

(c) capital gains and losses from collectibles (including works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages) held for more than one year, regardless of the date taken into account.

This group also includes long-term capital loss carryovers. For sales of certain small business stock after August 10, 1998, an amount equal to the gain excluded under § 1202(a) will be included in the 28-percent group.

(2) *The 25-percent group.* The 25-percent group consists of unrecaptured section 1250 gain (there are no losses in this group). Unrecaptured section 1250 gain is long-term capital gain, not otherwise recaptured as ordinary income, attributable to prior depreciation of real property and which is from property held for more than one year (if taken into account after May 6, 1997, but before July 29, 1997), or for more than 18 months (if taken into account after July 28, 1997).

(3) *The 20-percent group.* The 20-percent group (10 percent in the case of gain that would otherwise be taxed at 15 percent) consists of long-term capital gains and losses that are not in the 28-percent or 25-percent group. Thus, for 1997 a rate of 20 or 10 percent applies to net capital gain (other than collectibles gain or unrecaptured section 1250 gain) from capital assets held for more than one year (if taken into account after May 6 but before July 29), or for more than 18 months (if taken into account after July 28).

New § 1(h) also applies to gains and losses that are characterized as capital under § 1231, which covers certain transactions including sales of depreciable property or real property used in a trade or business. These gains and losses are included in the appropriate rate group, depending on the holding period and disposition date of the particular asset.

NETTING GAINS AND LOSSES

Within each group, gains and losses are netted to arrive at a net gain or loss. Taking into account the pending legislation, the following additional netting and ordering rules apply:

(1) *Short-term capital gains and losses.* As under prior law, short-term capital losses (including short-term capital loss carryovers) are applied first to reduce short-term capital gains, if any, otherwise

taxable at ordinary income rates. A net short-term capital loss is then applied to reduce any net long-term gain from the 28-percent group, then to reduce gain from the 25-percent group, and finally to reduce net gain from the 20-percent group.

(2) *Long-term capital gains and losses.* A net loss from the 28-percent group (including long-term capital loss carryovers) is used first to reduce gain from the 25-percent group, then to reduce net gain from the 20-percent group. A net loss from the 20-percent group is used first to reduce net gain from the 28-percent group, then to reduce gain from the 25-percent group.

Any resulting net capital gain that is attributable to a particular rate group is taxed at that group's marginal tax rate.

COORDINATION WITH OTHER PROVISIONS

The pending legislation coordinates the multiple rates of new § 1(h) with certain other provisions of the Code. Accordingly, the following rules apply:

(1) *Holding periods.* Under prior law, certain inherited property, if disposed of within one year after the decedent's death, was deemed to have been held for more than one year under § 1223(11) or (12). Such property, if disposed of within 18 months after the decedent's death, is now deemed to have been held for more than 18 months. A similar rule applies for certain patents described in § 1235(a). Gain or loss from a section 1256 contract, to the extent that it is treated as long-term capital gain or loss under § 1256(a)(3), is now treated as attributable to property held for more than 18 months. Rules similar to those of § 1233(b) and (d) (involving short sales of substantially identical property) and § 1092(f) (involving certain stock options) apply with respect to property held for more than one year but not more than 18 months.

(2) *Recharacterized section 1231 gains.* If a portion of the taxpayer's net section 1231 gain for the year is recharacterized as ordinary income under section 1231(c), the gain so recharacterized consists first of any net section 1231 gain in the 28-percent group, then any section 1231 gain in the 25-percent group, and finally any net section 1231 gain in the 20-percent group.

(3) *Alternative minimum tax.* Newly-enacted § 55(b)(3) provides favorable alternative minimum tax ("AMT") rates for certain categories of capital gain. The amounts of these gains are determined according to the principles used for regular tax purposes, although the AMT amounts can vary from the regular tax amounts because of AMT adjustments and preferences.

FORMS AND PUBLICATIONS

The Service is amending relevant forms, instructions, and publications (including Schedule D) to reflect the rules set forth above.

DRAFTING INFORMATION

The principal author of this notice is Susan J. Kassell of the Office of the Assistant Chief Counsel (Income Tax & Accounting). For further information regarding this notice contact Ms. Kassell at (202) 622-4930 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, §§ 41, 446, 481; 1.446-1, 1.481-1, 1.481-4)

Rev. Proc. 97-50

SECTION 1. PURPOSE

.01 This revenue procedure provides guidelines to be used in connection with the examination of federal income tax returns involving the costs paid or incurred by a taxpayer in its trade or business to convert or replace computer software to recognize dates beginning in the year 2000.

.02 This revenue procedure also provides procedures for a taxpayer to obtain automatic consent to change to a method of accounting described in this revenue procedure.

SECTION 2. BACKGROUND

Many computer systems use two digits rather than four digits to represent the year in a date field (for example, "97" to represent 1997). A two-digit year field, however, may be inadequate to represent years after 1999. For data involving the year 2000, for example, computer systems may not recognize "00" as a year, or may treat that year as 1900 instead of

2000. Thus, many computer systems may fail to operate, or may operate improperly, if the software is not converted or replaced to recognize four-digit years (*i.e.*, made “year 2000 compliant”). In order to ensure that their computer systems are year 2000 compliant, taxpayers may pay or incur costs to manually convert their existing software, to develop new software to replace their existing software, to purchase or lease new software to replace their existing software, or to develop or purchase software tools to assist them in converting their existing software to be year 2000 compliant (“year 2000 costs”).

SECTION 3. TREATMENT OF YEAR 2000 COSTS

Rev. Proc. 69–21, 1969–2 C.B. 303, provides guidelines to be used in connection with the examination of federal income tax returns involving the costs paid or incurred to develop, purchase, or lease computer software. Year 2000 costs fall within the purview of Rev. Proc. 69–21. Accordingly, the Internal Revenue Service will not disturb a taxpayer’s treatment of its year 2000 costs if the taxpayer treats these costs in accordance with section 3 of Rev. Proc. 69–21 (in the case of developed software, including converted software), section 4 of Rev. Proc. 69–21 (in the case of purchased software), or section 5 of Rev. Proc. 69–21 (in the case of leased software).

SECTION 4. RESEARCH CREDIT

Section 41 of the Internal Revenue Code provides a credit against tax for increasing research activities. To be eligible for the research credit, expenditures must be for activities satisfying the requirements of § 41 including the definition of “qualified research” in § 41(d). Except in extraordinary circumstances, year 2000 costs will not satisfy the definition of “qualified research” in § 41(d). For example, year 2000 costs generally do not involve research undertaken for the purpose of discovering information that is technological in nature where substantially all of the research activities constitute elements of a process of experimentation. Thus, a taxpayer that pays or incurs year 2000 costs may not claim the research credit except in those extraordinary circumstances in which those costs satisfy the definition of “qualified re-

search” in § 41(d) and otherwise meet all the requirements of § 41.

SECTION 5. APPLICATION

Any change in a taxpayer’s treatment of year 2000 costs to conform with section 3 of this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer wanting to change its method of accounting for year 2000 costs to conform with section 3 of this revenue procedure must follow the automatic change in accounting method provisions of Rev. Proc. 97–37, 1997–33 I.R.B. 18.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 69–21 is amplified. Rev. Proc. 97–37 is amplified to include this change in the Appendix.

DRAFTING INFORMATION

The principal author of this revenue procedure is Kimberly L. Koch of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Koch on (202) 622-4950 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, § 911, 1.911-1)

Rev. Proc. 97–51

SECTION 1. PURPOSE

01. This revenue procedure provides information to any individual who failed to meet the eligibility requirements of § 911(d)(1) of the Internal Revenue Code because adverse conditions in a foreign country precluded the individual from meeting those requirements for taxable year 1996.

02. The Internal Revenue Service previously has listed countries for which the eligibility requirements of § 911(d)(1) of the Code are waived under § 911(d)(4) because of adverse conditions in those countries during the time periods stated. See Rev. Proc. 96–33, 1996–1 C.B. 720, Rev. Proc. 95–45, 1995–2 C.B. 421, Rev. Proc. 94–31, 1994–1 C.B. 625, and Rev. Proc. 94–15,

1994–1 C.B. 575. This revenue procedure relists countries where the adverse conditions are still in effect. The Central African Republic is added to the list for 1996. Rev. Proc. 96–33, Rev. Proc. 95–45, Rev. Proc. 94–31, and Rev. Proc. 94–15 remain in full force and effect; the older periods listed therein are omitted from this revenue procedure solely for brevity.

SEC. 2. BACKGROUND

01. Section 911(a) of the Code allows a “qualified individual,” as defined in § 911(d)(1), to exclude foreign earned income and housing cost amounts from gross income. Section 911(c)(3) allows a qualified individual to deduct housing cost amounts from gross income.

02. Section 911(d)(1) of the Code defines the term “qualified individual” as an individual whose tax home is in a foreign country and who is (A) a citizen of the United States and establishes to the satisfaction of the Secretary of the Treasury that the individual has been a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (B) a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.

03. Section 911(d)(4) of the Code provides an exception to the eligibility requirements of § 911(d)(1). An individual will be treated as a qualified individual with respect to a period in which the individual was a bona fide resident of, or was present in, a foreign country if the individual left the country during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business. An individual must establish that but for those conditions the individual could reasonably have been expected to meet the eligibility requirements.

04. For purposes of § 911(d)(4) of the Code, the Secretary of the Treasury in consultation with the Secretary of State, has determined that war, civil unrest, or similar adverse conditions that precluded the normal conduct of business existed in the following countries during the specified periods: