning after December 31, 1986, the rules of §§ 1.861–8T through 1.861–12T shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the general phase-in amount, as defined in paragraph (b)(2) of this section.

(2) *General phase-in amount defined.* Subject to the limitation imposed by paragraph (b)(3) of this section, the general phase-in amount means the amount which is the applicable percentage (determined under the following table) of the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985:

Taxable year beginning after December 31, 1986	Percentage
First	75
Second	50
Third	25

(3) *Reductions in indebtedness.* The general phase-in amount shall not exceed the taxpayer's historic lowest month-end debt level taking into account all months after October 1985. However, for the taxable year in which a taxpayer attains a new historic lowest month-end debt level (but not for subsequent taxable years), the general phase-in amount shall not exceed the average of month-end debt levels within that taxable year (without taking into account any increase in month-end debt levels occurring in such taxable Year after the new historic lowest month-end debt level is attained).

Example. X is a calendar year taxpayer that had $100 of indebtedness outstanding on November 16, 1985. X's month-end debt level remained $100 for all subsequent months until July 1987, when X's month-end debt level fell to $50. In computing transition relief for 1987, X's general phase-in amount cannot exceed $75 (900 divided by 12), which is the average of month-end debt levels in 1987. Assuming that X's month-end debt level for any subsequent month does not fall below $50, the limitation on its general phase-in amount for all taxable years after 1987 will be $50, its historic lowest month-end debt level after October 1985.

(c) *Nonapplication of the consolidation rule*—(1) *General rule.* In the case of each of the first five taxable years of the taxpayer beginning after December 31, 1986, the consolidation rule contained in § 1.861–11T(c) shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the special phase-in amount, as defined in paragraph (c)(2) of this section.

(2) *Special phase-in amount.* The special phase-in amount is the sum of—

(i) The general phase-in amount,

(ii) The five-year phase-in amount, and

(iii) The four-year phase-in amount.

(3) *Five-year phase-in amount.* The five-year phase-in amount is the lesser of—

(i) The applicable percentage (the "unreduced percentage" in the following table) of the five-year debt amount, or

(ii) The applicable percentage (the "reduced percentage" in the following table) of the five-year debt amount reduced by paydowns (if any):

Transition year	Unreduced percentage	Reduced percentage
Year 1	8⅓	10
Year 2	16⅔	25
Year 3	25	50
Year 4	33⅓	100
Year 5	16⅔	100

(4) *Four-year phase-in amount.* The four-year phase-in amount is the lesser of—

(i) The applicable percentage (the "unreduced percentage" in the following table) of the four-year debt amount, or

(ii) The applicable percentage (the "reduced percentage" in the following table) of the four-year debt amount reduced by paydowns (if any) to the extent that such paydowns exceed the five-year debt amount:

Transition year	Unreduced percentage	Reduced percentage
Year 1	5	6¼
Year 2	10	16⅔
Year 3	15	37½
Year 4	20	100

(5) *Five-year debt amount.* The "five-year debt amount" means the excess (if any) of—

(i) The amount of the outstanding indebtedness of the taxpayer on May 29, 1985, over

(ii) The amount of the outstanding indebtedness of the taxpayer on December 31, 1983. The five-year debt amount shall not exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985.

(6) *Four-year debt amount.* The "four-year debt amount" means the excess (if any) of—

(i) The amount of the outstanding indebtedness of the taxpayer on December 31, 1983, over

(ii) The amount of the outstanding indebtedness of the taxpayer on December 31, 1982.

The four-year debt amount shall not exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985, reduced by the five-year debt amount.

(7) *Paydowns.* The term "paydowns" means the excess (if any) of—

(i) The aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985, over

(ii) The limitation on the general phase-in amount described in paragraph (b)(3) of this section.

Paydowns are first applied to the five-year debt amount to the extent thereof and then to the four-year debt amount for purposes of computing the five-year and the four-year phase-in amounts.

(d) *Treatment of affiliated group.* For purposes of this section, all members of the same affiliated group of corporations (as defined in § 1.861–11(d)) shall be treated as one taxpayer whether or not such members filed a consolidated return. Interaffiliate debt is not taken into account in computing transition relief. Moreover, any reduction in the amount of interaffiliate debt is not taken into account in determining the amount of paydowns.

(e) *Mechanics of computation*—(1) *Step 1: Determination of the amounts within the various categories of debt.* Each separate member of an affiliated group must determine each of its following amounts:

(i) *November 16, 1985 amount.* The amount of its debt outstanding on November 16, 1985 (after the elimination of interaffiliate indebtedness),

(ii) *Unreduced five-year debt.* The amount of any net increase in the amount of its indebtedness on May 29, 1985 (after elimination of interaffiliate indebtedness) over the amount of its indebtedness on December 31, 1983 (after elimination of interaffiliate indebtedness),

(iii) *Unreduced four-year debt.* The amount of any net increase in the amount of its indebtedness on December 31, 1983 (after elimination of interaffiliate indebtedness) over the amount of its indebtedness on December 31, 1982 (after elimination of interaffiliate indebtedness), and

(iv) *Month-end debt.* The amount of its month-end debt level for all months after October 1985 (after elimination of interaffiliate indebtedness).

(2) *Step 2: Aggregation of the separate company amounts.* Each of the designated amounts for the separate companies identified in Step 1 must be aggregated in order to compute consolidated transition relief. Paragraph (e)(10)(iv) of this section (Step 10) requires the use of the taxpayer's current year average debt level for the purpose of computing the percentages of debt that are subject to the three sets of rules that are identified in Step 10. For use in that computation, the taxpayer should compute the current year average debt level by aggregating separate company month-end debt levels and then by averaging those aggregate amounts.

(3) *Step 3: Calculation of the lowest historic month-end debt level of the taxpayer.* In order to calculate the lowest historic month-end debt level of the taxpayer, determine the month-end debt level of each separate company for each month ending after October 1985 and aggregate these amounts on a month-by-month basis. On such aggregate basis, in any taxable year in which the taxpayer attains an aggregate new lowest historic month-end debt level, add together all the aggregate month-end debt levels within the taxable year (without taking into account any increase in aggregate debt level subsequent to the attainment of such lowest historic month-end debt level) and divide by the number of months in that taxable year, yielding the average of month-end debt levels for such year. Such average shall constitute the taxpayer's lowest historic month-end debt level for that taxable year in which the aggregate new lowest historic month-end debt level was attained. Unless otherwise specified, all subsequent references to any amount refer to the aggregate amount for all members of the same affiliated group of corporations.

(4) *Step 4: Computation of paydowns.* Paydowns equal the amount by which the November 16, 1985 amount exceeds the taxpayer's lowest historic month-end debt level, determined under Step 3.

(5) *Step 5: Computation of limitations on unreduced five-year debt and unreduced four-year debt.* (i) The unreduced five-year debt cannot exceed the November 16, 1985 amount.

(ii) The unreduced four-year debt cannot exceed the November 16, 1985 amount less the unreduced five-year debt.

(6) *Step 6: Computation of reduced five-year and reduced four-year debt*—(i) *Reduced five-year debt.* Compute the amount of reduced five-year debt by subtracting from the unreduced five-year debt (see Step 5) the amount of paydowns (see Step 4).

(ii) *Reduced four-year debt.* To the extent that the amount of paydowns (see step 4) exceeds the amount of unreduced five-year debt (see Step 5), compute the amount of reduced four-year debt by subtracting such excess from the unreduced four-year debt (see Step 1).

(iii) To the extent that paydowns do not offset either the unreduced five-year amount or the unreduced four-year amount, the reduced and the unreduced amounts are the same.

(7) *Step 7: Computation of the general phase-in amount.* The general phase-in amount is the lesser of—

(i) The percentage of the November 16, 1985 amount designated for the relevant transition year in the table below, or

(ii) The lowest group month-end debt level (see Step 3).

GENERAL PHASE-IN TABLE

Transition year	Percentage
Year 1	75
Year 2	50
Year 3	25

(8) *Step 8: Computation of Five-Year Phase-in Amount.* The five-year phase-in amount is the lesser of—

(i) The percentage of the unreduced five-year debt designated for the relevant transition year in the table below, or

(ii) The percentage of the reduced five-year debt designated for the relevant transition year in the table below.

FIVE-YEAR PHASE-IN TABLE

Transition year	Unreduced percentage	Reduced percentage
Year 1	8⅓	10
Year 2	16⅔	25
Year 3	25	50
Year 4	33⅓	100
Year 5	16⅔	100

(9) *Step 9: Computation of Four-year Phase-in Amount.* The four-year phase-in amount is the lesser of—

(i) The percentage of the unreduced four-year debt designated for the relevant transition year in the table below, or

(ii) The percentage of the reduced four-year debt designated for the relevant transition year in the table below.

FOUR-YEAR PHASE-IN TABLE

Transition year	Unreduced percentage	Reduced percentage
Year 1	5	6¼
Year 2	10	16⅔
Year 3	15	37½
Year 4	20	100

(10) *Step 10: Determination of group debt ratio and application of transition relief to separate company interest expense.* (i) The general phase-in amount consists of the amount computed under Step 7. Interest expense on this amount is subject to pre-1987 rules of allocation and apportionment.

(ii) The post-1986 separate company amount consists of the sum of the amounts determined under Steps 8 and 9. Interest expense on this amount is subject to post-1986 rules of allocation and apportionment as applied on a separate company basis. Thus, § 1.861-11T(c) does not apply with respect to this amount of indebtedness. Because the consolidation rule does not apply, stock in affiliated corporations shall be taken into account in computing the apportionment fractions for each separate company in the same manner as under pre-1987 rules.

(iii) The post-1986 one-taxpayer amount consists of any indebtedness that does not qualify for transition relief under Steps 7, 8, and 9. Interest expense on this amount is subject to post-1986 rules as applied on a consolidated basis.

(iv) To determine the extent to which the interest expense of each separate company is subject to any of these sets of allocation and apportionment rules, each company shall prorate its own interest expense using two fractions. The general phase-in fraction is the general phase-in amount over the current year average debt level of the affiliated group (see Step 2). The post-1986 separate company fraction is the post-1986 separate company amount over the current year average debt level of the affiliated group. The balance of each separate company's interest expense is subject to post-1986 one-taxpayer rules.

(f) *Example.* XYZ form an affiliate group.

(1) *Step 1:* Determination of the amounts within the various debt categories.

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1983 (5-year)	90,000	$10,000
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Current Interest Expense	10,000	
Company Y:		
Nov. 16, 1985	200,000	
May 29, 1985 (5-year)	170,000	120,000
Dec. 31, 1983 (4-year)	50,000	10,000
Dec. 31, 1982	40,000	
Current Interest Expense	30,000	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	300,000	50,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	
Current Interest Expense	30,000	

(2) *Step 2:* Aggregation of the separate company amounts.

Aggregate Nov. 16, 1985	$600,000
Aggregate 5-year debt	180,000
Aggregate 4-year debt	120,000
Current year average debt level	700,000

(3) *Step 3:* Calculation of lowest historic month-end debt level.

An analysis of historic month-end debt levels indicates that in 1986, XYZ's aggregate month-end debt level fell to $500,000, which represents the lowest sum for all years under consideration. Because this historic low occurred in a prior tax year, there is no averaging of month-end debt levels in the current taxable year.

(4) *Step 4:* Computation of paydowns. The aggregate November 16, 1985 amount ($600,000), less the lowest historic month-end debt level ($500,000), yields a total paydown in the amount of $100,000.

(5) *Step 5:* Computation of limitations on aggregate unreduced five-year debt and aggregate unreduced four-year debt.

Aggregate Nov. 16, 1985 amount	$600,000
Aggregate unreduced 5-year debt	180,000
Aggregate unreduced 4-year debt	120,000

Because the November 16, 1985 amount exceeds the unreduced 4- and 5-year debt, the full amount of the 4- and 5-year debt qualify for transition relief. In cases where the November 16, 1985 amount is less than the 4- or 5-year debt (or the sum of both), the latter amounts are limited to the November 16, 1985 amount. See the limitations on the 4-year and 5-year debt amounts in paragraphs (c)(6) and (c)(5), respectively, of this section.

(6) *Step 6:* Computation of reduced five-year and four-year debt. The paydowns computed under Step 4 are deemed to first offset the aggregate unreduced five-year debt. Accordingly, the reduced amount of five-year debt is $80,000. Since the paydowns are less than the aggregate unreduced five-year debt, there is no paydown in connection with aggregate unreduced four-year debt. Accordingly, the unreduced four-year debt and the reduced four-year debt are both considered to be $120,000.

(7) *Step 7:* Computation of the general phase-in amount. In transition year 1, the general transition amount is the lesser of:

(i) 75 percent of the aggregate November 16, 1985 amount (75% of $600,000 = $450,000); or

(ii) the lowest month-end debt level since November 16, 1985 ($500,000).

Therefore, the general transition amount is $450,000.

(8) *Step 8:* Computation of the five-year phase-in amount. In transition year 1, the five-year phase-in amount is the lesser of:

(i) 8⅓ percent of the unreduced five-year amount (8⅓% of $180,000=$15,000); or

(ii) 10 percent of the reduced five-year amount (10% of $80,000=$8,000).

Therefore, the five-year phase-in amount is $8,000.

(9) *Step 9:* Computation of the four-year phase-in amount. In transition year 1, the four-year phase-in amount is the lesser of:

(i) 5 percent of the unreduced four-year amount (5% of $120,000=$6,000); or

(ii) 6¼ percent of the reduced four-year amount (6¼% of $120,000=$7,500).

Therefore, the four-year phase-in amount is $6,000.

(10) *Step 10:* Determination of group debt ratio and application of relief to separate company interest expense.

(i) As determined under Step 7, interest expense on a total of $450,000 of the XYZ debt in the first transition year is computed under pre-1987 rules of allocation and apportionment.

(ii) The sum of Steps 8 ($8,000) and 9 ($6,000) is $14,000. Interest expense on a total of $14,000 of XYZ debt is computed under post-1986 rules of allocation and apportionment as applied on a separate company basis.

(iii) The balance of XYZ's current year interest expense is computed under post-1986 rules of allocation and apportionment as applied on a consolidated basis. X, Y, and Z, respectively, have current interest expense of $10,000, $30,000, and $30,000. Thus, 64.3 percent (450,000/700,000) of the interest expense of each separate company is subject to pre-1987 rules. Two percent (14,000/700,000) of the interest expense of each separate company is subject to post-1986 rules applied on a separate company basis. Finally, the balance of each separate company's current year interest expense (33.7 percent) is subject to post-1986 rules applied on a consolidated basis.

(g) *Corporate transfers*—(1) *Effect on transferee*—(i) *General rule.* Except as provided in paragraph (g)(1)(ii) of this section, if a domestic corporation or an affiliated group acquires stock in a domestic corporation that was not a member of the transferee's affiliated group before the acquisition, but becomes a member of the transferee's affiliated group after the acquisition, the transferee group shall take into account the following transition attributes of the acquired corporation in computing its transition relief:

(A) November 16, 1985 amount;

(B) Unreduced five-year amount;

(C) Unreduced four-year amount; and

(D) The amount of any transferor paydowns attributed to the acquired corporation under the rules of paragraph (h)(1) of this section.

(ii) *Special rule for year of acquisition.* To compute the amount of the transition attributes described in paragraph (g)(1)(i) of this section that a transferee takes into account in the transferee's taxable year of the acquisition, such transition attributes shall be multiplied by a fraction, the numerator of which is the number of months within the taxable year that the transferee held the acquired corporation and the denominator of which is the number of months in such taxable year. In order for the transferee to assert ownership of a subsidiary for a given month, the transferee and the acquired corporation must be affiliated corporations as of the last day of the month. In addition, the transferor and the transferee shall take account of the month-end debt level of the transferred corporation only for those months at the end of which the transferred corporation was a member of the transferor's or the transferee's respective affiliated group.

(iii) *Aggregation of transition attributes.* The transition attributes of the acquired corporation shall be aggregated with the respective amounts of the transferee group.

(iv) *Conveyance of transferor paydowns.* The total paydowns of the transferee group shall include the amount of any paydown of the transferor group that was attributed to the acquired corporation under the rules of paragraph (h)(1) of this section.

(v) *Effect of certain elections.* If an election—

(A) Is made under section 338(g) (whether or not an election under 338(h)(10) is made),

(B) Is deemed to be made under section 338(e) (other than (e)(2)), or section 338(f), or,

(C) Is made under section 336(e), no indebtedness of the acquired corporation shall qualify for transition relief for the year such election first becomes effective and for subsequent taxable years, and no other transition attributes of the acquired corporation shall be taken into account by the transferee group.

(2) *Effect on transferor*—(i) *General rule.* Except as provided in paragraph (g)(2)(ii) of this section, in the case of an acquisition of a member of an affiliated group by a nonmember of the group, the transferor shall not take into account the transition attributes of the acquired corporation in computing the transition relief of the transferor group in subsequent taxable years. Thus, the November 16, 1985 amount, the unreduced five-year and four-year debt amounts, and the end-of-month debt levels of the transferor group shall be computed without regard to the acquired corporation's respective amounts for purposes of computing transition relief of the tranferor group for years thereafter.

(ii) *Special rule for the year of disposition.* To compute the amount of the transition attributes described in paragraph (g)(2)(i) of this section that a transferor shall take into account in the transferor's taxable year of the disposition, such transition attributes shall be multiplied by a fraction, the numerator of which is the number of months within the taxable year that the transferor held the acquired corporation and the denominator of which is the number of months in such taxable year. In order for the transferor to assert ownership of a subsidiary for a given month, the transferor and the acquired corporation must be affiliated corporations as of the last day of the month.

(iii) *Effect of prior paydowns.* Any paydowns of the acquired corporation that are considered to reduce the debt of other members of the transferor group under the rules of paragraph (h)(1) of this section (whether incurred in a prior taxable year or in that portion of a year of disposition that is taken into account by the transferor) shall continue to be taken into account by the transferor group after the disposition.

(3) *Special rule for assumptions of indebtedness.* In connection with the transfer of a corporation, if the indebtedness of an acquired corporation is assumed by any party other than the transferee or another member of the transferee's affiliated group, the transition attributes of the acquired corporation shall not be taken into account in computing the transition relief of the transferee group. See paragraph (g)(2) of this section concerning the treatment of the transferor group. Also in connection with the transfer of a corporation, if the transferee or another member of the transferee's affiliated group assumes the indebtedness of an acquired corporation, such assumed indebtedness shall only qualify for transition relief during the period in which the acquired corporation remains a member of the transferee group. Further, if the transferee group subsequently disposes of the acquired corporation, the indebtedness of the acquired corporation will continue to qualify for transition relief only if the indebtedness is assumed by the new purchaser as of the time such corporation is acquired.

(4) *Effect of asset sales.* If substantially all of the assets of a corporation are sold, the indebtedness of such corporation shall cease to be qualified for transition relief. Thus, the transition attributes of such corporation shall not be taken into account in computing transition relief.

(h) *Rules for attributing paydowns among separate companies*—(1) *General rule.* In the case of a corporate transfer under paragraph (g) of this section, it is necessary to determine the amount of paydowns attributable to the acquired corporation. Under paragraph (c)(7) of this section, paydowns are deemed to reduce first the five-year phase-in amount, then the four-year phase-in amount, and then the general phase-in amount. Thus, for example, a reduction in indebtedness of the group caused by a reduction in the debt of a group member that has no five-year debt will nevertheless be deemed under this ordering rule to reduce the indebtedness of those group members that do have five-year debt. In order to preserve the effect of paydowns caused by a reduction, each member must determine on a separate company basis at the time of any transfer of any member of the affiliated group the impact of paydowns (including those paydowns occurring in the year of transfer prior to the time of the transfer) on the various categories of indebtedness.

(2) *Mechanics of computation.* Separate company accounts of paydowns are determined by prorating any paydown among all group members with five-year debt to the extent thereof on the basis of the relative amounts of five-year debt. Paydowns in excess of five-year debt are prorated on a similar basis among all group members with four-year debt to the extent thereof on the basis of the relative amounts of four-year debt. Paydowns in excess of four-year and five-year debt are prorated among all group members with general phase-in debt to the extent thereof on the basis of the relative amounts of general phase-in debt. After an initial paydown has been prorated among the members of an affiliated group, any further reduction in the amount of aggregate month-end debt level as compared to the November 16, 1985 amount is prorated among all members of the affiliated group based on the remaining net amounts of four-year and five-year debt.

(3) *Examples.* The rules of paragraphs (g) and (h) of this section may be illustrated by the following examples.

Example (1): Computing separate company accounts of reductions—(i) *Facts.* XYZ constitutes an affiliated group of corporations that has a calendar taxable year and the following transition attributes:

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	80,000	$0
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Company Y:		
Nov. 16, 1985	200,000	

	Historic 3rd party debt	Increase
May 29, 1985 (5-year)	170,000	120,000
Dec. 31, 1983 (4-year)	50,000	10,000
Dec. 31, 1982	40,000	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	290,000	40,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	

In 1986, the XYZ group attained its lowest historic month-end debt level of $500,000. Because the November 16, 1985 amount is $600,000 the XYZ group therefore has a paydown in the amount of $100,000. This paydown partially offsets the $160,000 of five-year debt in the XYZ group.

(ii) *Analysis.* Applying the rule of paragraph (h)(1) of this section, separate company accounts of paydowns are computed by prorating the $100,000 paydown among those members of the group that have five-year debt. Accordingly, the paydown is prorated between Y and Z as follows:

To Y:

$$\$100,000 \times \frac{\$120,000}{\$160,000} = \$75,000$$

To Z:

$$\$100,000 \times \frac{\$40,000}{\$160,000} = \$25,000$$

Example (2): Corporate acquisitions—(i) *Facts.* The facts are the same as in example (1). On July 15, 1987, the XYZ group sells all the stock of Y to A. Having held the stock of Y for six months in 1987, the XZ group computes its transition relief for that year taking into account half of the transition attributes of Y. AY constitutes an affiliated group of corporations after the acquisition. Having held the stock of Y for six months in 1987, the AY group computes its transition relief for that year taking into account half of the transition attributes of Y. In 1987, the AY group attained a new lowest month-end debt level that yields an average lowest month-end debt level for 1987 of $150,000.

(ii) *Transferee group.* The following analysis applies in determining transition relief for purposes of apportioning the interest expense of the transferee group for 1987. The AY group has the following transition attributes for 1987:

	Historic 3rd party debt	Increase
Company A:		
Nov. 16, 1985	$180,000	
May 29, 1985 (5-year)	250,000	$5,000
Dec. 31, 1983 (4-year)	245,000	10,000
Dec. 31, 1982	235,000	
Company Y (half-year amounts):		
Nov. 16, 1985	100,000	
May 29, 1985 (5-year)	85,000	60,000
Dec. 31, 1983 (4-year)	25,000	5,000
Dec. 31, 1982	20,000	
Pre-acquisition year paydown by another member of the transferor group that reduced Y's five-year debt (one half of $75,000)	37,500	

Because the November 16, 1985 amount of the AY group in 1987 is $200,000 and because the 1987 average of historic month-end debt levels was $150,000, the AY group has a paydown in the amount of $50,000. In addition, the 1986 paydown by the XYZ group that was deemed to reduce Y debt is added to the paydown computed above, yielding a total paydown of $87,500. This amount is prorated between members, eliminating the four and five year debt of the AY group. Note that Y is only a member of the AY group for half of the 1987 taxable year. In 1988, Y's entire transition indebtedness and a $75,000 paydown must be taken into account in computing the amount of interest expense eligible for transition relief.

(iii) *Transferor group.* The following analysis applies in determining transition relief for purposes of apportioning the interest expense of the transferor group for 1987. The XZ group has the transition attributes stated below for 1987. In 1987, the XZ group attained a new lowest month-end debt level that yields an average lowest month-end debt level for 1987 of $250,000.

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	80,000	$0
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Pre-disposition paydown that reduced X's debt	0	
Company Y (half-year amounts):		
Nov. 16, 1985	100,000	
May 29, 1985 (5-year)	85,000	60,000
Dec. 31, 1983 (4-year)	25,000	5,000
Dec. 31, 1982	20,000	
Pre-disposition paydown that reduced Y's debt	37,500	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	290,000	40,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	
Pre-disposition paydown that reduced Z's debt	25,000	

Because the revised November 16, 1985 amount of the XZ group is $500,000 and because the 1987 average of lowest historic month-end debt levels of the XZ group was $250,000, the XZ group has a paydown in the amount of $250,000. This paydown offsets the total five and four year debt of the XZ group. Had the 1987 paydown of the XZ group been an amount less than the five-year amount, the paydown would have been prorated based on Y's adjusted 5-year amount of $22,500 and Z's adjusted 5-year amount of $15,000.

Michael J. Murphy,

Acting Commissioner of Internal Revenue.

Approved: July 3, 1989.

Kenneth W. Gideon,

Assistant Secretary of the Treasury.

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DEPARTMENT OF DEFENSE

Department of the Navy

32 CFR Part 706

Certifications and Exemptions Under the International Regulations for Preventing Collisions at Sea, 1972; Amendment

AGENCY: Department of the Navy, DOD.

ACTION: Final rule.

SUMMARY: The Department of the Navy is amending its certifications and exemptions under the International Regulations for Preventing Collisions at Sea, 1972 (72 COLREGS), to reflect that the Judge Advocate General of the Navy has (1) determined that USS MONTEREY (CG-61) is a vessel of the